Legal Fight Prevents Opening of $2.5 Billion Gas Pipeline to Mexico From Texas

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Despite fuel shortages, López Obrador's administration challenges natural-gas distributors, rattling private-sector investors and is the latest broadside from Andrés Manuel López Obrador's administration against privatization of the energy sector.

MEXICO CITY—In June, construction crews finished work on a 500-mile, $2.5 billion natural-gas pipeline that runs under the Gulf of Mexico from South Texas to the port of Tuxpan in northeastern Mexico.

Source: Mexican Energy Ministry

Once it turns on, the pipeline will increase Mexico's capacity to import natural gas by 40%, fueling the power plants and industrial installations that drive the country's export-driven manufacturing economy.

But the government of President Andrés Manuel López Obrador refuses to turn on the gas. Instead, Mexico's state-owned power utility, the Federal Electricity Commission, or CFE, has pushed the pipeline's builders, along with two other private operators, into arbitration.

The CFE is seeking nearly $900 million related to delays in the construction of the South Texas marine pipeline, which was originally scheduled for completion in October 2018, and around $2.7 billion more related to six other pipelines, according to people familiar with details of the negotiations.

The dispute is the latest broadside from the López Obrador administration against privatization of the energy sector, which began under his predecessor. Former President Enrique Peña Nieto authored a constitutional change in 2013 that ended more than 70 years of state monopoly on oil and gas exploration, and created a wholesale electricity market in which private-sector power generators compete with the state utility.

Mr. López Obrador has rolled back key parts of that overhaul, including halting auctions for drilling rights and canceling plans for more joint-drilling ventures between the state oil company and private operators. Now, his administration has provoked a conflict with the companies that distribute natural gas throughout the country.

Separate from the arbitration, the CFE also wants to reduce the capacity and usage rates it is charged under the contracts, and it has been holding weekly negotiating sessions with the pipeline companies, according to a person involved with the talks. Mr. López Obrador said Monday he is hopeful an agreement will be reached before this Thursday, but he didn't provide details.

"The companies accepted dialogue and a revision of the conditions in the contracts," the president said at his morning news conference. "They showed a willingness to reach an agreement and not go to the courts … We're on the right track, and this will mean a significant savings for public finances."

Even if it's resolved soon, the conflict has dealt a double blow to Mexico's economy by raising costs for industries that depend on gas-fired electric power and adding to persistent uncertainty over whether the López Obrador government will honor contracts, economists and business groups say.

Gustavo de Hoyos, head of Coparmex, Mexico's largest business chamber, described the pipeline conflict as a "war on triple-A foreign investors." He said the arbitration was illegal and an example of the type of decisions made by the administration that rattles the private sector.

"The thing that's most damaging is that President López Obrador makes decisions that are ideological, rather than based on evidence and analysis," Mr. de Hoyos said.

The conflict comes at a time of weak economic growth in Mexico, with GDP expanding 0.1% in the second quarter after contracting 0.2% in the first. Economists cite as key factors low government spending, lack of consumer confidence and an effective freeze on new private investment, as businesses with capital to spend remain on the sidelines.

The companies involved include Canada's TC Energy Corp. (formerly TransCanada), Sempra Energy 's Mexico unit Ienova , and two Mexican companies, including a unit of billionaire Carlos Slim 's Grupo Carso .

Concerns over the arbitration have resonated in the U.S. and Canada, key partners that Mexico has been urging to ratify the trade pact negotiated last year to succeed the North American Free Trade Agreement.

Texas Gov. Greg Abbott wrote a letter to Mr. López Obrador on July 25 urging him to resolve the pipeline issue quickly, raising the fear that "failure to honor longstanding contracts could jeopardize" the new trade deal.

"Lingering questions about Mexico-U.S.-Canada project … could negatively impact our economies for years to come," Mr. Abbott wrote.

TC Energy and Ienova, which built the underwater pipeline, say delays were caused by factors beyond their control, including slow government approvals for permits, and they invoked force majeure clauses in their contracts requiring the CFE to start paying before any gas was delivered.

A spokesman for the CFE didn't respond to requests for comment. In early July, Manuel Bartlett, who was appointed by Mr. López Obrador to be the utility's general director, said the arbitration was in response to the companies' use of force majeure and to what the government sees as unfair contract terms.

"The government's proposal is to renegotiate the contracts and arrive at equitable terms," Mr. Bartlett said in a statement.

These types of contracts, known as "take or pay" in the oil-and-gas industry, are standard for government suppliers, said George Baker, founder of Houston-based consultancy Energia and an expert on the Mexican energy industry. He said the negotiations over the pipeline send a signal that the government is willing to take political disputes “and turn them into damaging legal claims” against investors.

“The transoceanic pipeline is a wonderful project for Mexico,” Mr. Baker said. “It’s a real shame that they should find some pretext to keep it from working the way it should.”

TC Energy expects the arbitration, which is being heard by the London Court of International Arbitration in the U.K., could continue into early 2021 before there is a ruling.

“In our view the contracts were properly established in accordance with our original bid and regulatory requirements and remain valid,” said TC Energy Chief Executive Russ Girling in a recent company earnings call. “That said, we remain open to discussion and resolving these issues.”

The CFE is seeking nearly $900 million related to delays in the construction of the South Texas marine pipeline. Here, the CFE’s thermal power station in Acolman, Mexico. Photo: Luis Antonio Rojas/Bloomberg News

For decades, Mexico’s energy sector was off limits to private companies. The country opened its economy to trade and became a manufacturing export center in recent years, but state energy company Petróleos Mexicanos failed to supply enough natural gas, and Mexico relies on imports for about 70% of its needs.

Mexican companies have complained for years that they pay higher prices for electricity than companies north of the border.

After years of increasing openness to private-sector power generation, the López Obrador administration has changed tack. The CFE pulled out of a planned auction to buy renewable energy under long-term contracts and canceled several transmission-line projects that would for the first time have included private investment.

Meanwhile, as some parts of Mexico go without it, the U.S. is awash in cheap natural gas, a result of the fracking boom, which has driven prices to historic lows and produced so much natural gas that companies are flaring—or burning off—large quantities of it.

The pipeline dispute comes as parts of the country struggle with natural-gas shortages, particularly the Yucatán Peninsula where industrial users face higher costs for electricity generated from diesel or fuel oil. The South Texas pipeline doesn’t reach Yucatán, but it would free up gas availability in the region.

The Yucatán Peninsula is served by only one major gas pipeline, and lack of natural gas has affected local electricity generation. The National Energy Control

Center, a public entity that oversees administration of the power grid, put the region on “high alert” for outages in June.

Factory owners in the peninsula’s packaged foods, beverages and meatpacking industries have suffered from higher energy costs, especially seafood-processing plants around the coastal city of Progreso, which use large amounts of electric power to freeze fish for shipping, according to private sector groups.

“The energy-generation plants in the Yucatán, when they work at all, are running on diesel,” said Alberto Abraham Xacur, head of Canacintra Yucatán, the peninsula’s industrial chamber. “That means that industrial businesses, all of them, are seeing energy costs rise by between 12% and 17%.”

Other large producers, including Galletera Dondé, which makes cheese-flavored crackers and sandwich cookies in the city of Mérida, and beer maker Grupo Modelo, which has a nearby plant, have complained that the price of the natural gas they use in their production process costs between $8 and $12 per thousand cubic feet, well above that of other regions, Mr. Xacur said.

One of the biggest victims of the lack of natural gas will likely be CFE itself, which is Mexico’s biggest buyer of gas for its power-generation plants.

“Their generation costs have skyrocketed because they aren’t allowing their plants access to this natural gas,” said a former top energy regulator. “They could lose customers or start getting political pressure to do something about it.”