Intelligence MEMOS

As NAFTA renegotiations proceed, the C.D. Howe Institute Intelligence Memos will be looking at what to expect and provide analysis on the latest developments. This post is part of that series.

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To: Concerned Canadians

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Re: **A Modernized NAFTA: Energy Challenges and Opportunities**

The energy landscape in North America has changed dramatically over the past two decades. A notable transformation is Mexican reform. Four years ago, President Enrique Pena Nieto signed constitutional changes that allow private domestic and foreign investment in Mexico's oil, natural gas and power sectors. Although such reforms are subject to a ratchet clause in NAFTA (no backsliding once implemented), legal vagueness could enable Mexico to continue its preferential treatment of the giant state-owned producer, Petróleos Mexicanos (Pemex) – a likely outcome from sour NAFTA 2.0 negotiations.

Another transformation is the boom in natural gas production owing to hydraulic fracturing, or fracking, that spurs US and Canadian fossil fuel production. Enhanced low-cost production has made the United States the leading natural gas exporter to Mexico. Much more could be sold if the United States and Mexico remain on good terms in the wake of NAFTA 2.0 talks.

Sensitive issues could go wrong during the NAFTA renegotiation, although energy has not so far attracted much attention from President Trump. First, "Buy American and Hire American" policies applied to future US pipeline and infrastructure construction would violate the current NAFTA text, and would likely provoke retaliation by Canada and Mexico. Second, the renegotiation could easily fail to liberalize renewable energy production (solar and wind), owing to US and Canadian federal, state and provincial subsidies that are accompanied by local content requirements. Third, if strict rules of origin are applied to the energy sector, US tariffs might be imposed on diluted Canadian oil. Finally, Trump's insistence on payment for the wall and deportation of immigrants could easily spark Mexican nationalism that erupts in a "go slow" approach to participation by US firms in the Mexican energy sector.

It's worth speculating on alternative NAFTA scenarios in the energy sector. A successful NAFTA 2.0 would secure Mexican commitments to continue the Pemex and Comisión Federal de Electricidad (CFE) reform promise, opening the Gulf to more US deep drilling, and the Mexican northern states (Sonora and Chihuahua) to US fracking. CFE could purchase even more US natural gas for electricity production, and US firms could expand their footprint in retail sales and gasoline. As a by-product of a successful NAFTA 2.0, the three countries might agree to common standards for solar and wind power generation equipment. They might even collaborate in designing common standards for electric, hybrid, and driverless cars and trucks.

On the other hand, termination of NAFTA would discourage ongoing expansion of natural gas pipelines and power grids between the US and Mexico due to growing uncertainty about energy demand in the short and medium run. Also, US withdrawal from *both* the Canada-US FTA and NAFTA would jeopardize Canada's promise to treat the United States in an even-handed manner in the event of an energy supply shortage. Quebec and Ontario have become essential suppliers of hydro-electricity to New England and New York. It's hard to imagine that even the worst NAFTA 2.0 outcome would endanger these vital links. Last, there could be slippage in implementing trade and investment reforms in Mexico if NAFTA renegotiation talks fail. The worst-case scenario is that Mexico retreats towards 100 percent state control of the energy sector.

To summarize, given the strong foundation of energy trade and investment among North American countries, a constructive NAFTA 2.0 could foster more cross-border trade and investment, not only in traditional fossil fuels but also in renewable energy and the next generation of transportation technology. On the other hand, failed NAFTA talks could reverse past accomplishments – a lose-lose outcome for everyone.

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