

Morgan Lewis

Managing Regulatory Impacts on Generators

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Presentation Overview

- Laying the Groundwork for an Effective Compliance Program and Culture
- Unique Aspects of the FERC/NERC/Regional Regulatory Framework
- The Evolution of Mandatory Standards Compliance and ERO/FERC Activities
- Assessing Regulatory Exposure and Resource Utilization
- Key On-Going Issues and Concerns for Generators

Building an Effective Compliance Culture

Dedicated
Resources

Document
Control and
Quality

Publicize

Stay
Involved

Structure

Continuous
Improvement

Demonstrating a Culture of Compliance in CMEP Proceedings

- Significant mitigating factor for audit risk and enforcement actions
- How can you demonstrate a “culture of compliance”?
 - Examples:
 - A written program
 - Program documentation readily available
 - Understanding of how to demonstrate compliance
 - Single points of contact
 - On-going compliance training, including the field staff (documents are marked that are compliance mandatory) and “buy in”
 - Ability to get information quickly in response to requests
 - Cooperation with RE and NERC personnel (flexibility for change to schedule, provide additional information, etc.)
 - Continuous compliance efforts and testing (internal self assessments, self-reporting, compliance training)
 - Senior management engagement
 - Bottom line: Effective compliance programs *Detect, Report, and Correct* (see Commission guidance, US sentencing guidelines, NERC sanction guidelines)

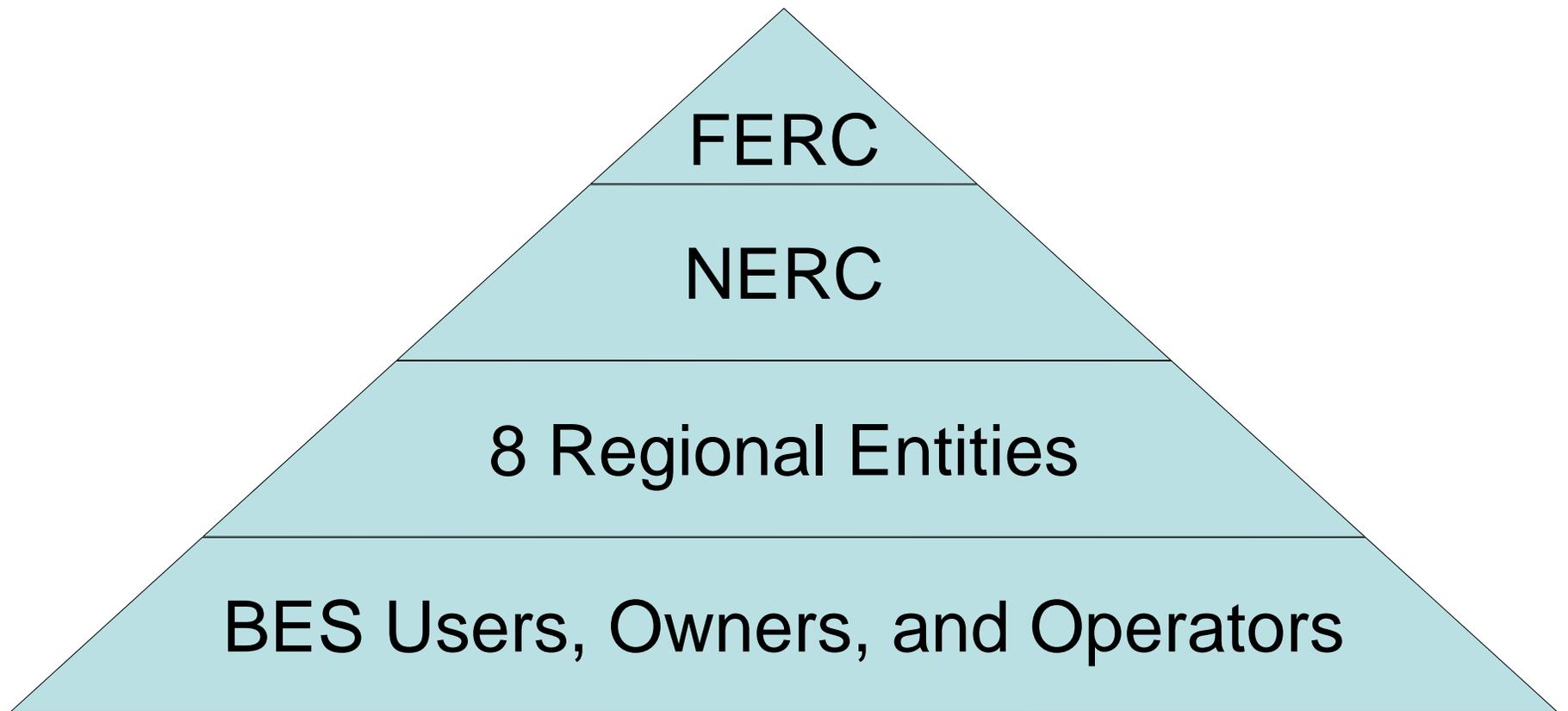
The Road to Mandatory Standards and the Current ERO Framework

- 1965: Northeast blackout leads to creation of North American Electric Reliability Council
 - Voluntary guidelines for BES operations
- Summer 1996: blackouts in western U.S.
 - DOE task force recommends federal legislation to make Reliability Standards mandatory
- August 14, 2003: Northeast blackout
 - U.S.-Canada Power System Outage Task Force recommends federal legislation
 - Congress creates section 215 of the Federal Power Act as part of the Energy Policy Act of 2005
 - Creates ERO structure and mandatory reliability compliance

Certification of NERC as the Electric Reliability Organization

- In July 2006, FERC certifies NERC as the Electric Reliability Organization, finding that NERC has:
 - 1) The ability to develop Reliability Standards that provide for an adequate level of reliability
 - 2) Rules that:
 - Assure independence
 - Assure fair stakeholder representation
 - Equitably allocate costs
 - Provide fair and impartial enforcement procedures
 - Provide for notice and comment, due process, openness, and balance in standards development
 - Provide for measures to achieve international recognition

Section 215 Structure



FERC Section 215 Authority and Responsibilities

- FERC retains ultimate authority over all matters related to mandatory Reliability Standards compliance
 - Approval of NERC and Regional Entities
 - Approval of Reliability Standards
 - Approval of all monetary sanctions for violations of Reliability Standards
 - Approval of budgets and business plans for NERC and Regional Entities
- FERC's day-to-day involvement
 - Reliability Standards development
 - Enforcement proceedings (individually and with NERC/Regions)
- Relevant FERC offices:
 - Office of Electric Reliability
 - Office of Enforcement

NERC Section 215 Authority and Responsibilities

- NERC's main responsibilities are:
 - Development of mandatory Reliability Standards
 - Stakeholder-driven, with assistance from NERC Staff
 - Enforcement of mandatory Reliability Standards
 - Professional NERC Staff, with industry volunteers from time-to-time
- Board of Trustees is ultimate authority
- President and CEO has day-to-day authority
- NERC Committees
 - BoT committees for key statutory functions
 - Stakeholder committees for other functions
 - Working Groups and Task Forces under these committees

Regional Entities

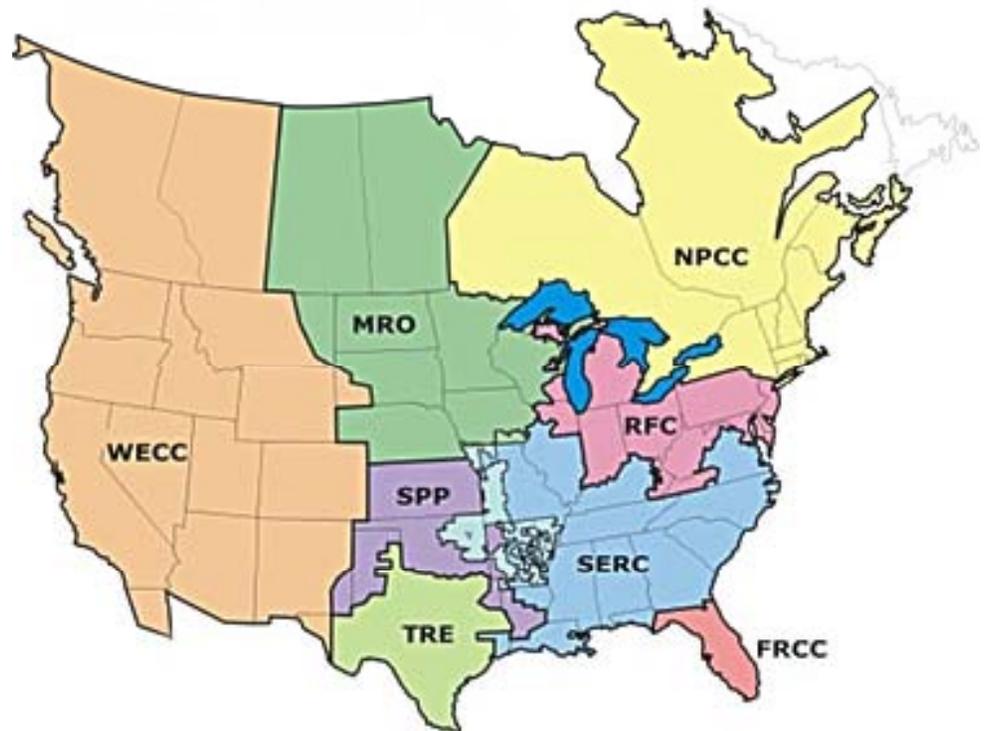
8 Regional Entities with delegated authority from NERC

- Two interconnection-wide
 - Special benefits
- Six for the Eastern Interconnection

Boards have three possible structures:

- 1) Independent board
- 2) Balanced stakeholder board
- 3) Combination independent and balanced stakeholder board

Regions develop Regional Reliability Standards and enforce compliance with Reliability Standards in their areas



Challenges in Standards Development: Who Writes the Reliability Standards?

- The legislative authority over Reliability Standards is split between FERC and NERC:
 - NERC drafts Reliability Standards and proposes them for approval: “The Electric Reliability Organization shall file each reliability standard or modification to a reliability standard that it proposes to be made effective under this section with the Commission.”
 - The Commission may approve, reject, or remand a proposed Reliability Standard: “The Commission may approve, by rule or order, a proposed reliability standard or modification to a reliability standard if it determines that the standard is just, reasonable, not unduly discriminatory or preferential, and in the public interest.”

Challenges in Standards Development: FERC Directives to Modify Standards

- But what sort of authority does FERC have to order changes to a Standard?
 - Directive to NERC to change a Standard to address a particular issue
 - But NERC is free to develop an alternative so long as it technically supports it and addresses FERC's concern
- NERC can develop an alternative proposals that is equally efficient and effective as the Commission's directive so long as NERC provides a strong technical justification for its proposal
- FERC has exercised this authority resolutely when it deems that key reliability values are threatened

Challenges in Standards Enforcement: Processing Violations in this Structure

- Violation backlog continues to grow:
 - Approx. 227 violations reported per month
 - Typically 50-150 resolutions approved by BoT per month
- Average of 330 days from discovery of violation by NERC to validation of the completion of the mitigation plan due to ongoing feedback loops.



It's Getting Better: The Evolution of Standards and Standards Enforcement

- Standards and Enforcement have both improved since 2007 as NERC and the Regions have developed and gained experience
- Standards:
 - More precise and measurable, losing some of the vagueness of Version 0
 - More technical demands rather than general guidance, supported by stronger technical justifications
 - Easier to understand and follow with additional guidance documents
- Enforcement:
 - More focused on high-risk violations
 - Growing discretion by Regional Entities and NERC
 - Willingness to use FFT process to short-circuit unnecessary compliance paperwork
 - Faster processing at NERC

A Success Story: No More Penalties for Everything?

- FERC enforcement actions do not always result in monetary penalties, even though noncompliance is found
 - FERC enforcement staff has significant discretion
 - FERC audits regularly uncover noncompliance, but typically do not refer them to investigations staff for potential monetary penalties
 - Generally no small FERC penalties
- Until recently, NERC enforcement actions often resulted in a formal monetary sanction, even for a \$0 monetary penalty, a full settlement agreement was required
 - Possibly due to lack of discretion provided
 - This created significant delays in addressing noncompliance
 - Incidents of noncompliance cannot be prioritized
- BUT, the FFT process is beginning to change this

Strategies for Maximizing Generation Compliance Resources



Key Areas of Compliance Exposure for Generators

- Compliance should emphasize known areas of significant risk, because improvements here provided the most bang for the buck in reducing regulatory exposure
- Certain Reliability Standards are seen as presenting especially large risk due to the importance of the protections provided

= Higher scrutiny in compliance monitoring

= Higher penalties for violations

- PRC-005
- FAC-008/FAC-009
- CIP (which is only going to get bigger)
- VAR-002
- Event-related Standards (EOP, TOP actions, etc.)

Resources vs. Reliability Benefits

- Reliability Standards compliance can be expensive, but the agencies responsible for developing and approving Reliability Standards (NERC and FERC) do not bear the cost of compliance, have no ratepayers, and are politically insulated
 - This creates a concern that new Reliability Standards or FERC directives to do not provide the greatest amount of protection for the cost imposed due to the lack of economic incentives for NERC and FERC
- Traditional cost-based regulated utilities can usually recover reliability costs in rates, but the state commissions are beginning to push back
- Market-based rate utilities, IPPs, and others without cost-based rates must eat the cost

Key Concerns: Major NERC Projects Affecting Generators

- Helping to shape Standards development and preparing for likely compliance obligations ahead of time reduces compliance risk and demonstrates a good culture of compliance.

Tie Lines

- TO/TOP Responsibility for generator tie lines

CIP Ver.5

- Much larger number of generators likely to be responsible for CIP compliance

Relay Loadability

- PRC-023 type requirements for generator relays

Key Concerns: Cyber Security Compliance Risk Continues to Increase

CIP Versions 1 through 3

Risk-Based Methodology

Few Generation Assets



CIP Version 4 (NOPR stage)

Bright-Line Criteria

All Large Generators



CIP Version 5 (Under Development)

Bright-Line Criteria

High/Medium Impact Split

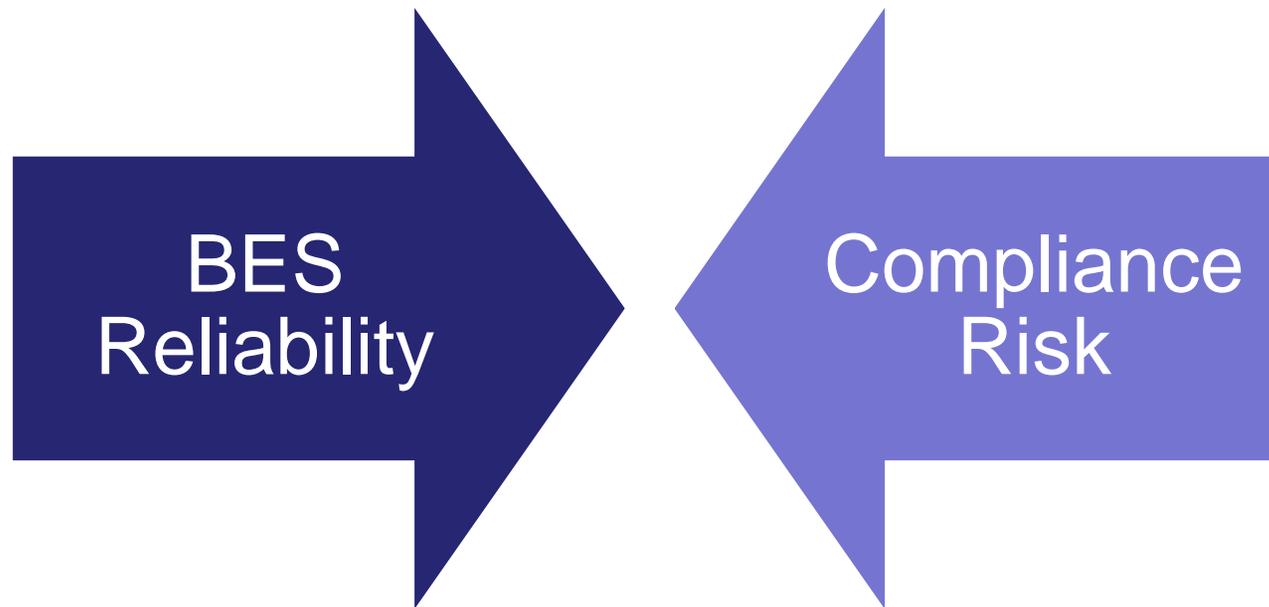
Key Concerns: Risks on the CIP Compliance Horizon

- When the first major cyber attack on an electric utility occurs, it will result in:
 - Significant federal investigations by FERC, DOE, DHS, and Congress
 - Major financial sanctions for the utility
 - Significant, increased compliance costs for other utilities
- New cyber security legislation remains a possibility, although it is often in response to new headlines and events. Possible characteristics that have been discussed include:
 - All critical industries must have cyber security plans approved by DHS
 - No development role for NERC; FERC is only development authority, with potential exception from notice and comment rulemaking
 - Authority transferred to an executive agency (e.g. Commerce or DHS)
 - Broader authority over more industries, not just electricity

Key Concerns: The Risks of Voluntary Sharing

- Bulk electric system reliability is strengthened by inter-utility sharing of best practices and lessons learned, and the early voluntary Reliability Standards, and NERC itself, grew out of these practices.
- However, under mandatory and enforceable Reliability Standards, these efforts have risks, particularly in the aftermath of a reliability event:
 - A spot check or investigation will follow on the event
 - Lessons learned sharing will create a trail of un-privileged, un-vetted, and potentially inaccurate information that could be used in an enforcement proceeding

Key Concerns: Lessons Learned and Event Analysis



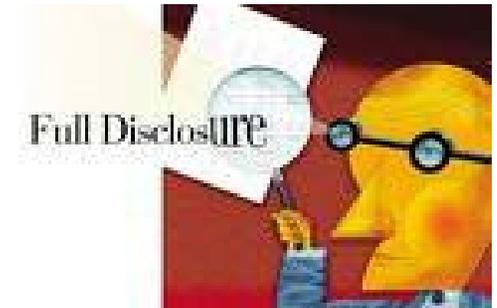
Recommendation: Make an intentional, case-by-case decision when engaging in these activities. These are critical exercises, but decisions regarding participation should consider the compliance risks involved.

Key Concerns: Increasing Penalties for Repeated Violations

- FERC is increasingly scrutinizing repeated violations by the same or affiliated Registered Entities
- The Commission has directed NERC to consider a violation repetitive if it is:
 - the result of conduct similar to the conduct underlying the previous violation of the same, or a closely-related, Reliability Standard Requirement,
 - the result of conduct addressed in a company's mitigation plan for a prior violation of the same, or a closely-related, Reliability Standard Requirement, or
 - an additional violation of the same Reliability Standard Requirement
- An affiliate's violation can be grounds for a finding of a repeat violation if the prior violation involved:
 - an affiliate operated by the same corporate entity or
 - an affiliate whose reliability compliance activities are conducted by the same corporate entity
- Whether the violations happened in different Regions is irrelevant
- Violations that are considered "repetitive" are subject to heightened sanctions

Key Concerns: Should I Self-Report?

- There is no affirmative duty to self-report
- Self-reporting is a significant mitigating factor in sanction determinations
 - BUT failing to self-report is not an aggravating factor
 - Quick remedial action and documentation of the event and the response is essential
- Certainty regarding violation
 - Is it dependent on your interpretation of a Requirement?
 - Has there been a Notice of Penalty regarding a violation of the same Requirement or based on the same facts?
- How significant is the violation?
- Is the mitigating credit worth it?
- The self-certification conundrum
- Self-reports in an FFT world



Questions?

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