





The Energy Policy Act of 2005 profoundly increases regulatory risk for energy market participants in the US, but implementing an effective compliance programme can have long-lasting benefits, writes former FERC executive *William Hederman*, *Michael Griffen* and *George Billinson*

Benefits of compliance

★ Every energy market participant in North America, from the sleepest municipal utility to the most aggressive Enron-alumni hedge fund, faces a profoundly different risk profile following the enactment of the Energy Policy Act of 2005 (EPAAct 2005). The Federal Energy Regulatory Commission (FERC) – the agency primarily responsible for implementing EPAAct 2005 – has strengthened its monitoring and investigatory capability, and has signalled its intention to police and enforce its market rules aggressively. Risk managers and other energy executives need to understand the new risks, and to move rapidly and proactively to address them.

The new risk exposure with FERC is massive. For unlawful conduct, FERC now is authorised to levy civil penalties of up to \$1 million per violation per day. Nevertheless, sound corporate leadership can manage regulatory risks, and a company can lessen its exposure to those risks by developing and executing an effective compliance programme. In fact, cost-effective regulatory compliance can be a sound business strategy that focuses corporate leadership on trading strategies and other practices with regulatory consequences, and smokes out overtly risky or inappropriate practices. It is also a great risk reduction investment.

There are two major dimensions to the expanded regulatory authority that Congress granted FERC through EPAAct 2005:

★ significantly strengthened civil penalty authority and the expansion of FERC's juris-

diction for market-related offences;

★ mandatory bulk power system reliability rules, enforceable by FERC to replace voluntary standards.

Penalty authority of FERC and courts

Historically, FERC had modest statutory authority under the Federal Power Act (FPA), the Natural Gas Act (NGA), and the Natural Gas Policy Act (NGPA) to sanction violations of its regulations and orders.

With EPAAct 2005's amendments to the FPA, NGA, and NGPA, FERC gained the strong enforcement authority it had lacked: power to levy civil penalties of up to \$1 million per



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violation per day for violation of any provision of FPA Part II, any provision of the NGA or NGPA, or any FERC rule, regulation, or order thereafter. EPAAct 2005 also expanded criminal liability significantly, increasing the maximum sanctions courts can levy to \$1 million in fines and five years in prison.

In addition, for the first time, FERC may now ask a federal court to bar individuals from the industry for knowing and willful

false reporting of prices or congestion information to FERC (on the electric side) or engaging in market manipulation (on the gas side). In such circumstances, the court may ban the person from the industry for a term of months, years, or even life. This new authority creates risk for both the individual and the organisation.

Finally, EAct 2005 has greatly expanded FERC's ability to affect companies traditionally thought beyond FERC's reach. Now, FERC has jurisdiction over 'any entity' that 'directly or indirectly' engages in market manipulation 'in connection with' a FERC jurisdictional transaction. As FERC has recognised, this greatly expands the universe of entities now subject to FERC jurisdiction – including banks, private equity, and hedge funds.



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Guidance from enforcement policy

As Congress broadened and strengthened FERC's authority to police and enforce its regulations, FERC increased its focus on regulatory compliance and enforcement. FERC budgeted approximately \$35 million for fiscal year 2006, for market oversight activities. It has also requested a budget allocation of more than \$37 million for activities in fiscal year 2007, an increase of approximately 7%. Recently, FERC renamed its Office of Market Oversight and Investigations the Office of Enforcement, sending another signal of FERC's intent to make

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itself a strong enforcement agency in the mould of the Department of Justice (DOJ), the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC).

With its authority strengthened and its compliance and enforcement priorities established, FERC issued its policy statement on enforcement in October 2005, to guide penalty determinations where FERC finds non-compliance and penalty mitigation for countervailing practices. One of the most important messages of the policy statement

on enforcement is that an established and effective regulatory compliance programme can serve an important role in mitigating penalties that could otherwise be assessed by FERC exercising its enforcement powers under the FPA, NGA and NGPA.

In making penalty determinations, FERC will weigh the seriousness of the violation against the 'credit' for countervailing behaviour that warrants the reduction of an otherwise appropriate fine or penalty.

On the one hand, FERC will assess such considerations, as the harm caused by the existence of fraud or deceit, the intent of the persons engaged in the violations, the violator's prior record, management's role (including management's role in facilitating or curing the violation), and the financial strength of the violator. On the other hand, FERC will assess the existence of mitigating factors – internal compliance, self-reporting, and co-operation. The policy statement on enforcement mentions 'credit', and the potential for a reduced penalty, when an entity reports its own violations to FERC and/or cooperates with FERC's enforcement actions.

Compliance as risk management investment

The compliance-related stakes for energy companies have never been higher. Improper trading activities in the electricity and natural gas markets have triggered investigations and prosecutions that have resulted in criminal convictions, FERC investigations that have led to costly settlements, stock price devaluations of companies with regulatory improprieties, and extensive class-action litigation by private claimants. Energy companies that fail to adopt effective, comprehensive regulatory compliance programmes do so at their peril.

FERC has emphasised that any entity engaged in FERC-jurisdictional activities – even an entity not directly subject to FERC's jurisdiction under the FPA, NGA, or NGPA – should have a regulatory compliance programme in place to instill within its organisation, a culture of compliance and to be positioned to respond proactively to regulatory issues.

FERC's authority and organisational ability to police compliance and sanction violations of its regulations, rules and orders has never been stronger. Under these circumstances,

