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C O U N S E L O R S   A T   L A W

# The New Reliability Enforcement Regime: FERC's Final Rule and NERC's Draft Application

Electric Utility Consultants, Inc.

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# Topics

- Topics for Discussion:
  - Electric Reliability Organization (ERO) qualifications
  - Proposing Reliability Standards
  - Delegation Agreements with Regional Entities (REs)
  - Enforcement and compliance program requirements
  - FERC's Penalty Authority
  - Conflicts
    - Reliability Standards and FERC-approved tariffs or orders; and
    - State action and Reliability Standards.
  - ERO and RE funding
  - Reliability reports
  - Regional Advisory Bodies
  - Need for Compliance

# Reliability – From Voluntary Compliance to Mandatory Standards

*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.*

Statement of Chairman Joseph T. Kelliher  
Regarding Promulgation of Reliability Final Rule  
February 2, 2006

# Background

- The Electricity Modernization Act of 2005 gave FERC significant new authority to ensure reliable operation of the bulk-power system.
- Voluntary compliance will be replaced by mandatory and enforceable Reliability Standards.
- FERC will certify a single ERO to oversee the reliability of the interconnected bulk-power system subject to FERC's ultimate oversight.
- FERC issued its Final Rule on Reliability (Final Rule) on February 3, 2006.

# Background

- NERC set to file its application to be certified as the ERO on April 4, 2006.
- The ERO will be responsible for developing and enforcing Reliability Standards, which will apply to all users, owners and operators of the bulk-power system.
- As part of its new power over reliability issues, FERC could impose civil penalties against those that have engaged in acts or practices that constitute violations of Reliability Standards.

# ERO Certification

- The Final Rule provides that FERC will certify one applicant as the ERO if it meets certain statutory criteria. 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 decisionmaking 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.

# ERO Certification

- As part of its ERO Application, NERC intends to file, among other things, its Rules of Procedure and its Version 0 Reliability Standards. Issues include:
  - Will the ERO “push down” rule changes on the REs? If so, how will it accomplish this?
  - Will FERC make major changes to the Version 0 Reliability Standards? If so, will FERC allow for implementation of a Version 0 Reliability Standard in the interim if FERC remands it for modification?

# ERO Certification

- The Final Rule requires the ERO to provide a self-assessment three years after certification and every five years thereafter, explaining how it satisfies the statutory requirements.
- FERC expects the assessment to include regular and systematic measurement and reporting of the ERO's performance.
- The ERO's assessment must also include:
  - an explanation of how it continues to satisfy the certification requirements;
  - recommendations by REs and other entities for improvement of ERO operations as well as ERO's response to such recommendations; and
  - ERO's evaluation of the effectiveness of each RE, recommendations for improvement of the RE's performance of delegated functions, and the RE's response to such evaluation and recommendations.

# ERO Certification

- Upon review of the performance assessment, FERC will issue an order either finding that the ERO meets the statutory and regulatory criteria or that the ERO has failed to comply.
- If the ERO fails to comply, FERC may take action, including decertifying the ERO.
- As part of its proceeding to assess the ERO's performance, FERC will also determine if each RE is complying with the statutory and regulatory criteria.
- If FERC finds that a RE is not in compliance, FERC may rescind its approval of the RE's delegation agreement.

# Adoption of Reliability Standards

- Consistent with Section 215 of the FPA, the Final Rule establishes the ERO as the only entity that can submit a proposed Reliability Standard to FERC for approval.
- REs may propose Reliability Standards to the ERO, but ultimately it will be the ERO that will submit such standards to FERC.
- FERC's Final Rule also discusses regional differences but will let the ERO define the different categories.

# Reliability Standards

- FERC may approve a proposed Reliability Standard, or a proposed modification to a Reliability Standard, if it determines the proposed Reliability Standard is just, reasonable, not unduly discriminatory or preferential, and in the public interest.
- The ERO shall rebuttably presume that a proposal for a Reliability Standard, or a modification to a Reliability Standard, meets the statutory standard if such proposal is from a RE organized on an Interconnection-wide basis.
- In reviewing proposed Reliability Standards, FERC will give due weight to the technical expertise of the ERO, or a RE organized on an Interconnection-wide basis, with respect to the content of a proposed Reliability Standard or a proposed modification to a Reliability Standard.

# Reliability Standards

- FERC will also give “appropriate weight” to the expertise of any RE in reviewing proposed regional standards; however, no rebuttable presumption of validity shall be provided to REs not organized on an Interconnection-wide basis.
- FERC states in its Final Rule that it will allow the ERO to develop proposed Reliability Standards that appropriately balance reliability principles and implementation features. FERC will not, however, defer to the ERO or a Regional Entity with respect to the effect of a proposed Reliability Standard on competition.

# Reliability Standards

- An approved Reliability Standard or modification to a Reliability Standard shall take effect as approved by FERC.
- If it disapproves a Reliability Standard in whole or in part, FERC will remand 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 modification to a Reliability Standard, if FERC considers a new or modified Reliability Standard appropriate to carry out its responsibilities under section 215 of the FPA.

# Delegation Agreements

- ERO may delegate authority to an RE if:
  - the RE is governed by an independent board, a balanced stakeholder board, or a combination of the two;
  - the RE otherwise satisfies the criteria required for certification of the ERO; and
  - the agreement promotes effective and efficient management of the Bulk-Power System.

# Other Regional Entity Functions

- FERC states it will not prohibit a Regional Entity from performing other reliability-related functions in service to its region.
- A Regional Entity may conduct such activities, provided that they do not conflict or interfere with the performance of a delegated function, which FERC views as the primary mission of a Regional Entity.
- Any additional activity must not compromise the oversight role or the independence of the Regional Entity and must not present a conflict of interest with the Regional Entity's reliability oversight role of transmission operators.
- Funding for these activities also must not compromise the independence of the Regional Entity.

# Regional Entity - Size and Scope

- FERC does not set criteria in the Final Rule for an RE's size, scope and configuration, but will evaluate each RE application on a case-by-case basis.
- Any change in the size, scope or configuration of an RE would constitute an amendment to the delegation agreement and would be subject to review by the ERO and approval by FERC.
- The Delegation Agreement thus should have some description of the RE's geographic configuration.

# Delegation Agreements

- It is anticipated that the existing regional reliability councils will seek to become the initial REs.
- It will consider a delegation agreement between the ERO and an existing regional reliability council in light of whether the application demonstrates compliance with the criteria to qualify as an RE.
- FERC may consider reconfiguration or consolidation if a specific problem is raised in the approval process or subsequently if inadequate scope or configuration or other factors hamper the performance of an RE.

# Delegation Agreements

- The Final Rule also addresses the subject of uniformity among delegation agreements.
- The Final Rule requires the ERO applicant to submit a *pro forma* delegation agreement concurrently with its ERO application.
- The Final Rule clarifies that an RE should not directly submit an RE Rule or Rule change to FERC. FERC directs the ERO to develop procedures and criteria by which an RE Rule or change to Regional Entity Rule will be judged by the ERO, and then be submitted to FERC for approval.

# Compliance and Enforcement

- The ERO, or a Regional Entity, may impose a penalty on an entity for a violation of a standard approved by FERC if the ERO or the Regional Entity:
  - finds that the entity has violated a reliability standard; and
  - the ERO files notice and the record of the ERO's or Regional Entity's proceeding with FERC.
- The Final Rule also requires that in conjunction with the filing of notice with FERC, the ERO simultaneously serve a copy of the notice of penalty on the entity that is the subject of the penalty.
- The Final Rule also sets forth the materials that must be included in the notice filed with FERC.

# Compliance and Enforcement

- FERC stated in its Final Rule that an appeals process at the ERO or RE level is appropriate and found that there should be a single appeal at either the ERO or the RE level.
- An entity that is the subject of a penalty may not elect to bypass the appeals process established by the ERO and seek immediate Commission review without the approval of the ERO.

# Compliance and Enforcement

- A penalty may take effect no earlier than the thirty-first (31st) day after the ERO or RE files with FERC notice of the penalty and the record of the proceedings.
- Such penalty shall be subject to review by FERC, on its own motion or upon application by the entity that is the subject of the penalty.
- An entity subject to a penalty must file within thirty (30) days after the date a notice of violation is filed with Commission.
- In the absence of the filing of an application for review or action by FERC, the enforcement action shall be affirmed by operation of law upon the expiration of the 30-day period.

# Compliance and Enforcement

- In any penalty review proceeding, FERC shall by order affirm, set aside or modify the penalty and, if appropriate, remand to the ERO or Regional Entity for further proceedings.
- If an entity subject to a penalty seeks review by FERC, its application shall contain a complete and detailed explanation of the reasons why the applicant believes that the ERO or RE erred.
- The application may provide any additional support not included in the record submitted by the ERO.

# Compliance and Enforcement

- FERC may issue an order on the merits to affirm, set aside, reinstate or modify the penalty and, if appropriate, remand to the ERO based upon the pleadings.
- FERC may also establish a hearing before an ALJ or initiate such further procedures as may be appropriate.
- FERC shall take action on an application for review of a penalty within sixty (60) days of the date the application is filed unless it determines on a case-by-case basis that an alternative expedited procedure is appropriate.
- Application to FERC for review, or the initiation of review by FERC on its own motion, shall not operate as a stay of a penalty unless FERC otherwise orders.

# Compliance and Enforcement

- FERC has included prior notice and audit requirements, so that it is aware of potential problems and alleged violations before they threaten bulk-power system reliability. In FERC's view, this will allow it to stay ahead of reliability issues and proactively manage possible reliability events.
- Towards that end, the ERO and each RE must have a program that provides for rigorous audits of compliance with Reliability Standards by users, owners and operators of the bulk-power system.
- Also, any person that submits an application to FERC for certification as the ERO, or any agreement for the delegation of enforcement authority to an RE, must include a proposal for the prompt reporting to FERC of any: (1) self-reported violation; (2) investigation of a violation; or (3) potential violation of a Reliability Standard and its eventual disposition.

# Compliance and Enforcement

- Other important aspects of the compliance and enforcement program include:
  - INPO-Type Programs. FERC will require the ERO to make a compliance filing no later than one year from the date of certification that proposes reliability enhancement programs, along with a program implementation schedule.
    - INPO has been extremely successful and FERC is seeking ways to mirror industry-driven approaches to best practices.
    - Many REs believe that they currently have programs in place that encourage industry-driven best practices.

# Compliance and Enforcement

- Other important aspects of the compliance and enforcement program include:
  - Compliance Directives. According to FERC, the ERO or RE may conclude, based on the evidence available to it, that an entity is violating a Reliability Standard and may issue a compliance directive.
    - Such compliance directives may establish a timetable for compliance.
    - Because a compliance directive is a remedial action and not a penalty, it does not have to satisfy the 31-day waiting period to take effect.
    - The ERO or RE must inform FERC of any compliance directives.
    - FERC directs ERO applicants to specify in their application these and other types of remedial actions that may be undertaken without invoking the waiting period required for monetary and non-monetary penalties to be imposed.
    - FERC will allow the ERO and REs to further clarify the distinction between a remedial action and a non-monetary penalty in the ERO certification application, penalty guidelines or delegation agreement.

# Compliance Directives

- FERC's discussion of compliance directives raises some important issues.
- Under the rule compliance directives may be implemented quickly without satisfying 31-day waiting period.
- Example: What if compliance directive requires entity to meet a Reliability Standard and to do so the entity must invest \$20 million in transmission upgrades, which will take five years to complete?
- These directives might be more burdensome than penalties.
- FERC has left it to ERO applicants to propose procedures to implement such directives; not clear if NERC has focused on this issue.

# Compliance and Enforcement

- Other important aspects of the compliance and enforcement program include:
  - Penalty Guidelines. FERC concludes that penalty guidelines, developed by the ERO and approved by FERC, would provide a predictable, uniform and rational approach to the imposition of penalties.
    - 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 an RE for determining the appropriate penalty for the violation of a Reliability Standard.
    - REs should adopt the penalty guidelines, with changes or supplements only as necessary to reflect regional differences in a Reliability Standard.
    - Any such changes by an RE must be approved by the ERO and the ERO must submit them to FERC for approval.

# FERC's Penalty Authority

- In addition to the penalty guidelines adopted by the ERO, FERC has significant penalty authority of its own for violation of reliability standards.
- FERC's new civil penalty authority allows it to issue penalties of as much as \$1 million per day for a violation of any provision contained in Part II of the FPA. See FPA, § 316A.
- In a Policy Statement issued in February 2005, FERC stated that "Good Utility Practice" required under the Commission's open access transmission tariff includes compliance with NERC's Version 0 Reliability Standards.
- Remains to be seen how FERC will implement its current penalty authority in conjunction with the penalty guidelines submitted by the ERO.

# Conflicts – Reliability Standards and FERC Orders

- Final Rule provides process for a Transmission Organization to notify FERC of a conflict between a Reliability Standard and a FERC Order or existing practice, in accordance with Section 215(d)(6) of the FPA.
- Under the Final Rule, if it is determined that a Reliability Standard may conflict with an existing practice, a Transmission Organization must notify FERC, the ERO and the relevant Regional Entity of the conflict.

# Conflicts – Reliability Standards and FERC Orders

- Within sixty days, FERC will issue an order determining whether such a conflict does exist.
- If FERC finds that there is a conflict, it will either direct the Transmission Organization to file a modification to the conflicting practice or direct the ERO to develop a proposed modification to the conflicting reliability standard.
- Until a determination is made, the Transmission Organization shall continue to follow the existing practice.

# Conflicts – Review of State Action

- Under the Final Rule, where a state takes action to ensure the safety, adequacy, or reliability of electric service, the ERO, a Regional Entity or other affected person may apply to FERC to determine consistency of the state action with a Reliability Standard.
- The application shall: (1) identify the state action; (2) identify the Reliability Standard with which the state action is alleged to be inconsistent; (3) state the basis for the allegation that the state action is inconsistent with the Reliability Standard; and (4) be served on the relevant state agency and the ERO, concurrent with its filing with FERC.
- Within ninety days of the application, FERC will issue a final order. FERC may stay the effectiveness of the state action, pending issuance of a final order.

# ERO and RE Funding

- **Delegated and Non-Delegated Activity Funding**
  - Section 215 of the FPA generally provides FERC authority to authorize funding for statutory functions.
  - In its Final Rule, FERC clarifies that while the ERO or a Regional Entity is not precluded from pursuing other activities funded from other sources, it may not use Commission-authorized funding for such activities and should arrange funds for its other activities on its own.
  - Because the ERO and REs may pursue other activities funded from other sources, the issue has become how to reflect these delegated and non-delegated functions in the Delegation Agreement.

# ERO and RE Funding

- The Final Rule directs ERO applicants to propose a method of funding addressing cost allocation and cost responsibility, along with a proposed mechanism for revenue collection.
- FERC added that funding based on “net energy for load” is one method that minimizes the possibility of double-counting; however, it did not rule out other methods shown to be just and reasonable.

# ERO and RE Funding

- As part of its oversight responsibilities, FERC required the ERO to submit its business plan, budget, and organizational chart to FERC, including those portions pertaining to activities in Canada and Mexico and any non-statutory activities.
- According to FERC, the complete business plan and the entire budget will allow FERC to determine the portion of the budget spent upon activities within the United States, and will provide it with necessary information about any non-statutory activities, the source of their funding, and whether the pursuit of such activities presents a conflict of interest for the ERO.

# ERO and RE Funding

- FERC also found that the ERO should fund the Regional Entities as well as approve their budgets, under FERC's general oversight. FERC clarified that its oversight, however, is limited to the delegated activities performed by a Regional Entity.
- In addition to the ERO budget review process, each Regional Entity must also submit its business plan, budget and organizational chart to the ERO, who shall in turn submit it to FERC.
- The business plan and the budget will provide FERC with necessary information about any non-statutory activities, the source of their funding, and whether the pursuit of such activities presents a conflict of interest for the Regional Entity.

# ERO and RE Funding

- For a Cross-Border Regional Entity, this information will also inform FERC as to what portion of the budget is spent upon activities within the United States.
- According to FERC, procedures for ERO review of a Regional Entity's budget should be addressed in the delegation agreement.
- Further, the ERO and each Regional Entity must ensure that the delegation agreement lists all the statutory activities that they intend the Regional Entity to undertake on behalf of the ERO.
- The Final Rule also requires periodic financial audits of Regional Entities.

# ERO and RE Funding

- The ERO also should include line-item budgets for the activities that it delegates to each Regional Entity and propose a plan for the collection of sufficient funds for delegated activities in their application for certification.
- The Final Rule further permits the ERO to request emergency funding on a demonstration of unforeseen and extraordinary circumstances.
- It also clarifies that Commission review and approval of ERO and Cross-Border Regional Entity funding mechanisms will be limited to their application in the United States

# Reliability Reports

- Under the Final Rule the ERO shall conduct assessments of the reliability of the bulk-power system in North America and provide reports to FERC regarding the same.
- The ERO must also conduct assessments of the adequacy of the bulk-power system in North America and report its findings to the Commission, the Secretary of Energy, each Regional Entity, and each Regional Advisory Body at least annually.

# Regional Advisory Bodies


- The Final Rule also allows for FERC to establish a Regional Advisory Body on the petition of at least two-thirds of the states within a region that have more than one-half of their electric load served within the region.
- A petition to establish a Regional Advisory Body shall include a statement that the Regional Advisory Body is composed of one member from each participating state in the region, appointed by the governor of each state.
- The Regional Advisory Body may include representatives of agencies, states and provinces outside the United States.

# Regional Advisory Bodies

- Regional Advisory Body may provide advice to the ERO, an RE or FERC regarding:
  - the governance of an existing or proposed Regional Entity within the same region;
  - whether a Reliability Standard proposed to apply within the region is just, reasonable, not unduly discriminatory or preferential, and in the public interest;
  - whether fees for all activities under this part proposed to be assessed within the region are just, reasonable, not unduly discriminatory or preferential, and in the public interest; and
  - any other responsibilities requested by the Commission. FERC may give deference to the advice of a Regional Advisory Body organized on an Interconnection-wide basis.

# Conclusion

- A new regulatory regime has been created.
- FERC intends to increase staff and utilize all resources at its disposal to determine if Reliability Standards are being violated.
- Entities need to treat this new regulatory regime as it would any other compliance need; the penalties will be just as severe.
- If the REs don't enforce, then the ERO will. If the ERO does not enforce, FERC will.



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