



CLIENT ALERT

August 20, 2018

1

INTERNATIONAL TRADE

NAFTA NOW, NINETEEN, OR POTENTIALLY NEVER

by Daniel D. Ujcz

This week is Now, Nineteen (as in 2019), or potentially Never in the ongoing renovation of the North American Free Trade Agreement (NAFTA). A US-Mexico agreement in principle (aka the “handshake”) likely will come in the wake of this week’s (Tuesday) meetings between Mexico’s Secretary Guajardo and United States Trade Representative (USTR) Lighthizer. The focus thereafter will target Canada as the parties attempt to close the entire deal before the December 1, 2018 transition to the new President of Mexico, Andrés Manuel López Obrador (AMLO).

The new NAFTA (NAFTANEXT) will include benefits for companies operating in the North American production platform, yet those will come with new compliance and documentation requirements that warrant close inspection. Additionally, this week’s NAFTA developments have implications beyond North America’s supply and value chains as they will provide guidance on the Section 232 national security tariffs on steel, aluminum, and potentially autos; US discussions with the European Union (EU officials are in Washington this week) and Japan; as well as the continued escalation of tariffs with China (China’s officials are in DC this week while USTR holds hearings on the \$200 billion in proposed tariffs). As a result, the coming days are a critical point in determining whether the “summer of disruption” will lead to a “fall of rebalanced resumption” in global trade or simply a fall in sales and earnings.

US-Mexico Bilateral Deal

The Trump Administration largely has its NAFTA deal as Mexico has agreed to new NAFTA rules of origin (ROO) for the auto sector that will include at least the following:

- A top-line regional value content of near 75% (up from 62.5% in the current NAFTA);
- 70% of all steel, aluminum, and glass used in the production of the automobile must originate in North America;
- Up to seven components, including most of the powertrain assembly, must originate in North America;
- If a plant is used in the production of the automobile that provides less than the North American wage (approximately USD16.00), 40% (passenger vehicles) and 45% (light duty trucks) of that final vehicle’s assembly must be made with at least the North American Average Wage;
 - In calculating the final vehicle produced at the North American Average wage, up to 15% (20% for light duty trucks) of that requirement may include R&D, marketing, sales, etc. salaries. Otherwise stated, companies may not work-around the wage

requirement by simply bolstering professional salaries as workers “on the line” must be part of the calculation; and

- The imposition of a 5 year (and potentially as short as 3 year) phase-in period.

In return for Mexico’s agreement to the new auto ROO, the United States has agreed to withdraw its proposal to make it easier for US farmers (e.g., Florida tomato growers) to bring trade disputes against Mexico’s seasonal producers (aka the “seasonality proposal”), and to maintain the status quo in NAFTA Chapter 20 state-state dispute resolution system (the US had proposed to make Chapter 20 decisions advisory/non-binding). The US and Mexico also have agreed to terms on nearly 20 of the 33 chapters/working groups of the new NAFTA including customs and trade facilitation (border issues), a digital chapter, textiles, and a series of areas on which the parties had no actual disagreement (e.g, anti-corruption).

What Is Left Between the US & Mexico?

Non-Conforming Autos - The highest remaining hurdle between the US and Mexico is the treatment of automobiles that do not meet the new NAFTA rules of origin; particularly European and Asian badged vehicles that are manufactured in Mexico that can meet some, but not all, of the new requirements. The default rule is that most-favored-nation treatment (MFN) rates of 2.5% (passenger vehicles), 25% (trucks), and 2.5% (auto parts average) apply to non-conforming auto imports into the US, and MFN rates of 20% (all vehicles/trucks) and 2.7% (auto parts average) for imports into Mexico. (Canada’s MFN rates are 6.7% for all vehicles and auto parts.) The US is proposing that a higher percentage than 2.5% apply to non-conforming vehicles imported into the US from Mexico (and presumably Canada).

There are significant implications for automakers and suppliers in this discussion as it is a “grey-area” of legal authority for the US to impose tariffs above the MFN rates. Solutions may be for the US to increase US MFN rates (which would involve Congress and the WTO, if even possible), inverting GATT Article XXIV (which is generally used to provide more favorable treatment than the MFN rates), or, most likely, imposing Section 232 national security tariffs on the auto sector (which creates challenges in how to justify that some, but not all, of imports of similar products from Mexico are a national security risk). The take-away for companies is that the Trump Administration’s statements regarding increased auto tariffs are not just theatrics and tactics—they are a forthcoming tenet of US trade policy.

Specifically, Mexico will not agree to a higher rate for non-conforming autos absent guarantees that it will apply to every other country. It therefore is highly likely that whatever tariff rate the new NAFTA imposes for non-conforming goods will be at least the new auto tariffs rate around the world. The only way products will escape these increased tariffs is to meet the new auto ROO in NAFTA or enter into new free trade agreements (e.g., EU and Japan) with the US. Alternatively, in the event the US and Mexico agree to keep the current default/MFN

rate, it is highly likely that the US will seek to impose tariffs on new automotive investment in Mexico. As a result, the treatment of non-conforming autos in the NAFTA is the signal-check for the global auto industry and requires vigilance.

Labor - Mexico and the US are close to reaching the terms of a new labor chapter that would seek to ensure unionization free from company interference (i.e., addressing “yellow” or “ghost” unions) and enforceability of the chapter. Coupled with the auto ROO’s wage issues, automakers and suppliers operating in Mexico will need to address management-labor issues as well as HR matters in NAFTANEXT.

Energy - AMLO’s “observers” added an 11th hour proposal to the energy chapter last week that seeks to provide more flexibility for AMLO’s government to manage the ongoing privatization of Mexico’s energy resources. Houston and Mexico’s business community have a problem with this proposal. While details remain unclear, this proposal will take up the majority of the time during Tuesday’s meetings. It is likely that this is Mexico’s attempt during the “close phase” of the deal to obtain last minute concessions from the US. There is little expectation that this will hold up the deal. Nevertheless, in the unlikely event that the energy issues slow down the agreement in principle, the parties will be unable to reach a “handshake” by their deadlines. In such a scenario, there likely will be more adversarial rhetoric and posture from the White House. We then would move to the “nineteen or never” part of the scenario in terms of reaching an agreement in principle.

Sunset Clause - Mexico and the US have not reached agreement on whether the US will drop/modify its demand to include a sunset clause that would automatically terminate the NAFTA after 5 years unless the parties renew the agreement. Notably, the US Congress likely will not ratify a new NAFTA absent some type of rendezvous/review mechanism. There appear to be developments on having certain controversial provisions (e.g., de minimis issues in the e-commerce/customs chapter) subject to periodic review, which may be a form of “sunset-lite”. It is unlikely that given the favorable deal that the US has received from Mexico on auto ROO that the sunset clause will hold-up a final deal. It may get heated in the negotiations, but the parties will reach an agreement on sunset.

Trilateral Issues - Somewhat surprisingly, Mexico and the US are extending their discussions beyond bilateral issues to touch on trilateral matters such as intellectual property rights (IPR), investor state dispute settlement (ISDS), Chapter 20, and several other areas. This suggests that the US strategy is to finalize the text of the entire agreement with Mexico, bracket the text that includes Canada, and then present to Canada as a done deal. While Mexico publically is stating that its focus is on US-Mexico issues, it is readily apparent that the technical teams are working on trilateral issues in preparation for Canada’s entry into the discussions.

We Have Heard This Before Regarding NAFTA Being Almost Complete, Why Is This Time Different?

The procedural and political calendars require a rapid timing and

tempo for the NAFTA. Procedurally, US Trade Promotion Authority (TPA) legislation requires three steps to close any trade deal. First, the parties must reach an agreement in principle/handshake where the parties announce that they intend to sign a deal. This is followed by a 90-day consultation period where USTR must present the text of the proposed agreement to Congress and stakeholders for at least 60 days during those three months for further review. Following those consultations, USTR may move to the next stage, which is to sign the agreement and prepare for submission to Congress.

The key procedural factor driving the NAFTA discussions is to have the deal signed and through Mexico’s Senate on or before AMLO’s taking office on December 1. Rolling back from December 1 using the 90-day TPA timeline and several other legislative requirements, the latest date for the NAFTA “handshake” is August 25, 2018.

The underlying political rationale to sign the NAFTA during Mexico’s transition is the recognition that Mexico will be more flexible. The outgoing President, Enrique Peña Nieto (EPN), is on his way out the door and potentially more malleable as he seeks to preserve his legacy, and AMLO can accept the deal with the political cover of “blaming the last guy.” This is similar to the situation in the original NAFTA where President Bush largely negotiated the deal, and President Clinton shepherded the deal through Congress. Additionally, the Mexico-US business communities want to “lock-in” AMLO and President Trump as a barricade to more protectionist forces within their political bases. Indeed, it is likely that once AMLO takes office, the list of Mexico’s NAFTA issues (e.g., US corn subsidies) grows longer.

Politics and policies in the US also call for a fall 2018 deal. Given the uncertain politics of the 2018 midterms, there is a significant need to make the deal now and advance the TPA process as far as possible. It must be emphasized that ratification is only possible in the next Congress (the deal cannot be ratified in 2018 due to procedural requirements); as a result, it is best to have the key procedural elements inked and then deal with vote-counting in 2019. Of greater immediate significance, the White House needs to address the concerns of US farmers and ranchers that are subject to retaliation from Mexico as a result of the Section 232 steel and aluminum tariffs. If President Trump can finalize a deal with Mexico that has the steel and aluminum requirements in auto ROO, the US and Mexico can quickly lift the tariffs and retaliation. This will provide relief to a key political base of the President and the Republican members of Congress just in time for the 2018 midterms. A closed NAFTA deal with Mexico and resolution of the Section 232 steel and aluminum tariffs is political gold to the Trump Administration in fall 2018.

What About Canada?

The current trajectory is that the US and Mexico will have a completed NAFTA over the coming days and then turn to Canada and advise “take it or leave it” on trilateral matters. The US also will attempt to strong-arm Canada on three outstanding bilateral issues—namely, supply management/dairy, Chapter 19 dispute resolution, and intellectual

property rights. Three scenarios may emerge at the end of this negotiating arc:

1. The US and Mexico reach a deal; the US lifts Section 232 steel and aluminum tariffs on Mexico and Canada to create a favorable negotiating environment; and Canada and the US reach agreement on the outstanding bilateral issues by the end of August;
2. The US and Mexico reach a deal; the US lifts Section 232 steel and aluminum tariffs on Mexico, but not Canada, and Canada and the US reach agreement on the outstanding bilateral issues at a slower pace, likely end of September 2018 (which allows for the 60 days publishing of text for trilateral agreement);
3. Same as #2, but no deal between the US and Canada is reached by the time signatures are needed by Mexico and US (by December 1).

At present time, any of these scenarios could occur with #2 having the highest degree of likelihood. In the event the parties are unable to reach a trilateral deal, it is unlikely that the US will withdraw from the current NAFTA for fear of congressional and public push-back during the elections season. The US therefore will proceed with its deal with Mexico. The US meanwhile will continue to impose steel and aluminum tariffs and possibly new auto tariffs on Canada in an effort to assert maximum pressure. As a result, the NAFTA status quo with Canada will remain in theory, but with layers of tariffs on critical sectors. The economic and political consequences are dire in such a scenario. The likely result is that the US Congress would intervene; however, the timing and nature of such intervention in an election year, lame duck, and 2019 transition is unpredictable at best. The remaining Canada issues—dairy, Chapter 19 (which is synonymous with softwood lumber in the US) and intellectual property rights—would have Canada defending a position to maintain protections for its sectors, as opposed to “opening up markets” for US customers. It may be difficult for even the strongest Canada supporters in the US Congress to “hold out” for Canada. While there are strong practical and policy reasons supporting Canada’s positions, the uncertain politics in the US do not provide ideal forums for enlightened policymaking.

It is this political challenge that gives rise to the argument being made by several leading and respected Canada-US commentators that the US TPA serves as a barrier to a US-Mexico only deal. The argument goes that as the US provided notice to Congress in spring of 2017 that the NAFTA would be trilateral, the only way to move forward on a bilateral deal is to restart the entire TPA process. This position fails to account that TPA is an ongoing set of consultations and checkpoints between the White House and Congress. In the event that Congress does not approve of a bilateral deal, the entire process does not start back at the launch point. Rather, Congress can use the variety of tools provided for at this stage of the negotiations such as marshalling votes for a disapproval resolution, using the 90 day period between the “handshake” and signature, and, ultimately, failing to ratify/implement any new deal. Simply, stakeholders concerned about the failure to

reach a trilateral deal need to get the votes from Congress. Practical, policy and political considerations are the key to having a trilateral NAFTA, not procedural niceties.

Canada also has difficult policy and political choices in an environment complicated by provincial elections in dairy-friendly Quebec in fall 2018 and federal elections in 2019. “Turning the screws to Canada” as an attempt to obtain leverage in the NAFTA negotiations likely will backfire on the US. As a result, a key indicator will be the US position on lifting the Section 232 steel and aluminum tariffs. If the US truly desires an agreement in principle in short order, it should be counselled to create favorable conditions for a deal by lifting the steel and aluminum tariffs on Mexico and Canada. Unfortunately, lifting the tariffs on Mexico-only will negatively impact the already tense tenor and tone of the NAFTA negotiations and strengthen the “no deal with Trump” political base in Canada.

Ratification

As a reminder, while the Agreement may be signed in 2018, the US and Canada still will need to ratify/implement the new NAFTA. (Presumably Mexico will finalize its process in 2018.) In the US, this process will not commence until the next Congress is seated in 2019. The passage of a new NAFTA post-2018 elections will be a heavy lift and subject to further outreach by Dickinson Wright. However, companies should be watching the key indicators reviewed above and make preparations for compliance.

Conclusion

It is highly likely that major announcements will be made this week regarding NAFTA that potentially will rebalance North America’s supply and value chains, address Section 232 steel and aluminum tariffs, put Europe, Japan and the global on notice that the US intends to create a tariff wall for autos absent free trade agreement negotiations, and settle in from the long haul with China. Companies must be engaged on these issues as this is the new trade reality in the US.

This client alert is published by Dickinson Wright PLLC to inform our clients and friends of important developments in the field of international trade law. The content is informational only and does not constitute legal or professional advice. We encourage you to consult a Dickinson Wright attorney if you have specific questions or concerns relating to any of the topics covered in here.

FOR MORE INFORMATION CONTACT:



Daniel D. Ujcz is a Of Counsel and Cross-Border Business Development Director in Dickinson Wright’s Columbus office. He can be reached at 614-744-2579 or dujcz@dickinsonwright.com.