

# ISSUE BRIEF **06.10.14**

## **Coordinated Regulatory Agencies: New Governance for Mexico's Energy Sector**

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In December 2013, Mexico's Congress approved constitutional reforms to the energy sector that liberalize the entire value chain of the hydrocarbon industry, open a wholesale electricity market, and propose a new institutional architecture for energy regulatory agencies. While the constitutional language describing the model to be adopted by the regulatory agencies is rather broad, the recently approved implementing legislation provides a clearer definition of their structure and areas of authority—to wit, two “coordinated regulatory agencies” will regulate Mexico's energy sector: the already existing National Hydrocarbons Commission (CNH) for upstream activities and the Energy Regulatory Commission (CRE) for midstream and downstream oil and gas activities. Before energy reform, both the CNH and the CRE existed as administrative, semi-independent units of the executive branch, overseen by Mexico's Department of Energy.

Since taking office in late 2012, the administration of Enrique Peña Nieto has made regulatory strengthening a principal aim of energy reform, specifically through the dissolution of monopoly power. Such measures are necessary because strong institutions that can effectively regulate monopolies and vertically integrated industries are crucial to the success of structural reforms that open state-owned and controlled industries to private investment in a free market. Moreover,

regulatory agencies are of great interest to investors, since autonomous regulators—protected from political pressures and able to make and sustain technical decisions—can guarantee greater legal consistency than government authorities who are more exposed to political pressures. In Mexico, both the CNH and the CRE have treated Pemex as a regulated entity, to the extent possible, while encountering substantial pressure from private and political interest groups. The CRE since its establishment has faced the challenge of compelling Pemex to operate in an open downstream natural gas industry. Thus, the CRE has already had the difficult and sometimes unsuccessful experience of nudging Pemex toward market-oriented conduct and practice. For its part, the CNH's task is compounded by the fact that Pemex has long monopolized Mexico's oil and gas exploration and production industry, and will continue to do so until energy reforms are implemented. Attempting to regulate Pemex while facing its resistance, political opposition, and even the criticism of industry contractors has been a very complex and difficult process. Understaffed and lacking the financial resources to fulfill its mandate, the CNH has played an important yet inadequate role in turning Pemex into a more efficient business.

In light of the above, one of the main concerns of legislators was the independence of regulating agencies from larger government



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ministries and from various interest groups. Previously, constitutionally autonomous agencies were created to ensure the consistency of regulatory decisions and antitrust measures in the telecommunications industry; the same model was therefore initially proposed for the regulatory agencies of the energy sector. However, in the course of legislative deliberation it was decided that such autonomy was excessive due to the sensitivity of energy reform; legislators reasoned that regulatory agencies required some oversight since they would have the primary role of opening Mexico's sole untouchable industry to outside interests. Special measures, short of the highest degree of autonomy provided by the Constitution, would have to be sought to ensure the agencies conformed to the newly approved market model. As too much autonomy could pose the risk of allowing the regulators to go astray, legislators found the notion of having them beyond the control of the executive branch alarming and unacceptable.

The issue, then, was the degree and scope of autonomy of the regulatory entities. The two political parties that promoted the opening of Mexico's energy sector, the Partido Revolucionario Institucional (PRI) and the Partido Acción Nacional (PAN), agreed that the regulatory agencies could no longer be mere administrative units in the Department of Energy; that the appointment and removal procedures of agency commissioners, executed by the executive branch, left the commissioners exposed to a myriad of pressures; and finally, that their budgetary dependence on the Department of Energy restricted their ability to fulfill their legal mandates. The analysis of the flaws in the design of the CRE and the CNH was clear. The difficulty was finding an alternative model that would ensure the institutional strengthening of the agencies without relinquishing too much control of the executive branch.

The solution reached by the PRI and the PAN in the proposed bill of December 20, 2013, was a model unknown in Mexico and likely unprecedented in the rest of the world. The new wording of Article 28 of the Constitution established the CNH and CRE

as new "coordinated regulatory agencies" of the energy sector in the executive branch. Though the Constitution provided no additional language establishing the structure or the specific legal powers held by the regulatory agencies, the implementing legislation would include such detail. Pursuant to the requirements set forth in the transitory articles of the Constitution, the executive branch had to submit this legislation by April 20, 2014, only four months after the enactment of energy reforms. Shortly before the end of the legislative term, nine new laws and over 20 amended laws were prepared and submitted to Mexico's Congress. The bill for the Law of the Coordinated Regulatory Agencies was made public, making it possible to analyze the proposed structure and legal powers.

The law states that the coordinated regulatory agencies are accountable to the executive branch and have certain legal obligations and responsibilities, technical and managerial autonomy, and an independent budget. This is clearly an improvement from the previous model that gave these responsibilities to the Department of Energy.

The general characteristics of the coordinated regulatory agencies are listed below:

1. Both the CNH and the CRE have a governing body composed of seven commissioners, including a chairperson, and a technical advisor. Commissioners are presidential appointees ratified by the Senate who serve a five-year term that may be renewed. They can be removed in the event of serious infractions described in the law.
2. The Coordination Council for the Energy Sector, which is composed of the Secretary of Energy, the undersecretaries of hydrocarbons and electricity, and the chairs of the CNH and the CRE, oversees both agencies.
  - a) This council was primarily established to ensure that all acts and rulings of the coordinated agencies comply with policies as defined by the executive branch.

- b) The purpose of the council is to ensure the efficient and consistent performance of the regulatory agencies.
- c) The council shall 1) make public the policies established by the council's technical advisor, and 2) analyze the annual work programs of both agencies in order to ensure they conform to general policy.
- d) The Secretary of Energy presides over the council and is responsible for all public policies applicable to the hydrocarbon and electricity industries, and provides leadership for their execution.

The law gives the following legal powers to both the CRE and CNH:

1. To issue regulations in matters of their respective authority
2. To supervise the regulated activities
3. To approve their respective budget bills, which are sent to the Department of the Treasury for inclusion in the federal budget
4. To provide technical information to the Secretary of Energy and the executive branch with regard to the national development plan and the energy sector plan
5. To conduct studies within their areas of authority

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### SUMMARY: THE LEGAL POWERS OF THE NATIONAL HYDROCARBONS COMMISSION (CNH)

1. The purpose of the CNH is to regulate and supervise the exploitation and extraction of hydrocarbons.
2. It is responsible for the promotion, bidding, and execution of Mexico's exploration and production agreements as well as other concerns related to the exploitation of hydrocarbons.
3. Its duties are as follows:
  - a) Supervise projects to ensure maximum recovery

- b) Promote reserve restitution as the basis for energy security
- c) Ensure that suitable technology is used for the exploration and extraction of hydrocarbons
- d) Establish the National Center of Hydrocarbon Information

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### SUMMARY: THE LEGAL POWERS OF THE ENERGY REGULATORY COMMISSION (CRE)

1. The purpose of CRE is to develop the means to regulate and promote the efficient transport, storage, distribution, compression, liquefaction, and regasification of hydrocarbons, as well as their sales to the public.
2. It will regulate the transport, storage, and sales of biofuels.
3. It will regulate the generation, transmission, and distribution of electricity, whether or not it is destined for the public.
4. It will promote the safe, stable, and efficient supply of energy services.

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### CONCLUSION

In light of the above, some conclusions may be drawn about the autonomy and authority of the new coordinated regulatory agencies. As for autonomy, it is true their newly acquired legal personality, budgetary independence, and separation from the Department of Energy enhance their independence. Also, the proposed appointment and removal procedures shelter the agency commissioners from political influence and other pressures. However, the supervision of the Coordination Council may hinder the agencies' autonomy. What will be the effect when the council, with the Secretary of Energy presiding, rules on the annual work plan of the regulators and whether regulatory actions conform to national policy? The nature and effect of the council's rulings have not yet been established in the proposed law. If their

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rulings are binding, regulators may be left with even less autonomy than before.

As for authority, the CNH and CRE each have problems under the proposed law. It is clear that the proposed powers of the CNH do not equal those of regulators in other countries, such as the Norwegian Petroleum Directorate or the Brazilian National Petroleum Agency. A review of the CNH's powers shows that it appears to be an advisory body that assists the Department of Energy, as it does not have the authority to choose the areas to be tendered, nor is it in charge of the language of new contracts with outside investors. These legal powers instead rest with the Department of Energy and the Department of Finance and Public Credit. Thus, if the new legislation is passed, the CNH would do notably less than a standard regulatory agency of its kind.

The new legal framework of the CRE presents a different situation. This agency is now empowered with many of the tasks it could not perform before. If the law is approved as is, the CRE will regulate the sale price of petroleum products from the well to the wheel. It will also be in charge of approving tariff rates for all downstream activities. In addition, it will create the rules of the newly formed electricity market and determine the corresponding tariff rates. The text of the law shows that the CRE will have almost all of the legal powers of a true downstream and electric regulator. Nevertheless, questions remain: Will the CRE have sufficient budgetary resources? Will it be allowed to hire the best workers to execute its duties? Will its learning curve keep up with changes of the industry? The answers to these questions will determine the success or failure of the CRE.

The existence of the Coordinating Council will undoubtedly affect the performance of the regulatory agencies. The autonomy of these agencies will be severely hampered if the council's decisions are binding. If the law is approved as currently written, and if the council interferes significantly in the actions of the agencies, then all efforts to confer autonomy to these agencies will be met with unsatisfactory

results. Mexico's new energy sector will begin with a weak institutional structure that may hinder its future effectiveness.

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