

USMCA Energy & Environmental Takeaways

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Energy and infrastructure investors are eager to understand how the United States-Mexico-Canada Agreement (“USMCA”), which recently replaced the North American Free Trade Agreement (“NAFTA”), will affect their investment and cross-border trade. Our view is that the USMCA’s modest reforms likely will not materially disrupt energy trade among the U.S., Canada and Mexico. However, market participants should be aware of the rule changes and note that, depending on the circumstances, discrete aspects of the USMCA may produce advantages or disadvantages at the margin.

USMCA

The USMCA, which was enacted on July 1, 2020, is intended to update the free trade arrangement between North American nations in recognition of their changing political and economic priorities. As discussed in [an earlier blog post](#), the USMCA largely preserves the favorable trade conditions NAFTA established, but adjusts the investor-state dispute settlement mechanism for energy sector investments and potentially strengthens Mexico’s interest in its subsoil hydrocarbons. Beyond those changes, the USMCA generally builds upon the foundation that NAFTA produced with certain targeted reforms with respect to energy markets and environmental regulations.

Energy Market Implications

The energy markets of the U.S., Canada and Mexico are highly interconnected and

interdependent. This system flourished under the NAFTA framework, originally adopted in 1994, which included a separate chapter on the treatment of energy products and petrochemicals. Under NAFTA, oil and gas exports benefitted from a liberal free trade regime that prohibited both import/export restrictions and export taxes. By 2018, [over half of the U.S.' energy exports](#) to free trade partners went to Canada and Mexico.

While the U.S. has recently become a net exporter of petroleum products, certain regions of the U.S. [continue to import significant amounts](#) of unrefined energy products, and to export both natural gas and refined products to Canada and Mexico. Natural gas exports to Mexico have been a particularly significant market for the U.S. natural gas industry. In 2019, the U.S. [exported nearly 20 times the volume of natural gas](#) to Mexico than it did in 2000, and U.S. exports represented nearly 70% of Mexico's natural gas consumption and 5-7% of the U.S.' total production. While political and commercial risks to this growing trade exist – including both general underinvestment in Mexican infrastructure to sustain the offtake, processing and consumption of U.S. energy exports and, recently, Mexican President Andrés Manuel López Obrador's ("AMLO") promotion of domestic energy exploration – U.S. gas exports to Mexico are poised to remain an important feature of the North American energy landscape.

Given NAFTA's proven results in fostering the North American energy trade, major oil and natural gas industry organizations from each of the U.S., Canada, and Mexico [expressed concerns](#) regarding the potential downside risk of renegotiating NAFTA. The USMCA appears to have successfully avoided that risk, preserving NAFTA's free trade regime for energy products, while also refining a handful of NAFTA provisions that have resulted in unresolved disputes and coordination issues.

Of particular note, one specific change from NAFTA in the USMCA's origin certification rules will allow up to 40% of diluent in crude oil transported via pipeline to originate outside of the U.S., Mexico or Canada without affecting the oil's duty-free status. This was an issue raised by Canadian crude oil exporters, whose domestic heavy crude oil requires such diluents be added to facilitate transport via pipeline. Under NAFTA, non-originating treatment of such heavy oil with diluents resulted in Canadian exporters [paying nearly \\$60 million](#) (Canadian) in annual duties. In addition, the U.S. and Canada [signed a side letter](#) memorializing certain matters relating to regulatory cooperation and transparency goals for regulatory oversight, which could, among other things, improve electricity market coordination between the U.S. and Canada.

With the USMCA in place, trade policies should not represent a burden for the continued development, financing or construction of cross-border energy infrastructure projects, or pose administrative hurdles with respect to issues such as applications to export natural gas or LNG, which the U.S. Department of Energy will continue to review under its simplified process for determining whether exports to free-trade agreement nations satisfy the Natural Gas Act's "public interest" standard. While economic uncertainty related to the COVID-19 pandemic has put the future of some projects in question, developers continue to evaluate Mexican west coast LNG projects that would facilitate the export of U.S.-produced natural gas for export to Asian markets without traversing the Panama Canal (as exports to Asia from U.S. gulf coast producers must do).

Environmental Implications

The USMCA builds upon the environmental provisions set forth in NAFTA by providing new environmental protections, but those protections likely will not have a major impact on the energy and infrastructure industry.

The USMCA contains novel environmental provisions in several areas of environmental concern, including fisheries management, ozone protection, protection of marine and endangered species, and marine litter. Although these changes are not likely to significantly affect the energy and infrastructure sectors, there are three particular changes that businesses should take into account:

- First, the USMCA drops "the proportionality rule" in place under NAFTA. The proportionality rule under NAFTA provided the U.S. with proportionate access to Canadian oil, natural gas, coal, electricity and refined petroleum products, even in the event of a supply disruption. The elimination of the proportionality rule is viewed as allowing Canada more flexibility to adopt climate change or other policies that would alter export levels relative to domestic consumption.
- Second, the USMCA promotes corporate social responsibility, but it does not include or require strict standards relating to corporate social responsibility.
- Third, the USMCA includes an Environmental Cooperation Agreement that establishes a commission for environmental cooperation that will work to address regional environmental concerns, help prevent potential trade and environmental conflicts, promote the effective enforcement of environmental laws and monitor the environmental effects of the USMCA.

The USMCA's environmental provisions appear to fall short of the reforms sought by various environmental groups. The Sierra Club, the League of Conservation Voters and the Natural Resources Defense Council urged Congress to push for specific policies within the USMCA, including (1) binding standards to adhere to the commitments of the Paris Climate Agreement; (2) binding standards to prevent pollution in Mexico; and (3) a strong system of environmental enforcement. Despite those efforts, the USMCA does not include any provisions regarding climate change or any specific provisions restricting corporations from moving to areas with lower environmental standards.

Looking Ahead

While energy markets remain under pressure due to a glut of oil driven both by supply increases and COVID-19-related demand declines, the medium- and long-term trends have been toward increased U.S. natural gas exports to Mexico and continued energy trade growth with Canada (especially for Northern refiners well-positioned to process heavier Canadian crude products). The USMCA's incremental reforms to the energy trade are not likely to materially disrupt these macro trends, and the USMCA largely can be expected to preserve the status quo in North American energy trade. Likewise, the USMCA only made relatively small incremental changes with respect to environmental and sustainability concerns and conflicts, which are not likely to have a significant impact on the energy and infrastructure sectors.

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