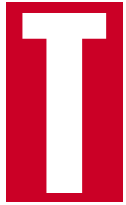




THE GOOD, THE BAD, AND THE FILL-IN- THE-BLANKS

How to prepare
for mandatory
enforcement.

**BY STEPHEN M. SPINA, MICHAEL C. GRIFFEN, AND
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The Energy Policy Act of 2005 (EPACT) brought sweeping reform to the regulation of energy markets and the enforcement of market rules, as well as to regulation of the transmission systems that are the backbone of those markets. Over the last few months, the breadth and scope of that reform has come into even sharper focus. New rules, promulgated by the Federal Energy Regulatory Commission (FERC) in a host of areas, significantly have altered the regulatory risk landscape.

One of the fundamental changes brought about by EPACT is in the area of bulk power system reliability. The current system of voluntary adherence to reliability standards is being replaced by mandatory compliance and enforcement, backed up by a FERC to which Congress has given substantially greater authority than it ever had in the past to levy significant civil penalties for violations of its regulations and orders. With FERC at the helm, users, owners, and operators of the bulk power system subject to reliability standards now face the possibility of stiff penalties for noncompliance. These entities need to consider carefully the new regulatory regime and arm themselves with proactive compliance programs that ensure that they meet or exceed the reliability standards developed to date. In this article, we present the framework of this new compliance and enforcement paradigm and offer suggestions on how to avoid some pitfalls.

Utilities know that reliability is of paramount importance. Nevertheless, compliance with existing voluntary reliability standards has not achieved the necessary levels of reliability that regulators and customers demand. Breaking with old, bad habits (such as loose compliance) can be more difficult than simply implementing new requirements on a “clean slate.” Given the importance of reform and the significant potential consequences (through FERC’s use of its new civil penalty authority), users, owners, and operators of the bulk power system must take special care to adjust to the new mandatory compliance world for electric reliability.

On April 4, 2006, the North American Electric Reliability Council (NERC) filed with FERC both its application for certification as the Electric Reliability Organization (ERO) and its petition for approval of mandatory reliability standards. In its petition, NERC submitted to FERC 102 reliability standards that it proposes be made effective on Jan. 1, 2007. NERC’s proposed reliability standards are the same as NERC’s existing voluntary reliability standards (*for a primer on the EPACT and NERC standards, see pp. 41 and 43, respectively*). As part of its petition, NERC requests that FERC institute a Notice of Proposed Rulemaking so that industry participants could comment fully on the proposed standards.

On May 11, 2006, the staff of FERC’s Division of Reliability, at the direction of FERC Chairman Joseph T. Kelliher,

filed a *Preliminary Assessment of NERC’s Proposed Reliability Standards*. FERC invited interested parties to comment on staff’s assessment and held a technical conference in early July to explore issues surrounding the proposed standards. Panelists at the technical conference included the president of NERC and senior leaders from investor-owned utilities, public power utilities, power marketers, regional transmission operators, and other industry groups.

FERC staff’s *Preliminary Assessment* centered on technical issues and identified a number of potential deficiencies in the proposed reliability standards. FERC staff noted that in its reliability standards filing, NERC had acknowledged a number of deficiencies in the proposed standards and had proposed a work plan for addressing them. FERC staff’s *Preliminary Assessment* identified those deficiencies and a number of other deficiencies as well. FERC staff identified the following major areas of concern:

■ **Blackout Report Recommendations.** Staff noted that although the report of the United States–Canada Power System Outage Task Force on the August 2003 blackout identified many of the primary causes of that blackout and other major blackouts in the United States, many of the task force’s recommendations were not yet reflected in NERC’s proposed reliability standards. FERC staff acknowledged that NERC has activities in place to address the recommendations, but those activities have not yet resulted in full implementation of the proposed reliability standards.

■ **Ambiguity.** Staff concluded that elements of numerous proposed reliability standards appear to be subject to multiple interpretations, especially with regard to the specificity of the standards’ requirements, measurability, and levels of compliance.

■ **Technical Adequacy.** Staff concluded that the requirements specified in some of the proposed reliability standards may not be sufficient to ensure an adequate level of reliability. Staff noted that while the final rule states that “best practice” may be an inappropriately high standard, the final rule also warns that a “lowest common denominator” approach will not be acceptable if it is not sufficient to ensure an adequate level of system reliability.

■ **Measures and Compliance.** FERC staff noted that many of the proposed reliability standards lack adequate crite-

ANTICIPATED TIMELINE (AT PRESS TIME) FOR ERO FORMATION AND RELIABILITY STANDARDS IMPLEMENTATION

Date	Action
July 2006	FERC Certifies NERC as the ERO
September 2006	FERC Issues Notice of Proposed Rulemaking to Adopt Reliability Standards
November 2006	ERO and Regional Entities File Proposed Delegation Agreements With FERC; ERO Submits Filing With FERC to Identify Compliance Elements and Risk Factors and Adopt Plan for Regional "Fill-in-the-Blank" Standards in Proposed Reliability Standards
First Quarter 2007	FERC Approves Reliability Standards
First Quarter 2007	FERC Approves ERO/Regional Entities' Delegation Agreements
June 2007	ERO Begins Operations

Source: Staff

plete but may need some improvement. FERC may consider proposed changes and improvements to these reliability standards as part of any rulemaking proceeding.

- Twenty-six reliability standards are referred to as "fill-in-the-blank" standards. These reliability standards provide no clear enforceable standard as

ria for measuring compliance with the NERC standards, and that such failure could lead to inconsistent interpretation and enforcement of the standards. Staff noted that NERC's petition identifies certain standards in this category and acknowledged that a project is underway for NERC to file measures and compliance components by November, 2006.

■ **Undue Negative Effects on Competition.** FERC staff stated that the primary purpose of its *Preliminary Assessment* was to provide a technical reliability analysis of the proposed Reliability Standards, rather than to identify those that could have an undue negative effect on competition. However, in certain instances FERC staff identified standards that could raise such concerns, such as the standards that govern the calculation of available transfer capability (ATC).

■ **"Fill-in-the-Blank" Standards.** In its petition, NERC identified "fill-in-the-blank" standards as those standards that do not contain a specific requirement that is enforceable for users, owners and operators of the grid, but rather provides only broad direction to the regional reliability organizations to adopt a particular program standard and to develop the specifics of the standard through a regional stakeholder process. Staff expressed a concern that "fill-in-the-blank" standards may not be enforceable under Federal Power Act (FPA) § 215 if they apply only to a regional entity.

■ **Applicability.** FPA § 215 requires that "all users, owners, and operators" comply with mandatory reliability standards approved by the commission. Staff expressed a concern that NERC's proposed reliability standards do not define or list the "users, owners, and operators" that are required to follow the standard. Staff recommends clarification of the applicability of each standard.

In its *Preliminary Assessment*, FERC staff also divided the reliability standards into three groups:

- Fifty-one reliability standards are, for the most part, com-

currently drafted. Rather, the NERC reliability standard provides broad direction to a regional entity so that the regional entity may develop a standard for its region. Staff expressed concern that these types of standards are not enforceable against users, owners, and operators of the grid, but rather only provide broad direction to regional reliability organizations. Furthermore, such standards have not undergone an approval process under FPA § 215 and thus cannot be enforced by FERC or the ERO.

- Twenty-five reliability standards do not contain measures for determining whether an entity is complying with the standard or levels of non-compliance necessary to gauge the severity of non-compliance. Without these elements, such reliability standards are much more susceptible to multiple interpretations and inconsistent enforcement across regions.

To deal with the various levels of development, NERC proposed that FERC approve the 51 reliability standards in the first group for enforcement. NERC also proposed that FERC conditionally approve the reliability standards in the other two groups. While the reliability standards in the second and third groups would be enforceable, consideration would be given to the developing nature of such reliability standards and enforcement would be adjusted accordingly.

NERC also proposed to file with FERC, no later than Nov. 8, 2006, measures and levels of non-compliance for the 25 reliability standards that are missing those elements, as well as a work plan to address issues associated with the 26 "fill-in-the-blank" reliability standards. The work plan would provide a detailed schedule for addressing all of the conditionally approved regional "fill-in-the-blank" standards either by developing uniform North American standards to replace the regional standards, developing regional reliability standards through approved procedures, or not including the regional criteria within reliability standards. (*Cont. on p. 42*)

PRIMER ON EPACK

The Electricity Modernization Act of 2005, part of the Energy Policy Act of 2005 (EPACT), created a new Section 215 of the Federal Power Act (FPA). FPA § 215 replaces the current system of voluntary compliance with reliability requirements with a system of mandatory and enforceable reliability standards to be established under FERC's authority. As part of the statutory framework, FERC must certify a single Electric Reliability Organization (ERO) to oversee the reliability of the interconnected bulk power system subject to FERC's ultimate oversight. The ERO will be responsible for developing, with FERC's approval, mandatory reliability standards that are enforceable. The reliability standards will apply to all users, owners, and operators of the bulk power system. The broad applicability of the reliability standards represents a significant expansion of FERC's jurisdiction, covering many entities normally not subject to FERC's rules, such as municipal power authorities and federal power administrations.

The ERO may, in turn, delegate the authority to propose and enforce reliability standards to regional reliability entities, with the ERO retaining the responsibility to ensure that regional entities apply and enforce reliability standards consistently across regions. The statute created some deference to regional entities organized on an Interconnection-wide basis. And under its newly strengthened FPA enforcement authority, FERC may impose potentially significant civil penalties—up to \$1 million per day per violation—against bulk power system users, owners, and operators that have engaged in acts or practices that violate reliability standards.

To implement FPA § 215's new reliability provisions, FERC issued a final rule¹ in February 2006 promulgating new regulations. Among other things, the final rule establishes:

- Criteria for ERO certification;

- Regulations related to ERO and regional entity funding;
- Procedures for proposing reliability standards;
- Procedures for enforcement of reliability standards;
- Guidelines for delegation agreement development;
- Procedures governing enforcement of FERC's rules and orders; and
- Procedures related to submitting reliability reports, addressing state action, and forming regional advisory boards.

Developing Reliability Standards

FPA § 215 defines the ERO as "the organization certified by [FERC] . . . the purpose of which is to establish and enforce reliability

The Final Rule establishes the ERO as the only entity that can submit a proposed reliability standard to FERC for approval.

standards for the bulk-power system."² The Final Rule provides that FERC will certify one entity as the ERO if it meets certain statutory criteria.³ Such criteria include a demonstration that the ERO has the ability to develop and enforce reliability standards that provide for an adequate level of reliability of the bulk power system. An ERO applicant must also document that it has established ERO rules

that provide for:

- Independence from the users, owners, and operators of the bulk power system, while assuring stakeholder representation in the selection of its directors and balanced decision making in any ERO committee or subordinate organizational structure;
- Allocation of reasonable dues, fees, and charges among end-users for all reliability activities;
- Fair and impartial procedures for enforcement of reliability standards;
- Reasonable notice and opportunity for comment, due process, openness, and balance of interests in developing reliability standards; and
- Appropriate steps, after certification as the ERO, to gain recognition in Canada and Mexico.⁴

The Final Rule establishes the ERO as the only entity that can submit a proposed reliability standard to FERC for approval, although regional entities may propose reliability standards to the ERO. FERC may approve a proposed reliability standard or a proposed modification to a reliability standard if it determines that the proposed reliability standard is just, reasonable, not unduly discriminatory or preferential, and in the public interest.⁵

In reviewing proposed reliability standards, FERC will give due weight to the technical expertise of the ERO, or a regional entity organized on an Interconnection-wide basis, with respect to the content of a proposed reliability standard or a proposed modification to a reliability standard.⁶ FERC will also give "appropriate weight" to the expertise of any regional entity in reviewing proposed regional standards; however, no rebuttable presumption of validity is provided to regional entities that are not organized on an Interconnection-wide basis.⁷ FERC stated in the Final Rule that it would allow the ERO to develop proposed reliability standards that appropriately balance reliability principles and implementation features.⁸ FERC will not, however, defer to the ERO or a regional entity with respect to the effect of a proposed reliability standard on competition.⁹

An approved reliability standard or a

modification to a reliability standard will take effect as approved by FERC. If it disapproves a reliability standard in whole or in part, FERC will remand it to the ERO for further consideration or modification. FERC may also, upon its own motion or a complaint, order the ERO to submit a proposed reliability standard, or a modification to a reliability standard, if FERC considers a new or modified reliability

standard appropriate to carry out its responsibilities under FPA § 215.¹⁰

—SMS, MCG, WFH

Endnotes

1. Rules Concerning Certification of the Electric Reliability Organization; and Procedures for the Establishment, Approval, and Enforcement of Electric Reliability Standards, Order No. 672, 71 FR 8,662 (Feb. 17, 2006), FERC Stats. & Regs. Regulations

Preambles ¶ 31,204 (2006), order on reh'g, 114 FERC ¶ 61,328, Order No. 672-A.

2. FPA, § 215(a)(2); see also, 18 C.F.R. §39.1 (2006).

3. See Final Rule at P 31.

4. See 18 C.F.R. § 39.3(b)(2) (2006).

5. See 18 C.F.R. § 39.5(c) (2006).

6. See 18 C.F.R. § 39.5(c)(1), (c)(2) (2006).

7. See Final Rule at P 351.

8. See Final Rule at P 260.

9. See 18 C.F.R. § 39.5(c)(3) (2006); FPA § 215(d)(2).

10. See 18 C.F.R. § 39.5(c)(3) (2006).

Reliability

(Cont. from p. 40)

Implications for Reliability Rules

Chairman Kelliher has stated publicly that FERC vigorously will enforce the reliability standards. He sees enforcement of the standards as an important component of FERC's enforcement agenda:

I will make no promise that the reliability standards ultimately established by the commission will never be violated. I can promise that, unlike in the past, if established reliability standards are violated, the violator will be subject to significant civil penalties.²

FPA § 215 and FERC's final rule on certifying the ERO and establishing reliability standards (Final Rule)³ give the ERO the primary role in auditing compliance with the reliability standards and investigating and enforcing violations of the reliability standards. Although the ERO and regional entities are not governmental authorities, companies subject to audits and investigations conducted by the ERO and regional entities should treat those entities as if they are federal agencies and provide the same level of diligence, accuracy, and truthfulness as they would if FERC itself were conducting the audit or investigation. False statements made to the ERO or a regional entity could be considered, by FERC and the courts, to be false statements made to FERC.

Federal law makes it a criminal offense to influence, obstruct, or impede a governmental agency in the conduct of any pending proceeding.⁴ Courts have held broadly that a "proceeding" of a governmental agency includes a preliminary or formal investigation.⁵ While the ERO and the regional entities that will conduct reliability investigations will not be governmental agencies, as entities created by federal statute and empowered by federal statute to conduct investigations and levy penalties with respect to reliability matters, the ERO and the regional entities potentially could be deemed to be "federal agencies" for purposes of the obstruction analysis. The

Final Rule requires the ERO to file its or a regional entity's record of investigatory findings with FERC when it proposes to levy a penalty for a reliability violation, so false statements made to the ERO or regional entity eventually may come to constitute false statements made to FERC. Finally, even false statements made in internal investigations potentially could lead to criminal liability for the individuals making the statements, if the statements have the effect of deceiving FERC.

EPACT amended the FPA to strengthen substantially FERC's authority to levy civil penalties for violations of its regulations, rules, and orders. In October 2005 FERC issued its *Policy Statement on Enforcement* to explain how it intends to implement its enhanced enforcement authority.⁶ FERC explained in its *Policy Statement* that it would consider the successful establishment of a culture of compliance within a utility, self-reporting of regulatory violations, and cooperation with FERC as mitigating factors in any enforcement action.

FERC has signaled that it will reward cooperation, and the ERO likely will do the same. In its application to FERC to become the ERO, NERC submitted proposed "ERO sanctions guidelines" that set out the processes and practices the ERO would follow, and the factors it would consider, when determining penalties, sanctions, or remedial actions for violations of reliability standards.⁷ The proposed ERO sanctions guidelines are consistent with the factors and considerations identified in FERC's *Policy Statement on Enforcement*, and they

EPACT amended the FPA to strengthen FERC's authority to levy civil penalties for violations of its regulations, rules, and orders.

expressly hold open the prospect for substantial penalties for “egregious conduct” by violators, including attempts to conceal violations.

Penalties for Non-Compliance

Under the authority of FPA § 215, the ERO, or a regional entity, may impose a penalty on an entity for a violation of a reliability standard approved by FERC if the ERO or the regional entity: (1) finds that the entity has violated a reliability standard; and (2) the ERO files notice and the record of the ERO’s or regional entity’s proceeding with FERC.⁸ FERC stated in its Final Rule that an appeals process at the ERO or regional entity level is appropriate and found that there should be a single appeal at either the ERO or the regional entity level. NERC, in its application to become the ERO, stated that it believes any appeal of a compliance or enforcement action should take place at the ERO level.

The Final Rule provides that the ERO and each regional entity must have a program that provides for rigorous audits of compliance with reliability standards by users, owners, and operators of the bulk power system. Other important aspects of the reliability compliance and enforcement program include:

- **Self-Regulating Programs.** FERC will require the ERO to make a compliance filing no later than one year from the date of certification proposing reliability enhancement programs that are industry-driven to improve bulk power system reliability, along with a program implementation schedule.⁹
- **Compliance Directives.** FERC stated in the Final Rule that the ERO or regional entity may conclude, based on the evidence available to it, that an entity is violating or is about to violate a reliability standard, and in such case the ERO or regional entity may issue a compliance directive. Such compliance directives may establish a timetable for compliance. The ERO or regional entity must inform FERC of any compliance directives.
- **Penalty Guidelines.** FERC concluded in the Final Rule that penalty guidelines, to be developed by the ERO and approved by FERC, should provide a predictable, uniform and rational approach to the imposition of penalties. Such guidelines would help ensure that a penalty bears a reasonable relation to the seriousness of the violation. Thus, the Final Rule requires the ERO to develop, and submit to FERC for approval, penalty guidelines that identify a range of non-monetary and monetary penalties to be applied by the ERO or a regional entity for determining the appropriate penalty for the violation of a reliability standard.¹⁰ Regional entities should adopt the ERO’s penalty guidelines, with changes or sup-

NERC BACKGROUND

How Did We Get Here?

Following the 1965 blackout in the Northeast, the electric utility industry established the North American Electric Reliability Council (NERC), a reliability organization that provided voluntary guidelines for operating and planning the bulk power system. For more than 30 years, the industry’s voluntary approach to compliance worked.

Then, during July and August 1996, Western portions of the United States experienced two cascading blackouts caused by problems arising in part from violations of NERC’s voluntary reliability standards. Responding to concerns about the blackouts, the Secretary of Energy convened a task force to advise the U.S. Department of Energy on possible solutions. The task force recommended, among other things, federal legislation that would grant the Federal Energy Regulatory Commission explicit authority to approve and oversee an organization responsible for ensuring compliance with mandatory, enforceable reliability standards. Congress, however, failed to act. Since 1998, a number of stand-alone electricity reliability bills, supported by NERC and a broad cross-section of the electric industry, were introduced in Congress. Until last summer, Congress failed to enact any of these reliability-related bills.

On Aug. 14, 2003, another major blackout occurred. This one affected large portions of the Midwest and Northeast, as well as Ontario. A joint U.S.-Canada task force studied the causes of the blackout and determined that several entities had violated NERC’s voluntary reliability standards—violations that directly contributed to the blackout. The joint task force identified the need for legislation to make reliability standards mandatory and enforceable and proposed the application of significant penalties for non-compliance. In August 2005, Congress took action. Included in EPACT was the Electricity Modernization Act of 2005, which provides a framework for the development of mandatory, enforceable reliability standards.

—SMS, MCG, WFH

plements only as necessary to reflect regional differences in a reliability standard. The ERO must approve any such changes by a regional entity and the ERO must submit them to FERC for approval.¹¹

Ways to Ensure Compliance

The new reliability regime created by EPACT and now taking shape through FERC’s Final Rule, the forthcoming establishment of the ERO, and the promulgation of mandatory reliability standards, will require utilities and other bulk power system users, owners, and operators to develop policies and procedures to ensure compliance. While there will not be one

“right way” to ensure compliance, some common process-oriented undertakings will help facilitate the achievement of compliance and the instillation of “cultures of compliance” that FERC expects of those subject to its rules.

■ **Procedures and Business Practices to Implement Reliability Standards.** FERC has not yet approved NERC’s proposed reliability standards as the final reliability standards, but it is not too early for bulk-power system users to begin the process of developing procedures and business practices for implementing the reliability standards. The outlines of the final reliability standards, if not the final details, are clear from NERC’s proposed standards. Entities should be planning their implementation guidelines and programs now.

■ **Training.** Employee buy-in of a culture of compliance with the ERO’s reliability standards (as part of an overall culture of compliance with all applicable regulatory requirements) will improve with the involvement of relevant employees in the training process. The key to success is to design a compliance-training program that provides practical guidance to affected employees, demonstrates senior management support, and gives employees opportunities to raise questions and discuss concerns.

■ **Compliance Assessment.** FERC has emphasized the importance of objective, third-party participation to assess compliance programs. Experience with other FERC compliance matters shows that third-party compliance assessments can help companies strengthen their compliance-related performance and demonstrate a commitment to compliance.

EPACT’s establishment of a new regulatory regime centered on bulk power-system reliability and mandatory compliance with new reliability standards increases the regulatory risk faced by every user, owner, and operator of the bulk power system. Companies that fail to comply risk substantial penalties and potentially significant reputational and financial risk.

Nevertheless, cost-effective compliance is feasible, and

companies that establish proactive compliance programs can protect themselves from reliability standards violations and the negative regulatory and financial consequences that will accompany those violations. Given the importance of reform and the significant potential consequences of failure, companies with a stake in the bulk power system should not delay in developing strategies to adapt to the new mandatory compliance world for electric reliability. ■

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Endnotes

1. Commission Staff Preliminary Assessment of the North American Electric Reliability Council’s Proposed Mandatory Reliability Standards (May 11, 2006).
2. Statement of Chairman Joseph T. Kelliher regarding promulgation of Reliability Final Rule, Feb. 2, 2006.
3. Rules Concerning Certification of the Electric Reliability Organization; and Procedures for the Establishment, Approval, and Enforcement of Electric Reliability Standards, Order No. 672, 71 FR 8,662 (Feb. 17, 2006), FERC Stats. & Regs. Regulations Preambles ¶ 31,204 (2006), order on reh’g, 114 FERC ¶ 61,328, Order No. 672-A.
4. 18 U.S.C. § 1505.
5. See, e.g., *United States v. Senffner*, 280 F3d 755, 761 (7th Cir. 2002) (an SEC investigation is a “proceeding”).
6. *Enforcement of Statutes, Orders, Rules, and Regulations, Policy Statement on Enforcement*, 113 FERC ¶ 61,068 (2005), 70 Fed. Reg. 66,378 (Nov. 2, 2005) (*Policy Statement on Enforcement*).
7. See, *Request of the North American Electric Reliability Council and North American Electric Reliability Corporation for Certification as the Electric Reliability Organization at Appendix 4 (FERC Docket No. RR06-1-000)*.
8. See, 18 C.F.R. § 39.7(c)(1)-(c)(2) (2006).
9. See, Final Rule at P 467-68.
10. See, Final Rule at P 561-64; See 18 C.F.R. § 39.7(g)(2) (2006).
11. See, Final Rule at P 561.

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