

Thoughts on the Preliminary Draft Agreement of the DACG on Cross-Participation

Mexico City, September 26, 2022

We make reference to:

- 1) The Preliminary Draft "Agreement by which the Energy Regulatory Commission ("CRE" or "Commission") issues the General Administrative Provisions, establishing the procedure and requirements for the authorization of cross-participation (*participación cruzada*), the methodology for the analysis of its effects on competition, the efficiency in markets and the effective open access, and interpretation, for administrative purposes, of the cross-participation provided in the second and third paragraphs of Article 83 of the Hydrocarbons Law ("LH")", sent by the CRE to the National Commission for Regulatory Improvement ("CONAMER") on August 9, 2022, (the "Preliminary Draft"); and
- 2) The General Administrative Provisions that establish the procedure and requirements for the authorization of cross-participation, the methodology for the analysis of its effects on competition, the efficiency in markets and the effective open access and, interpret for administrative purposes, the cross-participation provided in the second and third paragraphs of article 83 of the LH, (the "DACG") contemplated in the Preliminary Draft, in order to analyze and develop its implications, in light of the constitutional controversy 55/2021¹, issued by the Mexican Supreme Court ("SCJN") on April 6, 2022, against the Federal Executive Power, in which the Federal Economic Competition Commission ("COFECE") challenged the resolution RES/133/2021² dated on March 16, 2021, issued by the CRE.

In this regard, a brief review of the Preliminary Draft and of the DACG and the implications these could have in light of the constitutional controversy 55/2021 and the resolution RES/133/2021 is developed below.

¹ Available at: <https://www.scjn.gob.mx> > MI_ContConst-55-2021

² Available at: <https://www.cre.gob.mx/Resoluciones/index.html>

Terms in initial capital letters that have not been defined herein have the meaning attributed to them in accordance with the Preliminary Draft.

I. Motivation of the Preliminary Draft

According to the Preliminary Draft prepared by the CRE, there are legal and economic terms such as “cross-participation”, “effective open access”, and “competition and efficiency in markets”, whose definition and delimitation is necessary to provide legal certainty. Likewise, the Preliminary Draft establishes that it is essential to establish the methodology that the CRE will follow for the analysis of the effects of, amongst others, cross-participation, effective open access, and competition and efficiency in the markets. This in addition to determine the procedure that the CRE, the Economic Agents, and the Economic Interest Groups (“EIG”) involved must follow to carry out the process of authorization of cross-participation.

In this sense, and based on Article 22, sections XI, XII and XIII, of the Law on Coordinated Regulatory Bodies in Energy Matters (“LORCME”), the CRE argues that it has the power to request from regulated subjects all kinds of information or documentation and verify it with respect to regulated activities. These include:

- Requesting information directly from third parties that have any business relationship with regulated subjects within the scope of their competence;
- Order and conduct verification, inspection or monitoring visits;
- Require the presentation of information and documentation, and
- Summon to appear public servants and representatives of productive enterprises of the State and individuals who carry out regulated activities. This in order to supervise and monitor, within the scope of their competence, compliance with the applicable legal provisions, as well as with the regulation, authorizations and licenses they have issued, and contracts and agreements relating to regulated activities.

In addition, the CRE stipulates that, in terms of Article 72, last paragraph, of the Regulations for the activities referred to in Title Three of the Hydrocarbons Law (the “Regulation”), it may apply the measures referred to in Article 83 of the LH, so that the degree of expected intervention by CRE will depend on (i) the degree of openness of the relevant system or systems, (ii) the merger of participants, and (iii) other aspects related to the conditions of competition in each segment of the hydrocarbons industry.

Similarly, the Preliminary Draft states that, in accordance with the third paragraph of Article 83 of the LH, the resolution of a favorable opinion of COFECE is a necessary requirement to obtain

the authorization of cross-participation of CRE, without said favorable opinion prejudging the meaning of the authorization that will be issued by CRE in the same matter.

Finally, the Preliminary Draft establishes that, in order to promote the efficient and competitive development of regulated markets, guarantee effective open access, and other objectives, the CRE considers it essential to issue a new Agreement that abrogates and replaces the Agreement A/005/2016, in order to provide the CRE with a better regulatory tool.

II. Relevant Provisions of the Preliminary Project

The most relevant provisions of the Preliminary Draft are described below:

- Establishment of the methodology for the analysis of the effects of cross-participation on effective open access, competition and efficiency in the markets, and determine the procedure for the filing of applications for authorization of cross-participation, which are integrated in the Single Annex of the new Agreement, as well as the abrogation of the prior Agreement.
- The Economic Agents, up to the size of EIG, that have updated the cross-participation assumption and that have not made the request for its authorization, shall file before the Commission the mentioned request, no later than 30 (thirty) business days after the entry into force of these General Administrative Provisions, and
- The filings that are in process at the entry into force of these Provisions shall be conducted in accordance with the prior Agreement. In the event that the licensee considers, by means of a written request, it may ask this Commission to initiate the cross-participation authorization application process again in accordance with the General Administrative Provisions issued as of this Agreement.

III. DACG

The most relevant provisions and changes regarding economic competition, as well as cross-participation, contained in the DACG initiative mentioned in the Preliminary Draft, are referred below:

1. EIG and open access

The cross-participation assumption established in the second paragraph of Article 83 of the LH is actualized when the Economic Agents involved, up to their EIG dimension, are directly or indirectly owners of the capital stock, through shares, social parts or other instruments,

regardless of the amount, percentage or form of their participation, in the capital stock structure, of:

- a. End users, producers or marketers of hydrocarbons, petroleum products and/or petrochemicals that use transportation services by pipeline or storage, subject to open access, and
- b. Permit holders that provide transportation services by pipeline or storage subject to open access of hydrocarbons, petroleum and/or petrochemicals.

2. Modification to cross-participation

Pursuant to Articles 48, second paragraph, and 50 of the Regulation, it will be understood as modification to the cross-participation any amendments to the shareholding structure, permit assignments, changes in the permits, or changes in the market conditions, which may result in a cross-participation assumption established in section 3.5 of the DACG. These in addition to any modifications derived from the actions or omissions of the applicants to the market conditions that were analyzed by the CRE and under which the cross-participation was authorized, which include, but are not limited to, the following changes:

- In the route of the pipeline transportation system subject to open access;
- In the capacity of the pipeline transportation system and/or storage, subject to open access;
- In the conditions of the market and the activities carried out by the Economic Agents and that in turn imply the updating of the cross-participation assumption established in article 83, second paragraph of the LH;
- In the products authorized in the commercialization permits, transportation by pipeline or storage subject to open access, as well as in the hydrocarbons, petroleum and/or petrochemicals produced;
- Modification of the shareholding structure of involved Economic Agents that have one or more permits granted by the Commission. Changes derived from one or more permit assignments are included; and
- In the permit from which a given infrastructure is covered.

Changes that imply the reduction of authorized or produced products are excluded, as well as corporate restructuring in which the Economic Agents belonging to the same EIG remain unchanged and the Control or Decisive Influence is not modified, nor does the ownership of the permits change from one EIG to another.

3. Methodology for deciding on cross-participation

In order to analyze the effects that the request for cross participation authorization will have on competition, market efficiency and effective open access, the Commission will apply their own methodology, which includes:

- Identify the Applicants as Economic Agents up to their EIG dimension;
- Identify the economic activities in which the EIG participates and in which the cross-participation may have effects;
- Circumscribe the area or zone of influence of the economic activities in which the Applicants participate as Economic Agents up to their EIG dimension;
- Determine the possible affectations in the market in which the EIG could incur in the economic activities;
- Determine the effects of cross-participation on competition, efficiency in the markets and effective open access considering the possible gains in efficiencies, and
- If applicable, establish and apply the corresponding regulatory measures.

IV. Constitutional Controversy 55/2022 and its effects due to the Preliminary Project

COFECE filed a Constitutional Controversy against Resolution RES/133/2021, which denied the cross-participation authorization requested by an Economic Agent to carry out its operations, who already had a favorable opinion issued by COFECE. In a session held on April 6, 2022, the five Ministers of the First Chamber of the Mexican Supreme Court of Justice ("SCJN") declared the invalidity of such resolution.

In the respective resolution, the SCJN determined that, pursuant to the last paragraph of Article 83 of the LH, it is not optional for the CRE to have the opinion of the COFECE in order to resolve, on the merits, the corresponding cross-participation authorization procedure. Rather, this type of filing cannot be finally decided without obtaining such opinion.

The resolution establishes that the fourteenth and twentieth paragraphs of Article 28 of the Mexican Constitution grant COFECE the power to guarantee free competition and concurrence, as well as to prevent, investigate and combat monopolies, monopolistic practices, mergers, and other restrictions to the efficient operation of the markets. Therefore, it is necessary that the CRE refrain from resolving the administrative procedures it instructs regarding cross-participation authorizations, until it ensures that it has the respective opinion of the COFECE.

In this regard, the SCJN also stated that the information submitted to the CRE that will support the sense of its resolution, and that which supported the opinion issued by the COFECE must be the same. Therefore, and if during the course of a cross-participation authorization filing, new

information or evidence arises that COFECE did not have before it for the issuance of its respective opinion, such opinion would be useless to fulfill the coordinated structure required by Article 83 of the LH, and which would in turn prevent the CRE from issuing the respective resolution. If, despite such a situation, the CRE resolves in any sense the merits of a cross-participation authorization filing, without a new opinion from COFECE that considers the new elements of assessment, it is unquestionable that the CRE would be violating the coordination structure contemplated in Article 83 of the LH as well as the division of powers under the Mexican Constitution.

On the other hand, the SCJN emphasized that the CRE may promote competition in the sector, acting in such a way that in its regulation and the acts it issues (permits), it ensures the protection of the principles of economic competition, but this should not imply an exercise of its functions that exceeds such promotional context. In the same vein, the judgment is clear in establishing that it is possible to state that the CRE, when regulating the matter, may issue acts related to such regulation (granting of permits) or even promote competition in the sector, but it will always be bound by the Law to act in coordination with COFECE. This means that the CRE cannot establish provisions to promote the efficient development of competitive markets in the hydrocarbons industry without the opinion of COFECE; and at the same time, it cannot authorize cross-participation structures without the prior favorable opinion of COFECE itself. This includes cases in which such cross-participation schemes are subject to modifications.

According to the resolution, it is important to take into account that the intervention of COFECE should not be understood as limited to the issuance of the corresponding opinion. This since the knowledge it may have about the eventual scenarios of cross-participation could allow it to fully exercise other powers related precisely to the prevention, investigation, and as the case may be, the fight against monopolies, monopolistic practices, mergers, and so forth.

Based on the foregoing, the SCJN establishes that the eventual invasion of COFECE's sphere of competence, specifically with respect to the clause set forth in Article 83 of the LH, would occur if the CRE disregards the coordination model set forth in such provision, by disregarding the need to having COFECE's favorable cross-participation opinion.

Considering the above, it is clear that although the SCJN resolved the invalidity of Resolution number RES/133/2021, such judgment was limited to pointing out exclusively that COFECE and CRE should have the same level of information for providing their opinion or permit, and that the favorable opinion of COFECE is mandatory to have for the CRE before issuing a permit.

Due to this, the great shortcoming of the aforementioned resolution was to pronounce on what would happen if COFECE issued a favorable opinion and the CRE decided to deny the respective



permit or change based on the same issue of cross-participation. In this regard, the aforementioned resolution expressly states *"(...) it is not clear whether, despite a favorable opinion from this [COFECE], such an authorization could be refused."* This apparently cemented the basis for changes to the DACG and the basis for potential litigation since, as indicated above, the DACG itself indicates that having the favorable opinion of COFECE is an indispensable requirement to obtain the consent of the CRE but does not presuppose or ensure that the CRE will also give its authorization of cross-participation.

V. Conclusions

Although the judgment of the SCJN did not analyze the mandatory nature of the favorable opinion of cross-participation of the COFECE, the truth is that it clearly establishes that the constitutional power to guarantee free competition and competition, as well as preventing, investigating and combating monopolies, and so forth, corresponds to COFECE. The CRE, despite being the regulatory body in the field of hydrocarbons, can only promote competition in the sector, in a manner in which its regulation and the acts that it issues (related to permits), it ensures the protection of the principles of economic competition. However, and in practice, particularly if the DACGs are published, it is expected that the CRE will not limit its activities to the context of promotion.

The resolution is clear in establishing that it is possible to affirm that the CRE, even by promoting competition in the sector, is bound by the Law to act in coordination with COFECE. This means that the CRE cannot establish provisions to promote the efficient development of competitive markets in the sectors in question, without the opinion of COFECE; and at the same time, it cannot authorize cross-participation schemes without first having the favorable opinion of COFECE itself.

Consequently, and once the provisions of the DACG that would be issued under the Preliminary Draft have been analyzed, it is possible that future litigation on them will indicate that the content of the DACG exceeds the powers of the CRE to promote competition in the sector under the terms authorized by the Law. In this sense, it would seem that the DACGs establish regulations on economic competition, defining and developing concepts that seem to correspond exclusively to COFECE in terms of Article 28 of the Constitution.

In this sense, and as mentioned above, the DACGs develop a whole procedure of analysis of economic competition to decide on the authorization of licenses in terms of cross-participation, which can be found in contravention of the obligation that the CRE has by Law to act in coordination with COFECE. In addition, it establishes an important additional requirement for those Economic Agents who have to carry out a request for a favorable opinion before COFECE

with the sole purpose of re-following a procedure perhaps much more burdensome before the CRE. This also without prejudice to possible contradictions of criteria between both authorities.

In light of the above, and if the DACGs are eventually enacted, in the absence of litigation, Economic Agents will have at least to make their cross-participation filings before COFECE following the DACGs under a strict basis, in spite of them being issued by the CRE, to avoid a potential controversy of criteria between authorities.

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