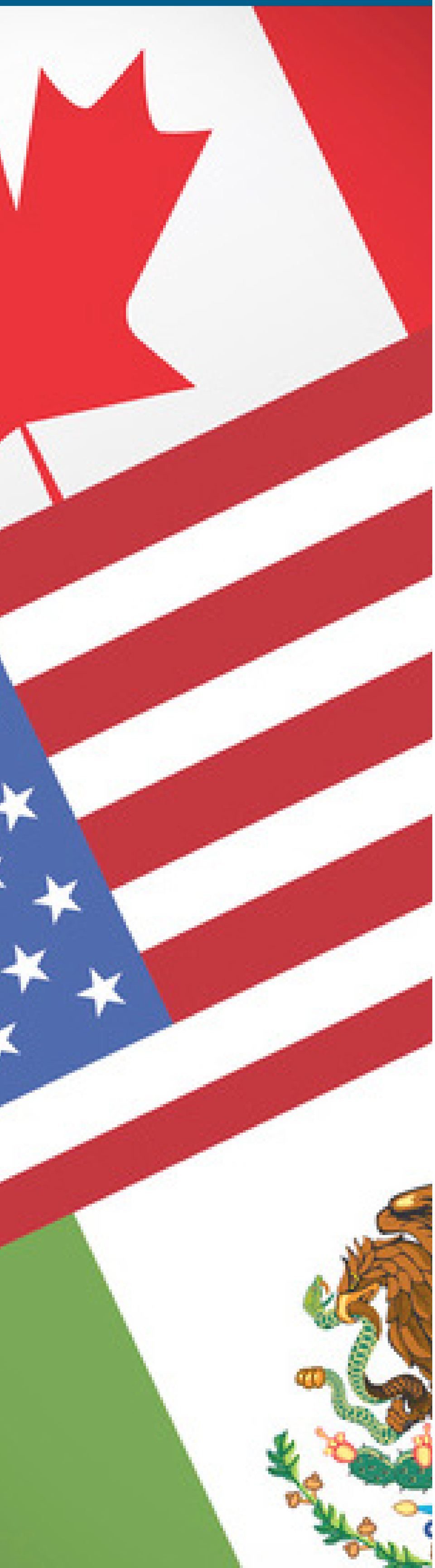
SIDLEY

CROSS-BORDER ENERGY UPDATE: NOVEMBER 2019

KEYS TO SUCCESS IN CROSS-BORDER ENERGY TRADE



A day of roundtable talks with thought leaders on issues currently impacting energy trade among the United States, Canada and Mexico.

A degree of uncertainty looms on the energy landscape for cross-border trade. The impact of trade actions by the governments of the U.S., Canada and Mexico, including the fluid future of the United States-Mexico-Canada Agreement (USMCA), impacts of steel tariffs, environmental challenges to energy infrastructure and changes in Mexican government policies toward private investment in energy, have each inspired caution among industry participants about the prospects for future business endeavors. While the value of energy trade between the U.S. and its North American neighbors exceeded a mammoth US$125 billion in 2017, these and other challenges threaten new opportunities in the sector as we head into the latter part of 2019.

Keys to success on this evolving landscape include:

- Remaining alert and adapting quickly to political changes
- Watching how Mexican President Andrés Manuel López Obrador's administration treats existing contracts and investment in practice, particularly with respect to approvals required under those contracts
- Factoring in the months-long—if partially resolved—stalemate over the Mexican segment of cross-border natural gas pipelines, which had left several pipelines in limbo
- Following closely developments in cross-border pipeline expansions from Canada to the U.S.
- Understanding the differences between NAFTA and the as-yet unratified USMCA, in particular involving arbitration

So said representatives of Borden Ladner Gervais (BLG) of Canada, García-Cuéllar, Aiza y Enríquez (Creel) of Mexico and Sidley Austin LLP in the U.S. in a half-day program featuring roundtable discussions. Panelists included lawyers Jesse Goldman and Bruce Lawrence of BLG, Santiago Sepúlveda of Creel and partners Ken Irvin, Andrew Shoyer and David Asmus of Sidley's Energy practice.

Of what inspired the roundtable event, Asmus, who moderated the panels said, "North America has become an increasingly successful, and integrated, energy powerhouse, but political developments in Canada, the U.S. and Mexico threaten both energy development and the cross-border integration that has been taking place. This therefore seemed to be a particularly appropriate time to examine changes, and challenges, facing the energy world in all three countries."

Ken Irvin had some blunt, yet practical, advice for how energy participants should handle the market's current high level of unpredictability: "Stop being so depressed and negative," he joked.

KEEP CALM AND CARRY ON

Tariffs, the border and months-long stalled Mexico pipeline projects rile the market

Ken Irvin had some blunt, yet practical, advice for how energy participants should handle the market's current high level of unpredictability: "Stop being so depressed and negative," he joked. Questions from his panel's audience did reveal concern about the difficulty of transacting in the current tumultuous marketplace, with its political upheaval and changes in sentiment about cross-border energy transactions.

Was he able to allay people's anxiety? "I think not, actually. But I tried" said Irvin. "I talked about the work I've done in the past helping Mexico's state-owned utility, Comisión Federal de Electricidad (CFE), buy gas in the United States and get it transported to Mexico. This particular transaction is so supported by supply and demand, by fundamentals—it ought to just be a natural. Unfortunately, it's been fraught with challenges due to a variety of political and economic factors on the ground." These include a months-long—if partially resolved—political stalemate in Mexico that had left at least $3 billion of payments and contracts for several natural gas pipelines in limbo.

Frustration over the stalemate was such that in August, Texas Governor Greg Abbott wrote a plaintive public letter to Mexican President Andrés Manuel López Obrador, urging his country to buy gas from the U.S. "Lingering questions about Mexico-U.S.-Canada project delays and longstanding contracts and business commitments could negatively impact our economies for years to come," Abbott wrote.

The economics of the pipelines in Mexico were not working out as well as the current government had hoped, Irvin said. "The head of the electric utility and the president described the contracts as abusive and they wanted relief from them. They wanted to change the tariff rate and the rights, and that had been stalling the in-service date and putting these pipelines in play." Mexican Pres. Obrador was ultimately able to break the impasse and secure a deal with several of the natural gas pipeline operators over contract prices, allowing them to avoid international arbitration and begin increasing gas deliveries across the country.

In particular, Sur de Texas-Tuxpan Pipeline has already begun commercial operations in Mexico. This will now enable more natural gas from the Eagle Ford Shale of South Texas and the Permian Basin of West Texas to flow south of the border in Mexico. The government is still negotiating with one of the parties involved, Fermaca, a Mexican infrastructure company contracted to build two of the seven pipelines under dispute. There is also the fact that despite the recently achieved deal, the long negotiation process triggered anxiety among the international investment community that will take time to calm.

Meanwhile, on the U.S. side, there is copious talk around the country about NAFTA and the USMCA, the border and immigration. The preoccupation with those hot topics has invariably disrupted commercial transactions and made people uncertain about investing. “You’ve kind of got these populous movements on north and south of the border,” Irvin said of the tumultuous immigration issues.

Despite such thorny problems, Irvin chooses to see things optimistically. “One of my comments at the conference was about what I consider the economic attractiveness of the situation. Texas produces gas and then sells it to Mexico and Mexico buys it. So it is just so compelling that it must carry the day at the end, ultimately, right?”

He urges his colleagues and participants in the industry to keep the faith. “Trust is a thing that’s like a contagion. It’s like a wildfire. What we’re facing now was somewhat foreseeable. We did include it in our thinking and build it into business planning. So don’t abandon hope.”

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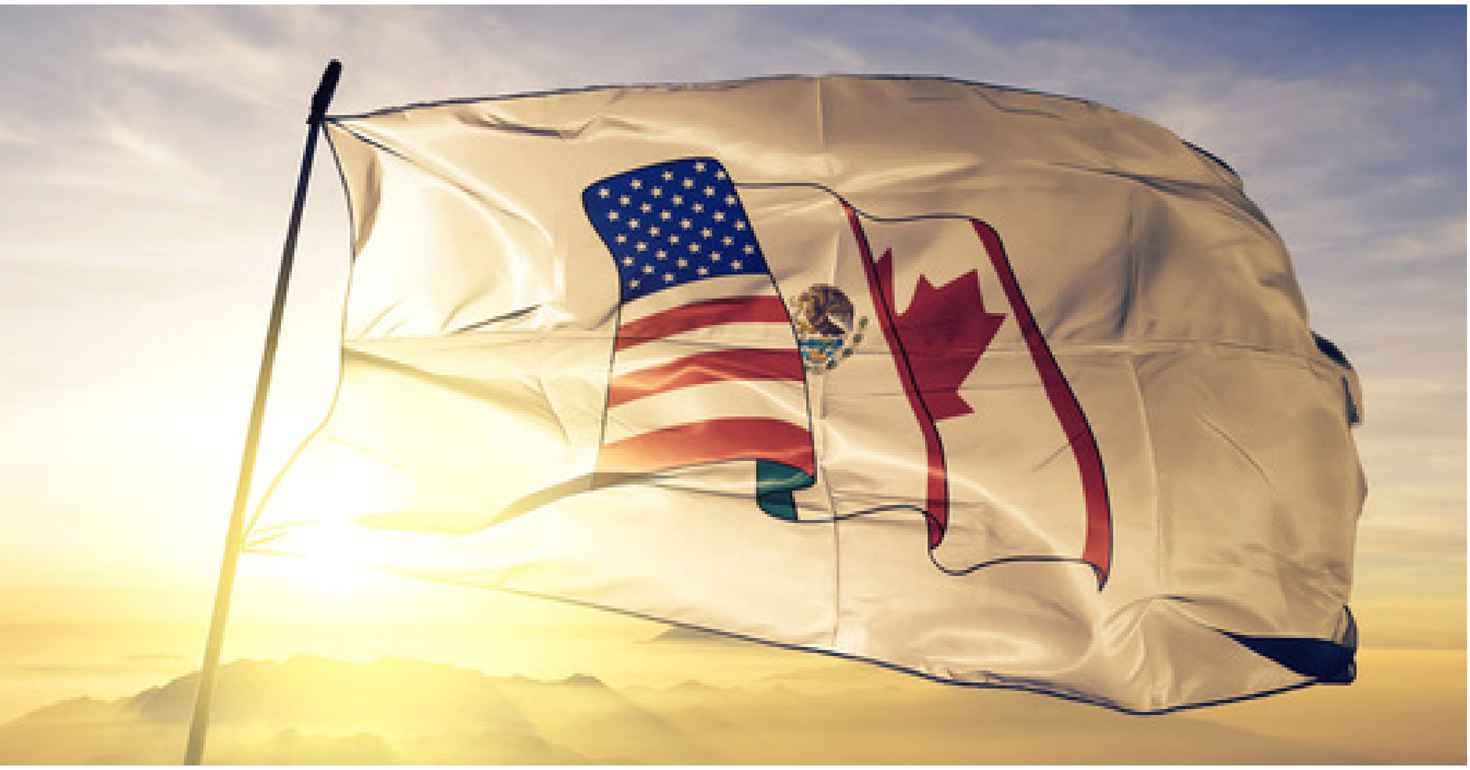
—ANDREW SHOYER

"THERE'S NO WAY TO SUGARCOAT IT"

NAFTA vs. USMCA and how changes in the new agreement may affect the energy market

As the current impeachment inquiry of President Donald Trump roils the administration, there is some hope a free trade agreement will be ratified, even amid the political upheaval. Just last week, House Speaker Nancy Pelosi (D-Calif.) said that a deal on the United States-Mexico-Canada Agreement (USMCA) is "imminent" and could see a House vote before the end of the year. Andrew Shoyer says clients and colleagues have been wondering about the differences between NAFTA, from which then-candidate Trump threatened to withdraw, and its new iteration, the as-yet unratified USMCA. He therefore sought to unpack the changes in his panel discussion, deeming most of the differences cosmetic.

"This has been very much a question of branding. The guts of the agreement—95 percent of the substance—is exactly the same. The biggest concern is the perception that we'd be walking away from the North American market, which is our largest market." As to the structural differences, Shoyer says the new agreement will likely make energy market participants nervous in that it does not contain a formal chapter on energy as NAFTA did. He does point out that most of the meat of that chapter can still be found in the USMCA.



There are, however, some concerning revisions, including a loss in the USMCA in some respects of the ability to arbitrate. "What was key for oil and gas companies was the move to reduce the availability of remedies for foreign investors as an alternative to suing the government in local court," Shoyer said. "Currently, under NAFTA, you can bring cases in arbitration – what is generally called investor-state dispute settlement or ISDS – and that has been significantly cut back. There are provisions in the USMCA that will extend it for certain types of energy investments, but perhaps not all, and it's pretty circumscribed, so that's a real loss for our client base."

Shoyer says the rationale for that loss of arbitration opportunities involves the desire to keep companies from moving jobs and investments outside the U.S. "The U.S. government looks at investment protections and thinks, 'Why should we offer protections that would somehow encourage American companies to invest abroad and relocate jobs abroad?' So to the extent that these investment protections and the availability of arbitration, assisted or encouraged U.S. companies to go abroad and take jobs abroad, there was a move to stop that. So the Trump Administration sought to eliminate ISDS generally. But stakeholders pushed back, pointing out that cross-border investment in certain sectors –such as energy and infrastructure and many types of services – cannot take a U.S. job and move it abroad, as the activity can only be performed abroad. So for certain enumerated types of investment, the USMCA provides investment protections and ISDS."

Another variable, Shoyer said, is that the USMCA places restrictions on the ability of signatories to sign free-trade agreements with certain non-market economies, a provision that appears clearly aimed at China. "The U.S. did not want Canada or Mexico entering into a free trade agreement with China that would allow China to circumvent U.S. restrictions."

In short, Shoyer says, "At least in the core area of cross-border investment, there's really no way to sugarcoat it: There will be fewer opportunities to protect yourself outside of local court if you invest under the USMCA than under NAFTA."

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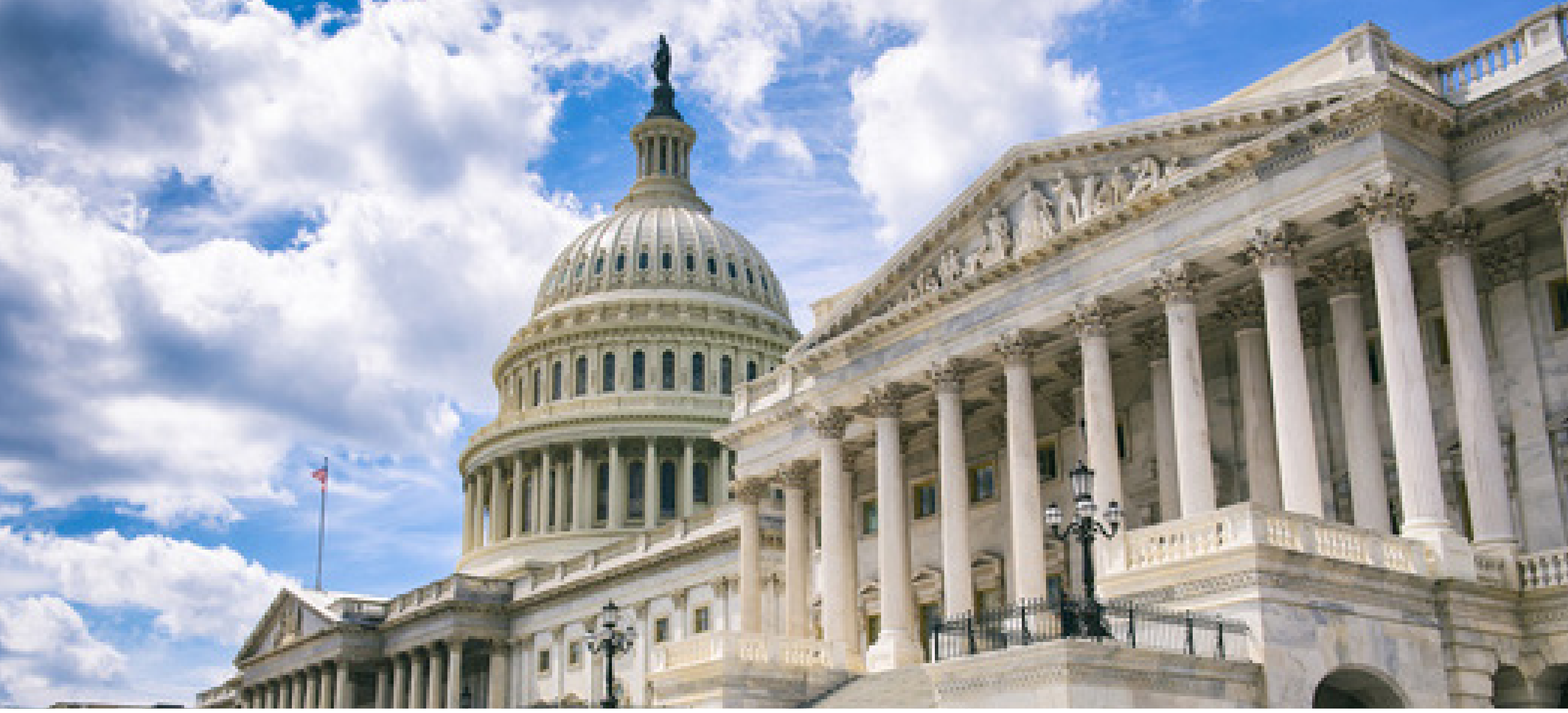

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>
> —DAVID ASMUS

POLITICAL RISK IN THE U.S.

"Change is unlikely to all be of the gentle sort"

Participants also noted that the 2020 Presidential election in the U.S. carries significant, if underappreciated, risks to energy companies and investors. Asmus points out that in Canada, both leading parties in this year's election are broadly supportive of oil and gas development, whereas the Republican and Democratic parties in the U.S. are at polar ends of the issues. "The Republicans view oil and gas development as an economic boon to the U.S. and as a foreign policy tool through exports. The Democrats see it as an enormous climate change threat that must be regulated out of existence. There is certainly the possibility of a 180-degree swing in the regulatory environment in the U.S. for oil and gas, including cross-border trade, if the Democrats win the presidency."

Asmus said that although little changes overnight in the regulatory world, President Trump's administration has shown the range of possibilities available to a determined administration, even without the support of both houses of Congress. He added that one area of particular concern for exports and cross-border pipelines is the availability of required Department of Energy and Presidential permits. If, and how quickly, those permits become available is heavily dependent on the outlook of the administration in power.

One thing is certain, Asmus said, given the state of politics in all of Canada, the United States and Mexico right now: "Change on the political front will impact energy companies and investors in North America more than it has in decades. And that change is unlikely to all be of the gentle sort."

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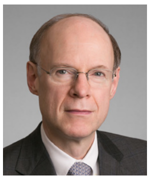

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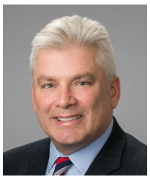

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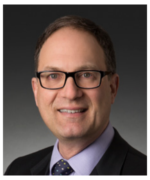

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