US & Multilateral Trade Policy Developments

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US General Trade Policy

Update on US-China Trade Negotiations

US officials have been upbeat in their assessment of the bilateral negotiations held from January 30-31 with a senior Chinese trade delegation in Washington, stating after the meetings that some form of agreement with China before the self-imposed March 1 deadline remains possible. However, they have done little to clarify their objectives for a final agreement or the status of negotiations on structural reforms to China's trade and industrial policies. Thus, with only three weeks remaining before the deadline, it remains unclear what concessions China will commit to making on structural issues such as those highlighted in the Section 301 investigation, and whether the Trump administration might accept a deal that only superficially addresses those issues. We provide an update on the status of the negotiations below.

<u>Results of the January 30-31 bilateral meetings</u>

Chinese Vice Premier Liu He and USTR Lighthizer led last week's bilateral negotiations, which were the first Ministerial-level meetings held by the two sides since they announced the temporary "cease fire" agreement on December 1, 2018. The White House stated that the discussions covered the following issues:

> "(1) the ways in which United States companies are pressured to transfer technology to Chinese companies;
>
> (2) the need for stronger protection and enforcement of intellectual property rights in China;
>
> (3) the numerous tariff and non-tariff barriers faced by United States companies in China;
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> (4) the harm resulting from China's cyber-theft of United States commercial property;
>
> (5) how market-distorting forces, including subsidies and state-owned enterprises, can lead to excess capacity;
>
> (6) the need to remove market barriers and tariffs that limit United States sales of manufactured goods, services, and agriculture to China; and
>
> (7) the role of currencies in the United States–China trading relationship.
>
> The two sides also discussed the need to reduce the enormous and growing trade deficit that the United States has with China. The purchase of United States products by China from our farmers, ranchers, manufacturers, and businesses is a critical part of the negotiations."

After the meetings, USTR Lighthizer indicated that the talks had focused primarily on structural issues, had been "detailed and specific", and that the two sides "did make progress on a variety of key issues[.]" However, he declined to elaborate on specific areas of progress and noted that "there's a lot more to be done". He further stated that "[a]t this point, it's impossible for me to predict success. But we are in a place where, if things work out, we could have that[.]" The White House's statement was similarly vague: "[t]he two sides showed a helpful willingness to engage on all major issues, and the negotiating sessions featured productive and technical discussions on how to resolve our differences. The United States is particularly focused on reaching meaningful commitments on structural issues and deficit reduction. Both parties have agreed that any resolution will be fully enforceable. While progress has been made, much work remains to be done." President Trump continued to express vague optimism about the negotiations, stating after the meeting that "we've made tremendous progress" and that there is "a very good chance" the two sides will reach an agreement.

By contrast, US Chamber of Commerce officials expressed concern about the status of the talks after last week's meetings. They indicated in a briefing with reporters that the two sides have made progress on market access, goods purchases, intellectual property rights enforcement, and other issues (e.g., electronic payments), but that China has not yet offered substantive concessions on structural issues including forced technology transfers and industrial subsidies. They described this as "problematic", as the Chamber has urged the administration to prioritize structural issues in the negotiations rather than goods purchases and trade deficit reduction. For example, in a recent **report**, the Chamber urged the administration to secure "[e]xplicit changes to Chinese normative guidance,

laws, and regulations that comprise the regulatory structure that China uses to force technology transfer" that are subject to "clear benchmarks, timelines, and intensive monitoring" and constitute "meaningful reform". It further called for "[t]he negotiation of new disciplines with China that will bind and limit its ability – in practice – to apply laws, regulations, and policies in a manner that results in discriminatory treatment against U.S. companies[.]" To achieve this, the Chamber proposed detailed draft legal texts modeled on the 2012 US Model BIT and other agreements, addressing issues such as standards setting, conformity assessment, antitrust enforcement, IP, SOEs, subsidies, national treatment, and national security, and proposed that such disciplines be subject to state-to-state or investor-state dispute settlement.

Given the state of the negotiations, however, it appears doubtful that such a wide-ranging and detailed agreement can be reached by March 1, and the Chamber officials expressed doubt that the two sides are even ready to begin working from a common, bracketed negotiating document. USTR Lighthizer acknowledged last week that the two sides had only just begun drafting such a document, which he indicated would take the form of a "Memorandum of Understanding" or something similar. Moreover, he indicated that the mechanism for enforcing the potential agreement has yet to be agreed. Some observers speculate that, rather than standard dispute settlement mechanisms, the United States will insist on retaining the ability to unilaterally evaluate China's compliance with the agreement and reimpose tariffs under Section 301 in the event of non-compliance. USTR Lighthizer did not address this point, stating only that "[i]f we come to agreement…it has to be something where we are prepared to take action if China does not follow through[.]"

China's reaction

The Chinese delegation's statement on the meeting also touted "important progress", but it only acknowledged Chinese concessions with respect to "measures to promote a more balanced development of bilateral trade", i.e., expanding imports from the United States. It stated that "[t]he Chinese side will make active efforts to expand imports from the United States in the sectors of agriculture, energy, manufacturing and services." The delegation also announced during its visit to the United States that China would make further purchases of US soybeans in the amount of five million tons.

China did not announce any specific concessions or progress on structural issues. At the outset of the meeting, China indicated that its National People's Congress (NPC) would accelerate consideration of a draft Foreign Investment Law that purports to address US concerns regarding technology transfer and IPR, among other things, and that the draft law has been improved from an earlier version introduced in December 2018. A Chinese official stated that, among other improvements, the new draft "further expanded the article on the system of pre-establishment national treatment plus a negative list…Definitions of the terms were included in the article, in addition to a clause requiring the state to give national treatment to foreign investments outside the negative list. It also stipulated that foreign invested enterprises have equal access to favorable policies for enterprises." It is expected that the law will be approved during a session of the NPC scheduled to open on March 5. However, observers continue to doubt that the law in and of itself will ensure significant reforms to the Chinese industrial policies at issue.

Regarding enforcement of a potential agreement with the United States, the Chinese delegation stated that "[b]oth sides believe that it is very important to establish an effective two-way enforcement mechanism, so as to ensure all measures agreed upon through consultations will be implemented. They have reached consensus in principle on the framework and basic elements of the enforcement mechanism, and will continue to hammer out more details." The United States, however, has not confirmed any such "consensus in principle".

Outlook

The United States has confirmed that USTR Lighthizer and Secretary Mnuchin will travel to China next week for further negotiations. USTR Lighthizer has indicated that, following those negotiations, he and Secretary Mnuchin will

make a recommendation to President Trump on whether to agree to a summit with President Xi aimed at finalizing an agreement. Some administration officials reportedly have stated that such a summit is "unlikely" to occur before the March 1 deadline (given the need to prepare for President Trump's summit with North Korea's Kim Jong Un from Feb. 27-28) but that the Trump-Xi summit could occur "shortly thereafter". They also indicated that the tariff increase on List 3 goods could be postponed until a Trump-Xi summit occurs, but this is speculative. President Trump, USTR Lighthizer, and Secretary Mnuchin in recent days have all publicly reiterated the United States' insistence on structural changes in any final deal with China, and President Trump emphasized this point in his recent State of the Union address: "we are now working on a new trade deal with China. But it must include real, structural change to end unfair trade practices, reduce our chronic trade deficit, and protect American jobs."

The Trump administration also faces external pressures to avoid a deal that does not substantively address structural issues. The congressional Democratic leadership has repeatedly warned the administration against accepting such a deal, including in a recent letter to Secretary Mnuchin which stated that "any trade agreement that merely addresses the trade balance with China and does not require China to make the permanent structural reforms necessary to remedy the very significant issues identified by the USTR's investigation will be an abject failure." Moreover, while the US business community has generally opposed the administration's strategy of imposing tariffs in an attempt to obtain concessions from China, it is now urging the administration to use the current negotiations to secure structural changes that reflect the longstanding concerns and priorities of US business.

On the other hand, some administration officials (including the President) likely remain concerned about the potential negative reaction of US financial markets to a failed negotiation with China and further tariff increases on US and Chinese goods. Indeed, the markets have appeared sensitive to developments in the US-China dispute, and they declined significantly today following CNBC's report that a Trump-Xi summit is "unlikely" to occur before the March 1 deadline. Moreover, the short timeframe for the negotiations and China's apparent reluctance to commit to changes to its industrial policies will make it challenging to reach an agreement by March 1 that substantively addresses structural issues. Given these circumstances, a range of outcomes remain possible, including an extension of the negotiations beyond March 1, a preliminary agreement that cancels or further delays the US tariff increase in exchange for Chinese concessions, or even a failed negotiation and immediate tariff increase on "List 3" goods.

Section 301 Exclusion Language Included in Spending Bill Explanatory Statement

On February 14, 2019, the White House announced that President Trump intends to sign a government spending bill, the Consolidated Appropriations Act of 2019, to avoid a government shutdown. The explanatory statement issued by Congressional appropriators in conjunction with the Act includes the following language directing USTR to establish an exclusion process for products subject to the Section 301 tariffs on "List 3" goods:

> *Section 301 Exclusion Process.*—USTR has finalized tariffs on goods from China under Section 301 of the Trade Act of 1974 in three separate rounds, and provided an exclusion process that allows U.S. businesses to obtain relief from the Section 301 tariffs for goods subject to tariffs in rounds 1 and 2. It is concerning that there is no exclusion process for goods subject to tariffs in round 3 of the Section 301 proceedings, as was done in the first two rounds. USTR shall establish an exclusion process for tariffs imposed on goods subject to Section 301 tariffs in round 3. This process should be initiated no later than 30 days after the enactment of this Act, following the same procedures as those in rounds 1 and 2, allowing stakeholders to request that particular products classified within a tariff subheading subject to new round 3 tariffs be excluded from the Section 301 tariffs. USTR shall consult with the Committees on Appropriations, the House Committee on Ways and Means, and the Senate Committee on Finance regarding the nature and timing of the exclusion process. USTR shall also report to such committees no later than 30 days after enactment of this Act on the status of the exclusion process.

Notably, however, the legislative text itself includes no such directives. The Congressional Research Service indicates that explanatory statements issued in connection with appropriations bills are not legally binding, though the directives contained therein usually are followed by agencies:

> In general, report language is used by House and Senate committees for two broad purposes. First, report language explains the provisions of a measure to the chamber or chambers that will subsequently consider it. Second, report language may also communicate legislative intent to the agencies that will carry out the measure once it becomes law. Although report language itself is not law and therefore not binding in the same manner as language in the statute, agencies usually seek to comply with any directives contained therein. As one congressional scholar has observed, "the criticisms and suggestions carried in the reports accompanying each bill are expected to influence the subsequent behavior of the agency. Committee reports are not the law, but it is expected that they be regarded almost as seriously."

Given these circumstances, it is not yet certain that USTR will establish the exclusion process for List 3 goods, though it seems likely the agency will do so.

Legislation to Reform Section 232 Introduced in the US Congress

In recent weeks, Members of the US Congress have introduced two bills that would modify the process by which the President may restrict imports for "national security" reasons under Section 232 of the Trade Expansion Act of 1962 (19 U.S.C. § 1862). The two bills (the "Bicameral Congressional Trade Authority Act" introduced by Sens. Pat Toomey (R-PA) and Mark Warner (D-VA) and the "Trade Security Act" introduced by Sen. Rob Portman (R-OH)) aim to reform Section 232 to prevent its use for purposes unrelated to national security, though they differ greatly on the extent to which they would curtail the President's authority to unilaterally impose import restrictions.

The Trump administration's threat to impose restrictions on automotive imports under Section 232, combined with its past use of the law to restrict steel and aluminum imports, has generated bipartisan interest in reforming Section 232 in the current Congress. Senate Finance Committee Chairman Chuck Grassley (R-IA) has identified Section 232 reform as a priority for the Committee in 2019, citing concerns about the threatened tariffs on automotive goods: "I do not believe that we should alienate our allies with tariffs disguised as national security protections. And certainly not when it comes to trade in automobiles and auto parts. For this reason, I intend to review the president's use of power under Section 232 of the Trade Act of 1962[.]" Though legislative efforts to amend Section 232 currently appear unlikely to advance, they could gain momentum should the Trump administration formally announce its intention to impose significant restrictions on automotive imports. We provide an overview of the two pending bills to reform Section 232 and their prospects below.

Bicameral Congressional Trade Authority Act of 2019 (S.287)

The Bicameral Congressional Trade Authority Act (BCTA) would make several changes to Section 232 that would significantly curtail the President's authority to unilaterally impose import restrictions under the law. The BCTA was introduced in the Senate by Sens. Pat Toomey (R-PA) and Mark Warner (D-VA) and presently has nine Senate co-sponsors; Reps. Ron Kind (D-WI) and Mike Gallagher (R-WI) have introduced an identical bill in the House. The key elements of the BCTA are as follows:

- **Definition of national security.** The BCTA would significantly change the law's current broad language on "economic welfare" and its relationship to "national security". First, it would eliminate language in the current law requiring the President to "recognize the close relation of the economic welfare of the Nation to our national security" and "take into consideration the impact of foreign competition on the economic welfare of individual

domestic industries; and any substantial unemployment, decrease in revenues of government, loss of skills or investment, or other serious effects resulting from the displacement of any domestic products by excessive imports…in determining whether such weakening of our internal economy may impair the national security." In addition, the BCTA would add a new definition of "national security" that expressly excludes ''general welfare" considerations. "National security" is defined in the BCTA to mean "the protection of the United States from foreign aggression", and the bill expressly states that national security "does not otherwise include the protection of the general welfare of the United States."

- **Scope of future investigations limited.** The BCTA would limit the types of articles that can be subject to a Section 232 investigation. Specifically, the bill provides that an article may only be subject to a Section 232 investigation if it is "related to the development, maintenance, or protection of military equipment, energy resources, or critical infrastructure essential to national security." By contrast, the current law places no limits on the types of articles that may be subject to a Section 232 investigation.
- **Change to investigative process.** The bill would make the following changes to the Section 232 investigative process:
  - *Initiation and finding of a national security threat.* The bill would transfer certain investigative authorities under Section 232 from the Department of Commerce to the Department of Defense, namely (1) the authority to initiate a Section 232 investigation (whether in response to a petition or by self-initiation); and (2) the authority to determine "the effects on the national security of imports" of the article under investigation. In the event that the Department of Defense makes an affirmative finding that imports threaten national security, the Department of Commerce would remain responsible for making recommendations to the President for actions to remedy the threat.
  - *Report submission.* The bill would require that, within 270 days after the initiation of an investigation, the Secretaries of Defense and Commerce "jointly submit to the President a report on the findings of the investigation and, based on such findings, the recommendations of the Secretary of Commerce for action or inaction." Notably, where the current law requires the Secretary's report to advise the President on whether imports "threaten to impair national security", the BCTA would establish a higher threshold, *i.e.*, the Secretaries must advise the President on whether imports are "a *substantial cause* of a threat to impair the national security" (emphasis added).
  - *Presidential determination and report to Congress.* Within 90 days after receiving a report that contains an affirmative finding of a national security threat, the President would be required to determine whether he concurs with the finding. Within 15 days after making an affirmative determination, the President would be required to submit to Congress a proposal regarding the nature and duration of the action that, in the judgment of the President, "should be taken to adjust the imports of the covered article and its derivatives so that such imports will not be a substantial cause of a threat to impair the national security." Unlike current law, the President would not be permitted to take any action unless Congress approves the proposal.
- **Congressional approval process.** The BCTA would introduce a significant check on Presidential actions under Section 232 by requiring that any proposed action to adjust imports under the law must be approved by the Congress before it can take effect. Specifically, it provides that a Section 232 action proposed by the President would have force and effect only if, within 60 calendar days after the proposal is submitted to the Congress, the Congress enacts a joint resolution approving the proposed action.

- **Retroactive application to cover current or pending Section 232 measures.** The BCTA provides that any Section 232 action taken during the four years prior to its enactment would cease to have effect 75 days after the BCTA's enactment, unless Congress approves a joint resolution approving the action. Thus, if the BCTA were to be approved during the current Congress, this requirement would apply to the Section 232 tariffs and quotas currently in place on imports of steel and aluminum, as well as any potential Section 232 restrictions on automotive imports if such restrictions are imposed prior to the enactment of the BCTA.
- **Exclusion processes.** The BCTA would require the US International Trade Commission to establish a product exclusion process whenever measures are imposed under Section 232. This would be a change from (1) the current law, which does not require an exclusion process; and (2) the Trump administration's current practice, under which the Department of Commerce is responsible for processing exclusion requests. The BCTA also would require that any exclusions granted be made available "to any person that imports the covered article", in contrast with the current process for steel and aluminum whereby exclusions generally are available only to the party that requested the exclusion.

Trade Security Act of 2019 (S.365)

In contrast with the BCTA, the Trade Security Act (TSA) of 2019 would make changes to the Section 232 investigative process but would not significantly curtail the President's authority to unilaterally restrict imports, nor affect existing Section 232 tariffs. The TSA was introduced in the Senate by Sen. Rob Portman (R-OH) and presently has 8 Senate co-sponsors; Rep. Ron Kind (D-WI) has introduced an identical bill in the House. The key elements of the TSA are as follows:

- **Investigative Process.** The TSA would make the following changes to the Section 232 investigative process:
  - *Initiation and finding of a national security threat.* Like the BCTA, the TSA would transfer the following investigative authorities from the Department of Commerce to the Department of Defense: (1) the authority to initiate a Section 232 investigation (whether in response to a petition or by self-initiation); and (2) the authority to determine "the effects on the national security of imports" of the article under investigation. However, unlike the BCTA, the TSA would modify the Section 232 investigation deadline by requiring that the Department of Defense issue its findings regarding the effects of the subject imports on national security within 200 days after the investigation is initiated.
  - *Development of remedies.* The TSA provides that, in the event that the Department of Defense makes an affirmative finding that imports threaten national security, the President "may" direct the Secretary of Commerce to devise recommendations to address the threat. Within 100 days of receiving such a direction, the Secretary of Commerce would be required to submit to the President a report containing recommendations "for action or inaction" under Section 232.
  - *Presidential determination.* Within 60 days after receiving the recommendations of the Secretary of Commerce, the President must decide whether "to take action based on such recommendations" and determine "the nature and duration of the action to be taken to adjust the imports of the article and its derivatives so that such imports will not threaten to impair the national security." As is currently the case under Section 232, the President would retain the authority to take a Section 232 action unilaterally within 15 days after making the determination to do so.
- **Congressional disapproval process.** Section 232 currently provides that an action taken by the President to adjust imports of petroleum or petroleum products "shall cease to have force and effect" upon the enactment by Congress of a joint resolution disapproving such action. The TSA would modify this language so that it is no longer specific to petroleum and petroleum products, *i.e.,* any action taken by the President under Section 232

would cease to have force and effect upon the enactment by Congress of a joint resolution disapproving the action. However, the Congress already possesses the authority under the US Constitution to repeal any Section 232 measure by enacting legislation to do so, so the practical impact of this change is likely to be limited.

Outlook

Although the BCTA and the TSA appear unlikely to advance in the near term, they or similar legislation could gain momentum should the Trump administration announce plans for further significant trade restrictions under Section 232, particularly on finished automobiles. A wide range of influential US business groups have endorsed the BCTA and the TSA, including the US Chamber of Commerce, the Business Roundtable, and groups representing the automotive and agricultural sectors, among others. Following the introduction of the two bills, Chairman Grassley stated that "I haven't endorsed any approach, but we're going to do something on 232...We're going to have to sit down and see what kind of compromise, hopefully bipartisan, that we can agree to." However, no formal action has been taken with respect to either bill, and such action appears to be on hold pending the outcome of the Trump administration's Section 232 investigation of automotive imports.

The US Department of Commerce on February 17 announced that it has submitted its report to the President on the Section 232 investigation of automotive goods, which has not been made public but reportedly finds a national security threat and recommends at least some import restrictions. Assuming the report is affirmative, the President has 90 days from the receipt of the report (*i.e.*, until May 18) to determine whether he concurs with its findings and will take "action" (*e.g.*, impose tariffs), though this deadline may be extended by an additional 180 days where the "action" is the negotiation of an agreement which limits or restricts the subject imports. At this stage, it is unclear what action, if any, the President will take based on the Section 232 report's findings. However, news of the report's submission already has led some Members of Congress to warn that the imposition of tariffs on finished automobiles may spur legislative action to curtail the President's Section 232 authority.

The text of the BCTA is available **here**. The **text** of the TSA is available here.

USTR Postpones Section 301 Tariff Increase on "List 3" Goods "Until Further Notice"; Signals No Exclusion Process Coming for List 3

On February 28, 2019, the Office of the US Trade Representative (USTR) published a Federal Register notice postponing "until further notice" a scheduled increase of the Section 301 duty rate on approximately $200 billion worth of annual Chinese imports, citing recent progress in bilateral negotiations with China. The products at issue are those covered by USTR's third tariff action in the Section 301 investigation of China's intellectual property rights practices (*i.e.*, "List 3"). As a result of USTR's notice, the Section 301 duty rate on List 3 goods will remain at 10 percent indefinitely, rather than increasing to 25 percent on March 2, 2019 as previously scheduled. However, USTR also indicated this week that it will not establish a product exclusion process for List 3 goods while the tariffs remain at 10 percent, despite receiving instructions from Congress to do so in the "explanatory statement" accompanying a recent federal appropriations bill. We discuss these developments below.

Postponement of Section 301 Tariff Increase and Outlook for US-China Negotiations

USTR postponed the List 3 tariff increase at the direction of President Trump, who on February 24 announced that he would delay the increase because the two sides have made "substantial progress" in negotiations on "important structural issues including intellectual property protection, technology transfer, agriculture, services, currency, and many other issues[.]" USTR's notice therefore was anticipated, but the administration's decision to postpone the tariff increase indefinitely (rather than setting a new deadline for the negotiations) was unexpected, as the United States has previously sought to use such deadlines as negotiating leverage. President Trump's announcement also stated that "[a]ssuming both sides make additional progress, we will be planning a Summit for President Xi and myself, at

Mar-a-Lago, to conclude an agreement." At this time, no date for the potential Trump-Xi summit has been announced, though press reports indicate it could occur in late March.

Given President Trump's announcement and recent reports on the status of the talks, it appears more likely than not that the two sides in the coming weeks or months will reach an agreement that averts further US tariff increases, at least temporarily, in exchange for Chinese commitments on goods purchases, market access, and some structural issues. The agreement being negotiated reportedly is comprised of separate documents covering the following issues: (1) forced technology transfer and cyber-theft; (2) intellectual property rights; (3) services; (4) currency; (5) agriculture; and (6) non-tariff barriers. However, the details of the potential agreement – including its substantive commitments, enforcement mechanism, and long-term implications for the US-China trade dispute – remain unclear:

- **Nature of commitments.** It appears likely that any agreement between the two countries will include commitments by China to increase purchases of US agricultural products and possibly other goods (*e.g.*, energy goods). Other commitments on market access and non-tariff barriers (*e.g.*, China's process for approving agricultural biotechnologies) also appear achievable. However, the extent to which the agreement will include detailed and meaningful commitments by China to enact structural reforms to its trade and industrial policies remains an open question. China thus far has expressed some willingness to enact minor policy changes that purport to address US concerns on structural issues: for example, it has announced new penalties for intellectual property violations and has expedited consideration of a draft foreign investment law that makes broad policy statements about forced technology transfer and protection of foreign investors' intellectual property. However, it is not yet known whether China will make detailed commitments to further change its laws, regulations, and guidance on these topics, subject to benchmarks, timelines, and intensive monitoring (as some US business groups have demanded). It also is unclear how, if at all, the potential agreement will address certain alleged Chinese government policies and practices that are not codified in official government documents, but allegedly are carried out through informal pressure (*e.g.*, for US parties to transfer technology) or other means (*e.g.*, cyber-theft). Some observers continue to speculate that President Trump is eager to reach an agreement with China, expecting a positive market reaction thereto, and may therefore be willing to accept an agreement that only superficially addresses structural issues (even if some administration officials such as USTR Robert Lighthizer oppose such a move).

- **Enforcement.** The Trump administration has indicated that it is seeking an enforcement mechanism that would permit the United States to impose tariffs on Chinese goods under Section 301 if it unilaterally determines that China has violated its commitments under the agreement. USTR Lighthizer emphasized this demand in a February 27 hearing before the House Ways and Means Committee, stating that the United States would seek to resolve any disputes arising under the agreement through negotiation, but that if such negotiations fail, "the United States would expect to react proportionally but unilaterally to insist on enforcement." However, China has not indicated whether it would be willing to accept such a mechanism. Moreover, monitoring China's compliance with commitments regarding alleged "unwritten" policies and practices could be challenging for the United States. The Trump administration also has not indicated how long it is willing to give China to implement its commitments under the agreement.

Moreover, it is unclear at this stage how any agreement and its enforcement mechanism would relate to the existing and threatened US tariffs under Section 301, and China's retaliation thereto. For example, the United States may agree to keep the tariff rate on List 3 goods at 10 percent for a predetermined period (*e.g.*, 180 days), but retain the ability to implement the threatened increase to 25 percent should China fail to implement its commitments by the end of that period. Alternatively, the United States could agree to cancel the List 3 tariff increase upon signing the agreement, and to remove some or all of the existing Section 301 tariffs if China complies with its commitments by a specific date. As another alternative, the United States could agree to remove some of the existing Section 301

tariffs upon signing the agreement, but provide that the tariffs will "snap-back" into place should China violate its obligations. Other arrangements also are possible. Though some administration officials (*e.g.*, USTR Lighthizer) may oppose granting any immediate tariff reductions before China has demonstrated compliance with the agreement, none of the aforementioned options can be ruled out.

Thus, while it appears more likely than not that the two sides will reach some form of agreement in the coming weeks or months, it remains questionable whether such an agreement will bring any long-term resolution or certainty to the US-China trade dispute, or any immediate reduction in bilateral trade restrictions. Indeed, trade restrictions between the two countries could remain at their current levels in 2019 even if an agreement is reached, and the agreement may contemplate further US tariff increases or a "snap-back" of tariffs if the United States unilaterally determines that China has violated its commitments. Therefore, while the potential agreement is likely to bring about a temporary pause in the trade dispute, it may provide little assurance that the dispute will be resolved (or at least not escalate) over the long-term. Moreover, while an agreement currently appears more likely than not, this outcome is not guaranteed, particularly given the hardline views of key US officials and the volatility of the President's own views and positions on trade policy.

USTR Indicates No Product Exclusion Process Forthcoming for List 3 Goods

During a House Ways and Means Committee hearing on February 27, USTR Lighthizer indicated that his agency does not plan to establish a product exclusion process for List 3 goods while the tariffs remain at 10 percent, despite receiving instructions from Congress to do so in the "explanatory statement" accompanying a recently-enacted federal appropriations bill (the Consolidated Appropriations Act of 2019). Though the bill itself did not address the Section 301 exclusion process, the accompanying explanatory statement drafted by congressional appropriators instructed USTR to "establish an exclusion process for tariffs imposed on goods subject to Section 301 tariffs in round 3…no later than 30 days after the enactment of this Act." Directives contained in such "explanatory statements" are usually followed by agencies, but generally are not viewed as legally binding.

Though Members of the Ways and Means Committee expressed support for the immediate initiation of a List 3 exclusion process, Ambassador Lighthizer reiterated his position that USTR will only establish such a process should the tariff rate on List 3 goods increase to 25 percent. Meanwhile, USTR has approved few exclusions under its existing process for goods on Lists 1 ($34 billion) and 2 ($16 billion). As of February 28, USTR had approved 985 exclusion requests for List 1 goods (out of more than 10,800 received) and had denied more than 4,500 requests. Moreover, USTR has not yet approved or denied any of the 2,900-plus exclusion requests submitted for goods on List 2.

USTR's Federal Register notice is available **here**.

Free Trade Agreements

Update on CPTPP Implementation and Implications for the United States

There have been several recent developments related to the implementation and administration of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) that could affect the United States, either in its own negotiations with CPTPP Parties or in its potential future accession to the Agreement. These developments include: (1) the inaugural meeting of the CPTPP Commission in Tokyo on January 19, at which the Parties discussed the potential accession of new members as well as implementation issues; (2) Vietnam's recent approval of a plan for its implementation of the CPTPP; and (3) indications that Brunei and other CPTPP signatories that have not yet ratified the Agreement may do so in 2019. We discuss these developments and their implications for the United States in detail below.

Inaugural Meeting of CPTPP Commission

The inaugural meeting of the CPTPP Commission took place in Tokyo on January 19, 2019. The Commission is the decision-making body of the CPTPP and oversees any matter relating to the administration and implementation of the Agreement. Other functions of the Commission include supervision of all CPTPP committees, working groups and other subsidiary bodies, review of the economic relationship and partnership among CPTPP parties, consideration of proposals to modify or amend the Agreement, and administration of dispute settlement proceedings.

During the meeting, Ministers and senior officials representing Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, and Vietnam discussed issues relating to administration and implementation of the CPTPP as well as accession of new members. In the Joint Ministerial Statement, the Ministers express their "firm commitment to fully implement the Agreement" and reiterate that it is "open to all economies" that are willing and able to meet the Agreement's high standards. The Commission also acknowledged the different stages of ratification by the four remaining CPTPP signatories (Brunei Darussalam, Chile, Malaysia, and Peru).

Along with the Ministerial Statement, the Commission adopted four decisions, namely on the approach to administer implementation of the agreement, an accession process for interested economies to join the CPTPP, a code of conduct for investor-state dispute settlement, and rules of procedure and a code of conduct for state-to-state dispute settlement panels. A summary of these decisions follows:

- **Administration and Implementation.** The Commission has established a rotating schedule for Commission chairmanship starting in 2020, proceeding in the order in which the Parties notified the CPTPP Depositary in writing of the completion of their internal ratification procedures. Mexico will chair the Commission in 2020, followed by Japan (2021), Singapore (2022), New Zealand (2023), Canada (2024), Australia (2025), and Vietnam (2026). Two Vice-Chair posts will be filled by the immediate past and future Chairs.

  For the transitional 2019 year, the current Chair is Japan, with New Zealand and Mexico as Vice-Chairs. During the transitional year, the signatories that have not yet ratified the CPTPP may attend all related meetings and working groups as well as participate in meetings related to accessions. In other words, Brunei Darussalam, Chile, Malaysia, and Peru are permitted to attend and participate in all relevant CPTPP meetings in 2019.

- **Accession.** The Commission decided on the accession process for a new State or separate customs territory, *i.e.*, an "aspirant economy", desiring to join the CPTPP.

  - **Notification**. As a first step, aspirant economies are encouraged to engage informally with CPTPP Parties regarding their interest in joining, and then must formally notify New Zealand (the CPTPP Depositary) of their request to commence negotiations to accede.

- **Request to commence accession process.** The Commission will then decide whether to commence the accession process within a "reasonable period of time," and the decision will be made public. The aspirant economy is encouraged to hold informal consultations with each Party and, should the Commission determine to move forward, it will establish an Accession Working Group.
- **Accession Working Group.** One or more Accession Working Groups, comprised of government representatives from each Party, with the Chair established by consensus, may be established to handle country-specific or multiparty accession processes. The aspirant economy first presents its efforts made to date, and changes needed in order to comply with the obligations of the CPTPP. Within 30 days of the first Working Group meeting, the aspirant economy will submit its market access offers and non-conforming measures (NCMs), which will be considered according to agreed-upon benchmarks. These benchmarks include the extent to which the aspirant economy demonstrates compliance with all existing CPTPP rules, and delivers the "highest standard of market access offers on goods, services, investment, financial services, government procurement, state-owned enterprises and temporary entry for business persons" that provide "commercially-meaningful" outcomes for each existing Party. Should the offers be in line with the benchmarks, the Parties then submit their own market access commitments to the aspirant economy. The Parties will then negotiate their respective market access offers via the Working Group and bilaterally. Finally, the Working Group will submit a written report on the terms and conditions of the aspirant economy's CPTPP accession for the Commission's consideration.
- **Commission's approval.** Should the Commission approve by consensus the terms and conditions for the aspirant economy's accession to the CPTPP, it will adopt a decision inviting the applicant to join the Agreement, and will specify an extendable six-month window during which the aspirant economy must deposit an instrument of accession with the Depositary accepting said terms. The instrument of accession may only be deposited after the applicant has ratified the Agreement and can demonstrate that it has completed all domestic reforms required to comply with its CPTPP obligations. Finally, each existing Party must notify the Depositary when it has completed its domestic legal procedures required to accept the aspirant economy into the CPTPP. The aspirant economy will officially become a Party to the CPTPP 60 days following the completion of these steps. Should there be a "significant delay" in the ratification process of one or more of the existing Parties to accept the aspirant economy, the Commission "may determine a different arrangement." This language was likely included to preclude a situation where potential delays in a particular CPTPP member's legislative process, for example due to a change in government, might negatively impact an aspirant economy's time horizon to join the Agreement.

- **Dispute settlement.** The Commission adopted rules of procedure and a code of conduct for state-to-state dispute settlement (SSDS) panels arising under Chapter 28 of the CPTPP. The former establishes details on the composition of panels, hearings, remuneration and payment of expenses, treatment of confidential information, and other elements of the SSDS process. The latter includes guidance on governing principles for panellists, disclosure obligations, impartiality of panellists, and other issues. The Commission also established a code of conduct for investor-state dispute settlement proceedings (ISDS), similar to those for SSDS, setting standards for arbitrators.

The Commission will hold its next meeting in New Zealand in the second half of 2019. While the Commission has focused on the process by which new members may join the Agreement, there remains concern about the pace of implementation among existing members. While all members have committed to implementing the CPTPP's high-standard provisions (though some on different timelines), some private sector stakeholders have questioned the capacity and/or political will of some members to expeditiously implement some of its more novel elements. The

agenda for the second Commission meeting is not yet known, but structured support for some members' adherence to their obligations under the CPTPP may be required.

Click **here** for the Joint Ministerial Statement and **here** for the texts of all Commission decisions.

Vietnam's Issuance of CPTPP Implementation Plan

Vietnamese Prime Minister Nguyen Xuan Phuc has issued Decision No. 121/QD-TTg ("Decision 121") dated January 24, 2019 to approve a plan to implement the CPTPP[1] for Vietnam. The plan consists of three broad areas, namely (i) dissemination of information on the CPTPP; (ii) amendment of relevant laws and regulations; and (iii) capacity building programs.

- **Dissemination of information on the CPTPP.** The Ministry of Industry and Trade (MOIT) will conduct workshops and training courses, issue publications, and conduct other activities to disseminate information on the CPTPP, starting in 2019 and continuing for as long as the CPTPP is in force.
- **Amendment of relevant laws and regulations.** In order to comply with its obligations under the CPTPP, Vietnam must amend a number of its laws and regulations. In May 2019, the government will present to the National Assembly amendments to the Law on Food Safety, the Law on Insurance Business, and the Law on Intellectual Property. These amendments will address commitments required for immediate implementation upon CPTPP's entry into force. For other commitments that have longer time horizons, Vietnam will stagger needed legal reforms over the next several years, including reforms related to labor and intellectual property rights protection. In addition, Vietnam's Ministry of Industry and Trade also has issued a Circular aimed at aligning Vietnamese exporters' origin procedures with the certification requirements under the CPTPP.[2]
- **Capacity building.** The Vietnamese government will develop a range of programs in 2019 to increase the capacity of small businesses to benefit from the CPTPP. The government also plans to conduct capacity building activities for government agencies dealing with trade unions and intellectual property in order to implement Vietnam's commitments under the Agreement.

Click **here** for a copy of Decision 121 (in Vietnamese).

Possible Ratification by Brunei and Other Signatories

According to recent comments by senior officials in Brunei Darussalam to US business executives, the Sultanate expects to ratify the CPTPP by the end of 2019. To do so, Brunei must enact a range of domestic legal reforms, including regarding intellectual property, state-owned enterprise reform, and enacting a national minimum wage. The specific timeline for passing or amending these and other laws, needed to bring Brunei in line with its obligations under the CPTPP, remains uncertain.

As one of the four original members to the predecessor agreement – the Trans-Pacific Strategic Economic Partnership Agreement (TPSEP) – along with Chile, New Zealand and Singapore, Brunei has lagged behind some other members in ratifying the CPTPP. To date, Australia, Canada, Japan, Mexico, New Zealand, Singapore, and Vietnam have ratified the CPTPP. Chile is expected to do so in the first quarter of 2019. In Peru, domestic political challenges may delay the country's ratification timeline. However, the CPTPP does not require congressional approval through a legislative resolution as no normative laws or existing agreements need to be changed to align the CPTPP with domestic law. As such, the CPTPP could be approved by presidential ratification through an

[1] The CPTPP entered into force for Vietnam on January 14, 2019.

[2] A copy of Circular No. 03/2019/TT-BCT is available **here** (in Vietnamese).

executive order. Malaysia has indicated that it is still evaluating the Agreement and its decision concerning ratification.

Implications for the United States

The above developments could have important implications for the United States' planned bilateral negotiations with CPTPP Parties, namely Japan, or its potential accession to the CPTPP in the future.

2019 US Trade Negotiations

In the near term, the ratification and implementation of the CPTPP by additional Parties will exacerbate the competitive disadvantages already faced by US exporters in key markets such as Japan and Vietnam as a result of the United States' withdrawal from the TPP in 2017. US exporters, particularly in the agricultural sector, already have urged the Trump administration to rapidly complete its proposed bilateral negotiations with Japan in order to mitigate the disadvantages caused by the recent entry into force of the CPTPP and the EU-Japan FTA. As additional countries gain preferential access to the Japanese market under the CPTPP, particularly those with strong agricultural export sectors, the Trump administration will likely face increasing pressure to quickly complete the negotiations with Japan and to secure equivalent market access for US exporters.

US Accession to CPTPP

In the longer term, it is possible that the United States would seek to re-join the CPTPP, especially if President Trump is not re-elected in 2020. However, this move could prove difficult because the CPTPP Parties have not established any special accession procedures for the United States. Consequently, if the United States were to seek to join the CPTPP in the future, it would need to do so through the same accession process that is available to all other "aspirant economies". Importantly, and as noted above, this would require the completion of several steps before the United States could officially accede, including: (1) negotiations between the United States and the existing Parties on the terms of US accession; (2) approval of the terms of US accession by all of the Parties; (3) ratification of the CPTPP by the United States (which would require congressional approval of implementing legislation); and (4) completion by each Party of the domestic legal procedures required to accept the United States into the CPTPP.

Each of these steps could pose obstacles. Though US accession would likely face little opposition from the CPTPP Parties if the United States were willing to accede to the agreement "as is" and based on its previous (TPP) market access commitments, such terms might not be acceptable to the US Congress. Members of Congress and important segments of the US business community would likely insist on the reinstatement of some or all of the TPP provisions that were suspended in the CPTPP (including controversial provisions on biologic medicines and patent test data) as a condition of the United States acceding to the Agreement. However, some CPTPP Parties might be reluctant to reinstate such controversial provisions, and any one Party would be able to block the United States' accession, given the requirement for consensus. Negotiations over the terms of the United States' accession could therefore be lengthy and contentious.

Moreover, even if the Parties were able to reach agreement on the terms of the United States' accession, ratification by the United States and other Parties would likely be a long and difficult process. The original TPP was controversial in the US Congress, and its passage was far from guaranteed. Though the prospects for congressional approval of US accession to the CPTPP would depend on the terms of the accession and US political dynamics at the time, the proposal almost certainly would be the subject of intense debate (and given TPA requirements, a quick vote would not be guaranteed). In addition, all 11 CPTPP Parties would have to complete their respective domestic legal procedures to approve the United States' accession – a process that could be politically controversial for some Parties and could take years for all 11 to complete. Thus, while the CPTPP provides an avenue for the United States to rejoin the Agreement, it appears doubtful that US accession would be a quick or easy process.

At this stage, it appears highly unlikely that the United States will seek to accede to the CPTPP in the near term, particularly under the current US administration. However, given the US business community's continued interest in rejoining the CPTPP and the Agreement's expected economic and geopolitical benefits for the United States, it is possible that a future US administration will consider initiating negotiations for US accession to the Agreement. In the meantime, the rules and market access outcomes negotiated by the United States in the original TPP will likely continue to be viewed by US stakeholders as a benchmark against which other trade agreements negotiated by the Trump administration are measured.

Implications of the US-Mexico-Canada Agreement for the Energy Sector

On November 30, 2018, the United States, Canada, and Mexico signed a new trade agreement, known as the US-Mexico-Canada Agreement (USMCA), to replace the North American Free Trade Agreement (NAFTA). The proposed USMCA would have important implications for the North American energy sector if approved and implemented by the signatories. Among other things, the Agreement would preserve existing duty-free trade in energy and energy-intensive goods between the three countries and preserve recent energy policy reforms in Mexico that have provided new opportunities for foreign investors. These aspects of the USMCA have been welcomed by the US energy industry, but other elements of the Agreement, such as its limitations on investors' ability to seek independent arbitration of investment disputes, have raised concerns in the industry. This report summarizes these and other important energy-related issues addressed in the USMCA.

Background: Key Elements of NAFTA for the Energy Sector

Since its entry into force in 1994, NAFTA has provided important benefits for the North American energy sector. The Agreement eliminated each Party's import tariffs on crude oil and natural gas, refined products, and other energy and energy-intensive goods. In addition, Chapter 11 of the Agreement provides protections for cross-border investors and investments in the energy sector, such as (1) requirements to afford them national treatment and most-favored nation treatment; (2) limitations on the nationalization or expropriation of investments; and (3) prohibitions on various types of "performance requirements" (e.g., requirements to export a given level or percentage of goods or services). Where an investor of a NAFTA Party believes that a host Party has violated such obligations, the investor may seek independent arbitration and compensation through the NAFTA's investor-state dispute settlement (ISDS) mechanism. The energy industry has been a frequent user of ISDS globally, and several of the investment disputes brought under the NAFTA's ISDS provisions have involved energy-related investments.

NAFTA also includes a dedicated Chapter 6 on "Energy and Basic Petrochemicals," which includes the following substantive elements that deviate from or clarify the Agreement's general rules for trade in goods:

- **Disciplines on export restrictions.** Article 604 provides that Parties may not impose any duties or taxes on the export of any energy or basic petrochemical good to the territory of another Party, unless such duty/tax or charge is uniformly applied to (1) exports of any such good to the territory of all other Parties; and (2) any such good when destined for domestic consumption. Moreover, between Canada and the United States only, Parties may only impose restrictions on the export of an energy or petrochemical good to another Party in cases where:
  - Doing so does not reduce the proportion of that specific good made available to the other Party, relative to the *total supply of that good of the Party* maintaining the restriction, as compared to that proportion during the preceding 36-month period;
  - The Party does not impose a higher price for exports of a good compared to the price charged for such good when consumed domestically, by means of any measure such as licenses, fees, taxation, and minimum price requirements; or

- The restriction does not require the disruption of normal channels of supply to that other Party or normal proportions among specific goods supplied to that other Party.

These disciplines are more permissive than the general prohibition on export restrictions under NAFTA Article 309.

In addition, Article 607 provides that Parties may not invoke Article XXI of the GATT (Security Exceptions) or NAFTA Article 2102 (National Security) to restrict imports or exports of an energy or basic petrochemical good, except to the extent necessary to: (1) supply a military establishment of a Party or enable fulfillment of a critical defense contract; (2) respond to a situation of armed conflict; (3) implement national policies or international agreements relating to the non-proliferation of nuclear weapons; or (4) respond to direct threats of disruption in the supply of nuclear materials for defense purposes. This Article also applies to Canada and the United States.

- **Energy regulatory measures.** Article 606 recognizes that energy regulatory measures are subject to NAFTA disciplines regarding (1) national treatment (Article 301); (2) import and export restrictions (Article 603); and (3) export taxes (Article 604), and states that Parties' energy regulatory bodies shall seek to "avoid disruption of contractual relationships."
- **Exemptions for Mexican State activities.** At the time of NAFTA's signing, many of the primary activities in the Mexican hydrocarbons and electricity sectors were considered to be exclusively State activities under Mexican law. Accordingly, the NAFTA Energy Chapter included significant exceptions allowing the Mexican State to reserve to itself a wide range "strategic activities", including (1) exploration and exploitation of crude oil and natural gas, (2) foreign trade, transportation, storage, and distribution of various energy products, and (3) the supply of electricity as a public service in Mexico. The Chapter also permits Mexico to restrict the granting of import/export licenses for certain goods, including petroleum gases and other gaseous hydrocarbons; petroleum bitumen; aviation gasoline, and others.

Key Elements of the USMCA for the Energy Sector

Trade in Goods

The USMCA updates or retains NAFTA provisions on tariffs, rules of origin (ROO), and Section 232 Measures:

Tariffs. The USMCA will retain the NAFTA's zero rates of duty on crude oil, natural gas, refined products, petrochemicals, and other energy and energy-intensive goods.

ROO. The USMCA also incorporates most of the NAFTA's product-specific rules of origin for goods classified under Harmonized System (HS) Chapter 27 ("Mineral Fuels, Mineral Oils and Products of Their Distillation; Bituminous Substances; Mineral Waxes"), including:

- A good of Chapter 27 that is the product of a chemical reaction is an originating good if the chemical reaction occurred in the territory of one or more of the Parties;
- Goods falling under HS heading 27.10 are considered originating if they undergo any of the following processes: atmospheric distillation; vacuum distillation; catalytic hydroprocessing; catalytic reforming; alkylation; cracking; coking; or isomerization; and
- A product classified under HS heading 27.10 is originating if created through "direct blending," so long as non-originating material constitutes no more than 25 percent by volume of the good.

The USMCA also introduces a new rule setting a threshold for non-originating diluent. In determining whether goods of HS heading 27.09 are originating under the USMCA, the origin of diluent used to facilitate transport between Parties will not be considered, so long as the diluent constitutes no more than 40 percent by volume of the good.

The USMCA also includes tariff shift rules for Chapter 27 goods, nearly identical to those under the NAFTA. The only change is that the USMCA specifies that paragraph 1 of Article 4.12 (De Minimis) (which generally sets a de minimis threshold of 10 percent) "applies to: (a) non-originating light oils and preparations of subheading 2710.20 when used in the production of other goods of subheading 2710.20; and (b) non-originating other oils of subheading 2710.20 when used in the production of light oils or preparations of subheading 2710.20."

National Treatment and Licensing. Moreover, under the USMCA, Canada and Mexico will continue to qualify under Section 3(c) of the US Natural Gas Act as countries "with which there is in effect a free trade agreement requiring national treatment for trade in natural gas[.]" Consequently, the US Department of Energy will automatically deem applications by US parties seeking to sell US-produced LNG to foreign buyers in Canada or Mexico to be consistent with the "public interest", and will approve such applications without delay.

Elimination of Energy Chapter. The USMCA would eliminate the NAFTA's Chapter 6 on "Energy and Basic Petrochemicals". As a result, measures now covered by Chapter 6 of the NAFTA would be subject to the USMCA's general disciplines on trade in goods, services, and investment (among other things). For example, the USMCA would eliminate the energy-specific disciplines on export restrictions set forth in Chapter 6 of the NAFTA, including those that apply only between the United States and Canada. Rather, measures related to energy trade would be subject to the USMCA's general disciplines on export restrictions, set forth in Chapter 2 of the Agreement.[3]

Industry Response and Section 232. Groups representing the US energy industry have welcomed the USMCA's rules for trade in energy goods, but have expressed frustration that the Agreement does not provide for the elimination of the "national security" tariffs that the United States has imposed on steel imports from Canada and Mexico pursuant to Section 232 of the Trade Expansion Act of 1962. The US oil and gas industry has been a vocal opponent of the Section 232 restrictions, which energy companies say have disrupted supply chains and increased costs for steel products that are needed to complete domestic oil and gas projects.

Investment Protections and Investor-State Dispute Settlement (ISDS)

The USMCA Investment Chapter largely replicates NAFTA's obligations regarding a Party's treatment of another Party's investors and their investments in its territory. However, compared to NAFTA, the USMCA limits investors' ability to seek recourse for alleged breaches of those obligations through ISDS by (1) limiting the obligations that are subject to ISDS; and (2) excluding Canada from the ISDS mechanism entirely, except for certain "legacy" claims brought within three years after the termination of NAFTA. The USMCA will allow certain investors in the oil, gas, and power generation sectors (among others) to bring a wider range of ISDS claims, but only where the claimant is a party to a "covered government contract" with a "national authority" of the host country, and only for disputes arising between the United States and Mexico. We summarize these changes below.

- **Investment protections.** Like NAFTA, the USMCA requires a Party to afford to investors of another Party and to their investments in its territory (1) national treatment; (2) most-favored nation treatment; (3) a minimum standard of treatment, including "fair and equitable treatment" and "full protection and security"; and (4) non-

[3] Article 2.11 of the USMCA provides that "no Party shall adopt or maintain any prohibition or restriction...on the exportation or sale for export of any good destined for the territory of another Party, except in accordance with Article XI of the GATT 1994". However, Mexico has secured an exception from this requirement (set forth in Annex 2-A) for certain measures it has taken pursuant to Article 48 of its Hydrocarbons Law to require permits for the export of certain energy products (i.e., hydrocarbons, liquefied petroleum gas, petroleum products, and petrochemicals). In addition, Article 2.15 provides that "[n]o Party shall adopt or maintain any duty, tax, or other charge on the export of any good to the territory of another Party, unless the duty, tax, or charge is also applied to the good if destined for domestic consumption."

discriminatory treatment in cases of armed conflict and civil strife. Also like NAFTA, the USMCA generally prohibits a Party from expropriating or nationalizing a covered investment without compensation, and from imposing various "performance requirements" in connection with an investment. In some cases, the USMCA investment disciplines go beyond those in the NAFTA (*e.g.*, by expressly prohibiting additional types of performance requirements such as requirements "to supply exclusively from the territory of the Party a good that the investment produces or a service that it supplies to a specific regional market or to the world market").

- **Exclusion of Canada from ISDS.** Under the USMCA, ISDS will be available only between the United States and Mexico, except for certain "legacy claims" (described below). That is, US and Mexican investors will not be able to bring ISDS claims with respect to breaches of the USMCA investment disciplines by Canada, and Canadian investors will not be able to bring ISDS claims with respect to breaches of the USMCA investment disciplines by the United States or Mexico. Given that Canada and Mexico are both parties to the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), their investors will continue to have recourse to the CPTPP's ISDS mechanism for disputes arising between them. However, the United States is not a Party to the CPTPP, and US and Canadian investors therefore will no longer have recourse to ISDS for investment disputes arising between the two countries should the USMCA replace the NAFTA. This change could have important implications for the energy sector, given the history of US-Canada investment disputes involving energy-related investments.

- **Legacy investment claims and pending claims.** Under Annex 14-C of the USMCA, each Party consents to arbitration under the existing NAFTA ISDS procedures for three years after the NAFTA is terminated, with respect to "legacy investments" only (*i.e.*, investments that were established or acquired between January 1, 1994 and the date of termination of the NAFTA and are in existence on the date of entry into force of the USMCA). During the three-year transition period, a Party's investors (as defined in the NAFTA Investment Chapter) will be permitted to bring claims in accordance with the NAFTA's ISDS provisions alleging a breach of an obligation of the NAFTA Investment Chapter or select provisions of the NAFTA Chapter on Competition Policy, Monopolies, and State Enterprises.

  Should the USMCA take effect, an arbitration initiated pursuant to the submission of a legacy claim will be permitted to proceed to its conclusion, and the Tribunal's jurisdiction with respect to the claim will not be affected by the expiration of the three-year transition period. Similarly, the USMCA provides that an arbitration initiated pursuant to the submission of a claim under the NAFTA while the NAFTA is still in force may proceed to its conclusion, and the Tribunal's jurisdiction with respect to such a claim will not be affected by the termination of the NAFTA.

- **ISDS only available for certain breaches by a host Party.** Annex 14-D to the Investment Chapter sets out procedures for the settlement of investment disputes between the United States and Mexico. Compared to NAFTA, the USMCA significantly limits the range of investment disciplines that are subject to ISDS (except in certain investment disputes involving government contracts, which are discussed separately below). Under Annex 14-D, an investor may only submit to arbitration a claim that the respondent has breached:

  - Article 14.4 (National Treatment) or Article 14.5 (Most-Favored Nation Treatment), except with respect to the establishment or acquisition of an investment, or
  - Article 14.8 (Expropriation and Compensation), except with respect to indirect expropriation.

By contrast, the NAFTA permitted investors to submit claims with respect to alleged breaches of any of the obligations of the NAFTA Investment Chapter, and it did not expressly prohibit claims related to indirect expropriation or the establishment or acquisition of an investment.

- **Mexico-US Investment Disputes Related to "Covered Government Contracts".** Annex 14-E allows investors in five specific sectors, including the energy sector, to bring a broader range of ISDS claims provided that the dispute relates to a "covered government contract" with a "national authority" of the host Party (i.e., the United States or Mexico). The "covered sectors" eligible to bring claims under Annex 14-E include the following:

  - Activities with respect to oil and natural gas that a national authority of an Annex Party controls, such as exploration, extraction, refining, transportation, distribution, or sale;
  - The supply of power generation services to the public on behalf of an Annex Party;
  - The supply of telecommunications services to the public on behalf of an Annex Party;
  - The supply of transportation services to the public on behalf of an Annex Party; or
  - The ownership or management of roads, railways, bridges, or canals that are not for the exclusive or predominant use and benefit of the government of an Annex Party.

  Under Annex 14-E, an investor may submit to arbitration a claim that the respondent has breached any obligation under the USMCA Investment Chapter, provided that:

  - The claimant is a party to a "covered government contract", defined as "a written agreement between a national authority of an Annex Party and a covered investment or investor of the other Annex Party, on which the covered investment or investor relies in establishing or acquiring a covered investment other than the written agreement itself, that grants rights to the covered investment or investor in a covered sector";[4] and
  - The respondent (*i.e.*, host country) is a party to another international trade or investment agreement that permits investors to initiate dispute settlement procedures to resolve an investment dispute with a government. Both the United States and Mexico are currently parties to such agreements.

Industry Response. The US energy industry has raised concerns about these changes to the Investment Chapter. Groups representing the industry have criticized the elimination of ISDS between Canada and the United States, as well as the sectoral limits on ISDS, noting that many energy-related activities requiring long-term, capital-intensive investments (e.g., coal and uranium extraction and exploration) will no longer benefit from the full suite of investment protections and ISDS under the USMCA. In addition, some observers speculate that certain investments in Mexico related to wind and solar plants, refining and natural gas infrastructure, and power transmission lines might also face limitations on their ability to bring ISDS claims under the USMCA, given common contractual arrangements in these industries.

<u>Preservation of Mexican energy reforms</u>

The USMCA contains important differences from the NAFTA with respect to US and Canadian investors' and service providers' ability to participate in energy-related business activities in Mexico. At the time of the NAFTA's signing, the primary activities of the hydrocarbon industry in Mexico were considered to be exclusively State activities and were, for the most part, exercised through the state-affiliated entity Petróleos Mexicanos and its subsidiary entities ("Pemex"). The generation, transmission, distribution, and marketing of electricity also were generally deemed to be exclusive activities of the Mexican State. Accordingly, and as noted above, the NAFTA Energy Chapter included

[4] Alternatively, the Annex permits such claims where the investor is "engaged in activities in the same covered sector in the territory of the respondent as an enterprise of the respondent that the claimant owns or controls directly or indirectly and that is a party to a covered government contract".

significant exceptions allowing the Mexican State to reserve to itself the following "strategic activities", including investment in such activities and the provision of services in such activities:

- exploration and exploitation of crude oil and natural gas; refining or processing of crude oil and natural gas; and production of artificial gas, basic petrochemicals and their feedstocks and pipelines; and
- foreign trade; transportation, storage and distribution, up to and including the first hand sales of the following goods: (i) crude oil, (ii) natural and artificial gas, (iii) certain goods obtained from the refining or processing of crude oil and natural gas, and (iv) basic petrochemicals; and
- the supply of electricity as a public service in Mexico, including (with some exceptions) the generation, transmission, transformation, distribution and sale of electricity.

In recent years, however, Mexico has enacted legal reforms allowing both local and foreign private investment in its energy sector. Among other things, the reforms opened up certain oil, electricity, gas, transmission, production, and sales activities to private and foreign investment while keeping ownership of Mexico's hydrocarbons under state control, as established in the Mexican constitution. The USMCA reflects these changes, as it does not include provisions like those in Chapter 6 of the NAFTA reserving activities in the oil, gas, and electricity sectors for the Mexican State. In fact, Mexico in the USMCA has not taken reservations from the Agreement's services, investment, or state-owned enterprise disciplines for any existing or future "non-conforming measures" in the energy sector. At the same time, the USMCA includes a Chapter entitled "Recognition of the United Mexican States' Direct, Inalienable, and Imprescriptible Ownership of Hydrocarbons", which affirms (consistent with the recent energy reforms) that Mexico "has the direct, inalienable, and imprescriptible ownership of all hydrocarbons in the subsoil of the national territory" and "reserves its sovereign right to reform its Constitution and its domestic legislation".

The USMCA also includes provisions that appear to limit the extent to which Mexico can reverse the recent liberalization of its energy sector. Article 32.11 provides that, with respect to the obligations in Chapter 14 (Investment), Chapter 15 (Cross-Border Trade in Services), and Chapter 22 (State-Owned Enterprises and Designated Monopolies), Mexico reserves the right to adopt or maintain a measure with respect to a sector or sub-sector for which Mexico has not taken a specific reservation in its schedules of non-conforming measures "only to the extent consistent with the least restrictive measures that Mexico may adopt or maintain under the terms of applicable reservations and exceptions to parallel obligations in other trade and investment agreements that Mexico has ratified prior to entry into force of [the USMCA], including the WTO Agreement, without regard to whether those other agreements have entered into force." This provision would appear to bind Mexico to at least the level of openness to energy-related foreign investment and services to which it committed under the CPTPP.

Industry Response. These changes in the USMCA have been welcomed by groups representing the US oil and gas sector, given the expectation that they will have the effect of "locking in" the recent Mexican energy reforms and retaining their benefits for US investors.

Canada-United States Annex on Energy Regulatory Measures and Regulatory Transparency

Canada and the United States have negotiated between them an Annex to the USMCA regarding "Energy Regulatory Measures and Regulatory Transparency". The Annex includes the following substantive requirements, which do not exist under the NAFTA:

- Each Party must ensure that it accords access to electric transmission facilities and pipeline networks for purposes of importation from another Party "that is neither unduly discriminatory nor unduly preferential". To the extent that tolls, rates, or charges are set, assessed, approved, or subject to oversight by a Party, the Party must ensure that they are "just, reasonable, and neither unduly discriminatory nor unduly preferential." In addition, the

Annex specifically states that the United States will ensure that “the Intertie Access Policy of the Bonneville Power Administration affords British Columbia Hydro treatment no less favorable than the most favorable treatment afforded to utilities located outside the Pacific Northwest.”

- Each Party must maintain or establish regulatory authorities that are “separate from, and not accountable to, persons subject to energy regulatory measures”.
- A Party may require an authorization to participate in energy-related activities in its territory, and may require a “reasonable” monetary payment for such authorization, but must ensure that the applicant for such authorization has a right of appeal or judicial review of the decision concerning the authorization “by an authority independent from the authority that issued the decision”.

Outlook

The US energy industry has generally been supportive of the USMCA, citing its retention of key benefits of the NAFTA (e.g., tariff elimination) and the expectation that it will preserve current levels of market access for energy-related investments and services throughout North America. At the same time, the industry has expressed serious concerns about some of the changes introduced in the USMCA, including the limitations on ISDS as well as the Agreement’s failure to eliminate the United States’ Section 232 tariffs on steel (a key input for the energy industry). US energy industry groups also have expressed opposition to the USMCA’s “sunset provision”, pursuant to which the Agreement will terminate 16 years after its entry into force unless each Party confirms it wishes to continue the Agreement for a new 16-year term, due to the long-term nature of many investments in the energy sector. In its assessment of the Agreement, the Industry Trade Advisory Committee on Energy and Energy Services stated that, while the Committee “supports the USMCA overall, we are disappointed that some provisions have fallen short of our preferred outcome and therefore do not fully work for the energy interests of the US. Specifically, we refer to those provisions which include sectoral limits to ISDS eligibility in Mexico and the elimination of ISDS for Canada.” The Committee further noted that “given our reservations about the aforementioned provisions, we do not view the USMCA as a precedent that should be used by the US in the negotiation of energy-related provisions in future US trade and investment agreements with other countries.” These comments reflect the USMCA’s mixed results for the energy industry, i.e., its retention of market access benefits coupled with changes to other aspects of NAFTA that are likely to increase the uncertainty associated with long-term cross-border investments in North America.