THE RESURGENCE OF THE PHOENIX

MODIFICATIONS TO CHAPTER VI OF THE NORTH AMERICAN FREE TRADE AGREEMENT

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I. INTRODUCTION

It is a fact that day to day Public International Law is surpassed by the activity of persons (States and individuals) that are part of the same. Specially, concerning the areas that regulate economic activity between them and that depend on diverse volatile factors, such as the change of political wing in the States governments, climate issues that impact commodities, social phenomena and consumerism trends, among other aspects.

Foreign Trade Law is a relatively new area, at least from the perspective of free trade, notwithstanding that in diverse occasions the regulations that comprise it are outdated compared to the reality they regulate.

Free Trade Agreements, regulating pillars of Foreign Trade, are without a doubt the most affected by evolution when addressing tangible matters day to day such as exchange of goods under tariff preferences, rules of origin to determine said tariff preferences, requirements focused on protecting human health and life (best known as technical obstacles), etcetera.

Pursuant to data provided by the World Trade Organization (WTO), there are currently 247[1] in force regional trade agreements entered into pursuant article XXIV of the General Agreement on Tariffs and Trade (GATT), also known as exceptions to the principles of National Treatment and Most Favored Nation from the multilateral trade system, among which there is one that is

[1] Regional Trade Agreements, World Trade Organization. Available on August 5, 2017, at: https://www.wto.org/spanish/tratop_s/region_s/region_s.htm

significantly relevant for the North America region: the North American Free Trade Agreement (NAFTA).

Canada, the United States of America (USA) and Mexico held the first round of NAFTA negotiations in 1991, signed the Agreement on December 17, 1992 and it entered into force on January 1, 1994; that is 26 years had to elapse for the Parties to decide to (or be persuaded to) renegotiate the benefits and obligations contained in such Agreement.

Since back then (1991) Mexico has been through diverse structural reforms[2], which means that changes to multiple matters at a constitutional level have been carried out in the country, that is at the highest legal level in Mexico, of which some are regulated by NAFTA.

Among the most relevant matters covered by NAFTA that were affected by such structural reforms, are the provisions and reservations on energy and basic petrochemical matters covered by Chapter VI, that as of today as previously anticipated, are regulations that have been superseded by an economic and political reality in constant evolution.

Derived from the 2013 energy reform in Mexico, it is necessary to modify Chapter VI of NAFTA to eliminate or modify (as necessary) the reservations established by Mexico, same that were in accordance with the legislation in force at the time of execution of the Agreement, specifically to allow for the National Treatment principle to be applicable for the calculation of the national

[2] Same that can be defined as those reforms that have the purpose of modifying the base of the legal and economic system of Mexico, of which examples may be: the tax reform, the renegotiation of the external debt, the trade openness and foreign investment and privatization of public companies program during Salinas de Gortari's six-year period; Ernesto Zedillo's reforms related to monopolies owned by the State; among others.

content requirement in the allocations and contracts of hydrocarbons exploration and extraction in Mexico.

In virtue of the foregoing, this essay is focused on presenting a proposal to improve trade in the energy sector considering the reform to the Constitution of the United Mexican States and the issuance of secondary laws and administrative provisions (regulations) in Mexico, for it to be clear, guarantee legal security to the economic agents, promote economic development and growth of the three States Parties to the NAFTA.

To facilitate reading by the reader, the analysis is presented as follows:

II. PAST AND PRESENT OF ENERGY REGULATIONS.

A. NAFTA provisions on energy.

B. Reforms to Mexican law on energy.

III. PROPOSALS OF MODIFICATIONS TO NAFTA DERIVED FROM THE REFORMS IN MÉXICO FOCUSED ON IMPROVING TRADE OF THE REGION RELATED TO ENERGY.

II. PAST AND PRESENT OF ENERGY REGULATIONS.

A. NAFTA provisions on energy.

Chapter VI of NAFTA regulates "Energy and basic petrochemical"[3] in which the Parties acknowledge respect to their Constitutions, the important role that energy and petrochemical sectors represent in their economies, as well as the desire of a "gradual and sustained liberalization" being the principles of the Agreement applicable except for those activities listed in Annex 602.3.

Annex 602.3 of NAFTA establishes the reservations[4] set by the Parties to the provisions of Chapter VI, Mexico specifically established a reservation on the investment and rendering of services in the following strategic activities:

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[3] In terms of article 602, for effects of NAFTA goods classified as follows are considered energy and basic petrochemical goods: subheadings 2612.10, 2707.50, 2707.99 (only solvent naphtha, extender oil for rubber and raw material for lampblack (*negro de humo)*), 2844.10 to 2844.50 (only uranium compounds), 2845.10 and 2901.10 (only ethane, butanes, pentanes, hexanes and heptane); headings 27.01 to 27.06, 27.08 and 27.09, 27.10 (except normal paraffin mixes from C9 to C15), 27.11 (except ethylene, propylene, butylene and butadiene, with purity degrees greater than 50%), and 27.12 to 27.16.

[4] It is necessary to remember that pursuant article 2, letter d) of the 1969 Vienna Convention on the Law of Treaties, a reservation is "a unilateral statement, however phrased or named, made by a State when signing, ratifying, accepting or approving a treaty or adhering to it, **with the purpose to exclude or to modify the legal effects of certain provisions of the treaty in their application to that State**".

1. **Exploration, exploitation,** and refining **of crude oil** and natural gas; and production of artificial gas, basic petrochemicals and their supplies (*insumos*); and pipelines.
2. Foreign trade; transportation, storage and distribution, including first-hand sale of: (i) crude oil; (ii) natural and artificial gas; (iii) goods obtained from refining or processing of crude oil and natural gas; and (iv) basic petrochemicals.

3. Public service of electric energy, including generation, conduction, transformation; distribution and sale of electricity.
4. Exploration, exploitation and processing of radioactive minerals, nuclear fuel cycle, nuclear energy generation, transport and storage of nuclear wastes, use and reprocessing of nuclear fuel and regulation of their applications for other purposes, as well as production of heavy water.

It can be understood from the foregoing that the areas established as reservations would be only and exclusively carried out by the Mexican State through the parastatal company Petroleos de Mexico (PEMEX) and its subsidiaries, without the possibility for private persons to contribute in its development, according to the national laws that at that time and until 2013 was in force in Mexico.

Article 603 incorporates provisions on restrictions to trade of energy and petrochemical goods agreed in the framework of the GATT[5], which mainly prohibit: imposition of quantitative restrictions and establishment of minimum or maximum prices to export and import (except for antidumping duties).

Notwithstanding the foregoing, the third paragraph of such article, establishes that the Treaty does not impede the importation carried out from the territory of any Party to be limited or prohibited when such is of goods coming from a third State over which any prohibition or restriction to import or export is adopted or maintained, or that requires the good to be consumed within the territory of the Party for it to be

later exported to its territory. In the case of restrictions to goods from other countries, pursuant to NAFTA, Canada, Mexico and the USA may carry out consultations with the purpose of avoiding "an undue interference or distortion in the prices, commercialization and distribution mechanisms" between them.

On the other hand, it sets the possibility for countries to establish importation and exportation permits according to the NAFTA provisions, except for certain goods that Mexico listed in Annex 603.6 with the purpose of reserving for itself the foreign trade of such goods.

Pursuant to article 604 the imposition of export taxes is prohibited except when the good is destined for internal consumption and is applied according to the Most Favored Nation principle, that is to say equally to all Parties. In that same sense, article 605, which is not applicable to Mexico in its relationship with the USA or Canada, establishes the possibility of imposing the following justified measures:

[5] The Parties agreed that such incorporation does not include their respective GATT protocols of provisional application.

- Pursuant to article XI:2(a) of the GATT, the imposition of temporary measures to the exportation to prevent or remedy an acute shortage of products is allowed;
- For the conservation of non-renewable natural resources applied jointly with restrictions to national production or consumption, in terms of article XX, letter g) of the GATT;
- Restrictions to exportation to ensure the essential supply of national raw materials to a national transformation industry when the national price is lower than the worldwide price because of a governmental stabilization plan,

  if they do not constitute an unfair and discriminatory practice to promote exportation, article XX, letter i) of the GATT; and
- Those essential for the acquisition or distribution of products of which there is a general or local shortage, pursuant to article XX, letter j) of the GATT.

The above measures may be established, only if:

- The exportations and offer of the energy or basic petrochemical good in question are not reduced in comparison with the 36 months previous to the adoption of the measure.
- The Party does not impose a greater price for the exportations than the price when it is destined for internal consumption, either by means of permits, governmental fees, taxes or minimum price requirements.

On the other hand, Article 606 establishes that the measures regulating such matter must comply with the National Treatment principle, the aforementioned rules established for the imposition of restrictions to the importation and exportation and with the limits established for the imposition of taxes to the exportation. Likewise, it establishes that in the application of regulatory measures, the corresponding authorities must prevent the rupture of contractual relationships and will apply them orderly, properly and equitable.

Except for Mexico, in virtue of the reservation expressly established in Annex 607, the States agree not to restrict importations or exportations of an energy or basic petrochemical good with the justification of national security pursuant to NAFTA or article XXI of the GATT, except when necessary to supply a military facility, for the compliance of a contract on defense matters, to respond to an armed conflict, to prevent weapons and nuclear explosives proliferation in virtue of national politics or international treaties and for direct threats of interruption of nuclear materials supply for defense purposes.

Finally, pursuant to article 608 the Parties agreed to allow the establishment of incentives for exploration, development and activities related with the search of oil and gas, with the purpose of maintaining the level of reserves of such resources, except for previous agreements entered into between the USA and Canada.

From the foregoing, it can be summarized that today NAFTA regulates the following aspects:

- Prohibition of restrictions to importation and exportation with exceptions;

- Prohibition of imposing burdens, taxes or encumbrances to exportation and importation of energy goods and basic petrochemicals;
- Regulatory provisions in domestic law and disciplines for their application in the territory of the Parties; and
- The possibility of granting incentives if they do not represent a hidden measure to the exportation.

Provisions in which Mexico established reservations to investment and rendering of services in diverse strategic activities.

B. Reforms to Mexican law on energy.

1. Constitutional Reform.

On December 20 of 2013 the reform to the Political Constitution of the United Mexican States known as "the Energy Reform" was published in the Federal Official Gazette by means of which articles 25, 27 and 28 of said Constitution were modified, with

the purpose of allowing the participation of private parties in certain activities that until then were exclusively reserved and considered as strategic areas and of priority for the Mexican State. Prior to 2013, only PEMEX and its subsidiaries (parastatal company) were able to carry out activities such as exploration and extraction of hydrocarbons, situation that in the long term limited the potential and development of Mexico for the exploration and extraction of hydrocarbons because of financial and technological matters.

First it is important to point out that a strategic area of the State is "the set of economic activities – production and distribution of goods and services – that are carried out exclusively by the federal government through public decentralized agencies (*organismos públicos descentralizados*), and units of the public administration, because of imperatives of national security, general interest or social benefit basic for the national development"[6].

Since this essay is focused on the provisions on exploration[7] and extraction[8] of hydrocarbons, activities considered as State strategic areas, below is a comparative chart of the constitutional modifications that affected such activities:

Legal basis	**Text prior to 2013**	**2013 reform**
Article 25, fourth paragraph.	The State is in charge of directing national development and must guarantee that such development is comprehensive and sustainable, that strengthens national sovereignty […] The public sector shall be in charge, in an exclusive manner, of those strategic areas established in Article 28, fourth paragraph of the Constitution, and the Government shall at all times maintain ownership and control over the entities which may be established, if the case may be.	The State is in charge of directing national development and must guarantee that such development is comprehensive and sustainable, that strengthens national sovereignty […] The public sector shall be in charge, in an exclusive manner, of those strategic areas established in Article 28, fourth paragraph of the Constitution, and the Federal Government shall at all times maintain ownership and control over the entities and **productive State companies (*empresas productivas del Estado*) which may be**

[6] Diccionario Jurídico Mexicano (*Mexican Legal Dictionary*), Instituto de Investigaciones Jurídicas de la Universidad Nacional Autónoma de México, Mexico (1991).

[7] Pursuant to the Law of Hydrocarbons "exploration" is defined as the activity or activities made through direct means, including well drilling, for the identification, discovering and evaluation of Hydrocarbons in the Subsoil, in a defined area

[8] Pursuant to the Law of Hydrocarbons "extraction" is defined as the activity or activities destined to the production of Hydrocarbons, including production wells drilling, injection and stimulation of deposits, improved recuperation, Recollection, conditioning and separation of Hydrocarbons, elimination of water and sediments, within the Contractual or Assignment Area, as well as construction, localization, operation, use, abandonment and dismantling of facilities for the production

		established, if the case may be. Regarding the planning and control of the national electric system, and the public service of transmission and distribution of electric energy, as well as the **exploration and extraction of oil and other hydrocarbons, the Nation will carry out such activities in terms of what is provided by paragraphs sixth and seventh of article 27 of this Constitution.**
Article 27, fourth and sixth paragraph.	The Nation has Direct ownership over […] petroleum and all solid, liquid or gaseous hydrogen carbides (*carburos de hidrógeno*) […] In the case of petroleum and solid, liquid or gaseous hydrogen carbides, or of radioactive minerals, neither concessions nor contracts shall be granted, nor shall the ones previously granted, if any, survive, and the Nation shall carry out the exploitation of such products under the terms set forth in the respective regulatory law…	The Nation has Direct ownership over […] petroleum and all solid, liquid or gaseous hydrogen carbides (*carburos de hidrógeno*) […] In the case of petroleum and solid, liquid or gaseous hydrocarbons, in the subsoil, the ownership of the Nation is inalienable and imprescriptible and no concessions will be granted. With the purpose of obtaining income for the State to contribute to the long term development of the Nation, the Nation will carry out the activities of exploration and extraction of petroleum and other hydrocarbons by means of assignments to productive State companies or through contracts with them or with private parties, in terms of the Regulatory Law. To

		fulfill the purpose of such assignments or contracts the productive State companies may contract with private parties. In any case, hydrocarbons in the subsoil are owned by the Nation and so shall be stated in the assignments or contracts.

Article 28, fourth paragraph	The functions performed in an exclusive manner by the State in the following strategic areas shall not constitute monopolies: postal service, telegraphs and radiotelegraphy; petroleum and any other hydrocarbons; basic petrochemical; radioactive minerals and generation of nuclear energy; electricity and any other activities expressly established by the laws enacted by the Congress of the Union.	**The functions performed in an exclusive manner by the State in the following strategic areas shall not constitute monopolies**: postal service, telegraphs and radiotelegraphy; radioactive minerals and generation of nuclear energy; planning and control of the electric national system, as well as the public service of transmission and distribution of electric energy, and the **exploration and extraction of petroleum and any other hydrocarbons, in terms of paragraphs sixth and seventh of article 27 of this Constitution**, respectively; as well as the activities expressly established by the laws enacted by the Congress of the Union […].

Derived from the reform, the nation stays as owner of the hydrocarbons in the subsoil and the exploration and extraction of hydrocarbons are still strategic activities of the State, however such may be carried out through assignments to Productive State Companies (PSC) or through contracts with such companies or private parties.

With said constitutional reform came the issuance of secondary laws such as the Law of Hydrocarbons and its Regulations, laws that establish diverse matters related to

assignments and contracts for the exploration and extraction of hydrocarbons, including the ones related to the compliance of national content.

2. Law of Hydrocarbons and its Regulations.

Article 3 and 5 of the Law reaffirms that exploration and extraction of hydrocarbons, being a strategic area, will be carried out pursuant to articles 25, fourth paragraph, 27, seventh paragraph and 28, fourth paragraph of the Constitution through the assignees and contractors that fulfill the conditions of the Law, the regulations derived from it and the terms of the tenders (*licitaciones*) and contracts.

Article 19 of the Law of Hydrocarbons establishes the minimum clauses that must be included in the contracts, within such mandatory provisions is the one that establishes the minimum percentage of national content.

Pursuant to article 46 of said Law, the activities of exploration and extraction shall jointly reach at least 35% of national content (subject to the five-year analysis by the authorities and adjustments that may be done depending on the specific activity), assignees and contractors will have to comply individually and progressively with a minimum percentage of national content pursuant to the compliance program that establishes applicable terms and stages.

Likewise pursuant to articles 46 and 126 of the Law, the Ministry of the Economy is the authority responsible of determining the methodology for the calculation of national content for which it must consider: goods and services contracted, considering their origin; national and qualified manpower; training of national manpower; investment in local and regional physical infrastructure, and transfer of technology.

In terms of article 46 of the Law of Hydrocarbons and 95 of the Regulations, the Ministry of the Economy is in charge of notifying the Ministry of Energy the noncompliance with the minimum

percentage by any participant in an agreement or assignment, which will be sanctioned pursuant to the penalties established in the specific rules of the project.

Finally, article 46 of the Law establishes that is application will be notwithstanding what is provided in International Treaties and Commercial Agreements entered into by Mexico; meaning that the provisions of minimum national content will be valid independently from what the State agreed at an international level. In this regard, it is convenient to stop for a moment to reflect this provision which will only be valid if a reservation by Mexico was established in the Treaty in question, otherwise and pursuant to Mexican law[9], International Treaties have a higher hierarchy than Federal Laws such as the Law of Hydrocarbons. Thus, since there is no constitutional provision on the requirement of minimum national content, there is no basis that justifies the imposition of article 46 of the Law over what is provided in any Treaty.

Continuing with the analysis of the provisions of the Law of Hydrocarbons, with the purpose of further describing the aforementioned responsibilities, transitory article (*artículo transitorio*) Eighteenth of the Law established that the Ministry of the Economy had to create a specialized unit in charge of establishing the methodology, issue it no later than 90 days after the publication of the Law and modify it afterwards based on the projects carried out during 2014.

[9] It is convenient to remember that the Plenum (*Pleno*) of the National Supreme Court of Justice, in 2007 ruled on the hierarchical superiority of International Treaties over Federal Laws, being part of the Supreme Law of the Union (*Ley Suprema de la Unión*).

On the other hand, transitory article Twenty Fourth established that the minimum percentage of national content for exploration and extraction of hydrocarbons, will increase gradually from a 25% in 2015 to at least 35% in 2025.

Pursuant to the Regulations of the Law of Hydrocarbons the Ministry of the Economy must issue its opinion regarding the minimum percentage of national content for each exploration and extraction contract, ensuring that no undue advantages are generated and that could affect competition.

3. Agreement by means of which the Methodology to Measure National Content in Assignments and Contracts for Exploration and Extraction of Hydrocarbons, as well as permits of the Hydrocarbons Industry (the Agreement) is established.

Pursuant to articles 46 and 126 of the Law of Hydrocarbons, on November 13, 2014 the Ministry of the Economy published the Agreement in the Federal Official Gazette, by means of which the methodology for the calculation of national content in all activities comprised within assignments, contracts and permits was established.

The Agreement defines "national content" as the "percentage representing the value in Mexican Pesos of the goods, services, manpower, training, transfer of technology and local and regional physical infrastructure, of the total value in Mexican Pesos of said items as defined in this methodology" and provides the formula below:

$$\text{PCN}_{\text{(Acronym in Spanish for National Content Percentage)}} = \frac{\text{CNB + CNMO + CNS + CNC + TT + I}}{\text{B + MO + S + C + TT + I}} \text{ X100}$$

- CNB: acronym in Spanish for value of used national finished goods
- CNMO: acronym in Spanish for manpower CN value
- CNS: acronym in Spanish for services CN value
- CNC: acronym in Spanish for national value of training services
- TT: acronym in Spanish for sum of transfer of technology expenses in national territory
- I: acronym in Spanish for sum of expenses of investment in national infrastructure

- B: acronym in Spanish for sum of the value of used national finished goods
- MO: acronym in Spanish for sum of the manpower CN value
- S: acronym in Spanish for sum of services CN value
- C: acronym in Spanish for sum of national value of training services
- TT: acronym in Spanish for sum of transfer of technology expenses in national territory
- I: acronym in Spanish for sum of expenses of investment in national infrastructure

From the previous formula it is understood that to determine the national content in an exploration and extraction project, the value of national goods, the national manpower cost, the value of national services (calculated from the goods and manpower used to render such services), investment in training, infrastructure and transfer of technology are considered.

Although it is a comprehensive formula, unfortunately the Agreement does not provide a definition clear enough to determine what does "national" mean; That is, it establishes the specific rules of origin for the calculation of each of the values but it does not establishes what must be understood by the term national when referring to national goods or services[10].

[10] With the exception of "national worker" which is defined as one with Mexican nationality or that is permanent resident pursuant to Mexican laws.

It is important to point out that along with the modifications to NAFTA in the area in question, there are diverse improvements that from the standpoint of domestic law should be implemented to such Agreement, such as the clarification of the term national.

Thus, considering the historical moment in which the renegotiation of the NAFTA will be developed, the 2013 energy reform and the requirements of national content for exploration and extraction assignments and contracts, the renegotiation of Chapter VI of NAFTA will have to contemplate new provisions and market conditions.

III. PROPOSALS OF MODIFICATIONS TO NAFTA DERIVED FROM THE REFORMS IN MÉXICO FOCUSED ON IMPROVING TRADE OF THE REGION RELATED TO ENERGY.

In virtue of the foregoing, the following modifications to NAFTA are proposed:

1. Acknowledgement of exploration and extraction of hydrocarbons as Mexico's strategic activity.

   Continue acknowledging exploration and extraction of hydrocarbons in Mexico as strategic activity, however establish that the participation of private parties is allowed in the terms and conditions of the national laws (in the modality of assignments and contracts pursuant to the Political Constitution of the United Mexican States, the Law of Hydrocarbons, its Regulations and administrative provisions derived from them).

2. Application of National Treatment and Most Favored Nation principles.

   Acknowledge that the National Treatment and Most Favored Nation principles are applicable to the activities of exploration and extraction of hydrocarbons to the extent the national laws allow.

   It is convenient to point out that with this modification, article 46 of the Law of Hydrocarbons (by means of which it is established that the minimum requirements of national content will be applicable notwithstanding what is established in the in the Treaties subscribed by Mexico) would be incompatible with the provisions of the Treaty and potentially

against the constitution in virtue of the principle of conventionality control (*control de convencionalidad*) applicable in Mexico.

3. Calculation of regional content for exploration and extraction of hydrocarbons contracts and assignments.

   Since based on the National Treatment principle, which is also applicable in provisions on the origin of goods, NAFTA establishes that each of the Parties will grant the treatment that would be granted to a national good of said State, it would be necessary to negotiate the adoption of a methodology of "calculation of regional content" for the exploration and extraction of hydrocarbons, instead of the current methodology that only establishes "national content".

   Otherwise, if the possibility of a calculation of regional content is not contemplated, the Agreement would be incompatible with the principles of NAFTA (specifically, with article 606 of NAFTA regarding the respect to the principle of National Treatment in the application of the industry regulatory measures) since it would only cover the possibility of computing the "Mexican" content in the projects, that is why, the following is proposed:

- Contemplate the methodology of calculation of regional content in the aforementioned assignments and contracts, if the goods have a certificate of origin issued pursuant to the NAFTA.
- With the purpose of making the negotiation viable and accepted by the Parties, including Mexico, agree that when a private party wishes to carry out the calculation of regional value instead of national content, the percentage to be reached in the first case should be superior than the second; or, that in the case of regional content, it should have a minimum of Mexican content.

  It will be prevailing to establish a reservation to article 606 and to the principle of National Treatment by Mexico.
- The foregoing, in tandem with the review of specific rules of origin established in Annex I of the Agreement to determine if it is necessary or convenient to modify those applicable between the NAFTA Parties.
- Regarding the services, implement a model of certificate of origin that prior review by the Mexican authorities evidences compliance with the rules established in the Agreement considering at all times that instead of applying a national content criteria a criteria of regional content should be adopted.

IV. CONCLUSION

With such modifications to the Treaty it is expected that the substitution of regional content instead of the national content requirement will allow the access of goods of the region in exploration and extraction of hydrocarbons projects under the scope of the National Treatment principle which will promote the growth of the North American zone.

The foregoing, through the use of technologies pending to be developed in the Mexican territory, the use of the experience in the training of manpower of the three nations, the exchange of technical trained personnel, as well as the investment in infrastructure in exploration and extraction zones.

Modification to Chapter VI is an inevitable fact, the modifications may vary according to the will of the Parties, however for them to be congruent with the desire of a "gradual and sustained liberalization", objective established since 1994 in NAFTA, it will be necessary to analyze the areas of opportunity of the energy and basic petrochemical market, such as the adoption of a methodology to calculate regional instead of national content.

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