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How energy policy could revive trade risks for Mexico regardless of who becomes the U.S. president

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- Last Thursday, October 22nd, forty-three U.S. legislators sent a complaint letter to President Donald Trump about Mexico's energy policy, claiming that Mexico's latest policy actions threaten "U.S. energy companies' investment and market access and undermine the spirit of the USMCA."
- AMLO's response to the U.S. legislators came within the next few days. He argued that Chapter 8 of the USMCA clearly recognizes the Mexican ownership of their hydrocarbons, thus hinting at Mexico's right to change its energy policy without violating the free-trade spirit embedded in the USMCA.
- Notwithstanding the above, Chapters 14, 15, 22, and 28 include several rules that apply to all economic sectors unless party countries express their reservation, which Mexico did not.
- Although the exceptions and general provisions chapter included in Article 32.11 of the agreement allows Mexico to implement changes to its current legislation concerning the issues included in chapters 14, 15, and 22 in the future, those changes cannot revert Mexico's current degree of openness.
- Hence, independently of Mexican authorities' perspective, any changes to the Mexican energy sector's current legislation aiming to give unequal treatment to U.S. and Canadian firms would transgress the USMCA.
- Should this scenario materialize, Mexico would likely face resolution mechanisms involving firm-state or state-state dispute settlements. A new episode of tariffs' threats would affect Mexico's risk premium through the price of different financial assets in the latter case.

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Last Thursday, October 22nd, forty-three U.S. legislators sent a complaint letter to President Donald Trump about Mexico's energy policy. According to the document that circulated in the news and social media, Mexico's latest policy actions threaten "U.S. energy companies' investment and market access and undermine the spirit of the United States-Mexico-Canada Agreement (USMCA)." In turn, legislators urged the President to consider the set of policies and measures that the Mexican government has put in place to favor its SOEs –Pemex and CFE– to prevent competition within various markets, affecting private U.S. companies who now face disadvantageous rules.

There are plenty of examples of this type of action. Last year, for instance, Mexican authorities started a dispute over a gas pipeline agreement signed by U.S. firm SEMPRA and CFE. The conflict ended up with an arrangement that, surprisingly, lowered the NPV of the project for CFE. Another case is the controversy between Pemex and U.S. firm Talos over the Zama field in the Gulf of Mexico. Although Pemex has not developed any exploration works on its area, it alleges interest over Talos' discovery because they have neighboring areas. CNH, the local regulator, provided its technical assistance, and the episode will likely end in a unitization process for the two companies.

Since the beginning of his presidential term, it has been evident that President López Obrador, AMLO, aims that the two SOEs regain the monopolistic power that they had in the past. Given the vertical integration of Pemex and CFE within their respective industries, the latter opposes the hydrocarbons, oil derivatives, and electricity's opening process, as incentivizing the entry of new competitors is key for the liberalization of those markets.

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Indeed, Chapter 8 replicates the wording of Article 27 of the Mexican Constitution: "Mexico 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." Nonetheless, that wording does not oppose the secondary legislation that resulted from the 2013 Energy Reform. Therefore, it does not constitute a sufficient argument to revert the legal changes that allowed the private sector to participate in key energy markets.

In addition, and notwithstanding the above, Chapters 14, 15, 22, and 28 include several rules that have a transversal application to all economic sectors unless party countries express their reservation, which Mexico did not.

Specifically, these four chapters include provisions on Investment, Cross-Border Trade in Services, State-Owned Enterprises, and Good Regulatory Practices. Separately, they include the rules that the three countries subscribed to as part of their trade relation, applying to all economic sectors, unless stated differently. For instance, Mexico made explicit some related reservations in the TPP (Trans-Pacific Partnership) agreement. However, the former exceptions were not included in the USMCA (see Annexes I, II, and IV for Mexico within the TPP).

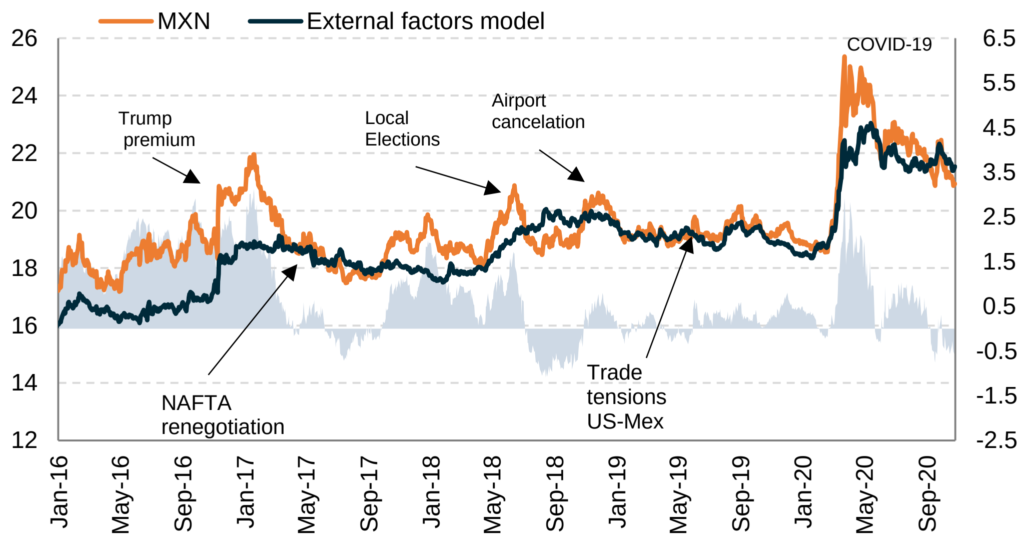
Moreover, despite that the exceptions and general provisions chapter included in Article 32.11 of the agreement allows Mexico to implement changes to its current legislation concerning the issues included in chapters 14, 15, and 22 in the future, those changes cannot revert Mexico's current degree of openness and shall be consistent with other trade agreements signed by the country.

An important ingredient to add to the picture is the degree of openness to which Mexico committed in NAFTA, the USMCA's predecessor. Particularly in the energy sector, Mexico committed to full liberalization; therefore, there is no reason to expect that the U.S. trade negotiators would accept anything less for the USMCA. The TPP itself also provides another case to assess Mexico's liberalization commitments when adhering to free-trade agreements. The USMCA rules take from that level on. Hence, independently of Mexican authorities' perspective, any changes to the Mexican energy sector's current legislation aiming to give unequal treatment to U.S. and Canadian firms vis-à-vis Mexican ones would transgress the USMCA.

Worth noting here, as AMLO himself has acknowledged, the 2021 midterm election in Mexico is critical for his political project. If his qualified majority is confirmed after the election for the second half of his administration, the likelihood of seeing a major overhaul, i.e., a (counter)-energy reform, is high. Yet, the implications for Mexico's trade agreements would be sizeable as well.

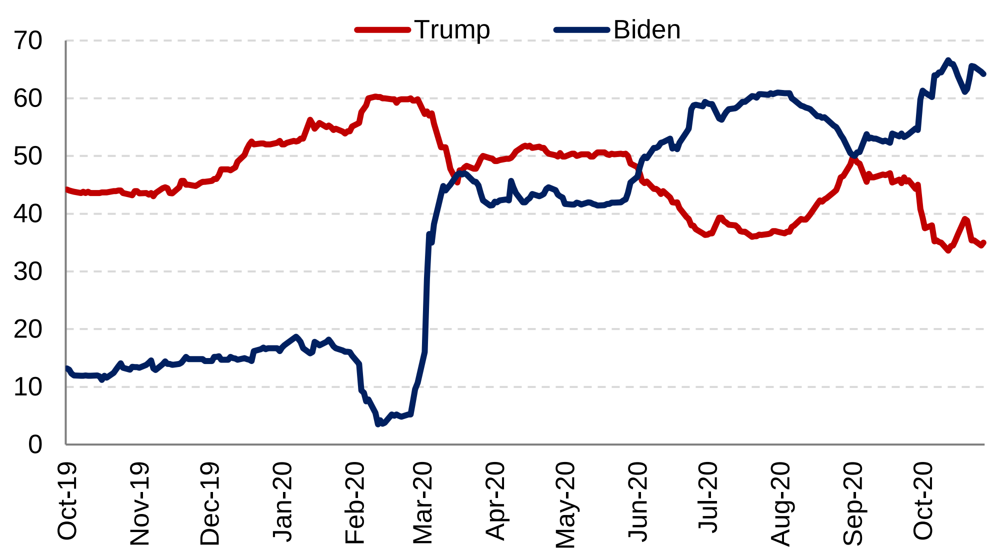
Should this scenario materialize, Mexico would likely have to face resolution mechanisms involving firm-state or state-state dispute settlements. A new episode of tariffs' threats would affect Mexico's risk premium through the price of different financial assets in the latter case, as it happened with the MXN in mid-2019 when Mexico faced a progressive tariff threat imposition from President Trump.

Figure 1. USDMXN: Observed vs. External & Internal factors model (MXN per USD)



The blue line refers to our external factors model, aiming to approximate the USD/MXN using global drivers.
The gray area represents the difference between MXN (in orange) and the external factors model.
Source: Finamex Economic Research with data from Bloomberg.

Figure 2. US general election betting odds (%)



Source: Finamex Economic Research with data from Bloomberg and Real Clear Politics.

Back on May 30th, 2019, President Trump announced its intention to impose progressive tariffs on all Mexican exports to the U.S. as a way to incentivize Mexican authorities to step up measures to avoid the "sustained influx" of illegal immigrants into U.S. territory via Mexico's northern border. Although the struggle ended-up with Mexican authorities pledging to request migration control, particularly from Central America, there was a non-negligible Mexico-specific risk-off episode that is not explained by our model of external factors for the USD/MXN (the gray area), i.e., episodes when Mexico's currency reacted to elements beyond global factors (see Figure 1).

Furthermore, if a firm-state dispute arises, Mexico could be imposed sizeable fees in international arbitrage panels if the U.S. and Canadian firms win. The second case of a state-state dispute can easily find the argument to retaliate with tariffs. Both potential implications put in context the material cost of introducing constitutional changes to Mexico, regardless of the U.S. election results.

Currently, the odds seem to favor the Democratic candidate Joe Biden. However, experience shows that this apparent disadvantage proved to be one of Donald J. Trump's main assets to win the election (see Figure 2). Although the treatment of the tariff imposition would differ between current candidates, if such a scenario materializes, the underlying critical aspect is that it would respond to Mexico's first move. Such an event will be key to follow up in 2021, particularly if the chance to see the 2013 Energy Reform's reversal continues to move forward.

Disclaimer

(*) Research analyst(s) primarily responsible for the preparation and content of this research report.