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The compliance risk equation: Preparing for the "new" FERC

Introduction

The relationship between players in the U.S. energy industry and the Federal Energy Regulatory Commission (FERC) has changed significantly, largely because of the Energy Policy Act of 2005 ("EPAct"). EPAct resulted in the most significant expansion in FERC authority since it was charged with regulating the sale and transportation of electricity and natural gas by the 1935 Federal Power Act and 1938 Natural Gas Act.

Criticized in the past for being too passive, FERC has run with its new authority, stepping up enforcement activity. It is looking more like a cop on the beat, much in the mold of the Securities and Exchange Commission. At the same time, FERC is championing a goal of compliance, urging companies to develop comprehensive compliance programs, and signaling that a robust program would be considered a mitigating factor in FERC investigations. As a result, adhering to FERC requirements is of growing concern for all market participants.

Unfortunately, compliance is more than simply aiming to refrain from market manipulation. First, many penalty cases do not involve market manipulation. And second, it is not necessarily evident what constitutes such manipulation; the scope could be very broad. The result is a heavier burden on firms that trade and transport energy, as well as on the end users, who joined the ranks of those directly affected by FERC rules and regulations with passage of EPAct.

That said, clues to FERC expectations surrounding compliance programs can be found in its recent policy statements, as well as in settlements reached with companies regarding violations.

History

FERC's history is one of a burgeoning mission and mounting authority, paralleling the growth and development of U.S. energy industries. Established in 1920 as the Federal Power Commission (FPC), it was initially charged with licensing nonfederal hydroelectric projects.

Adjustments made in the Commission's first 15 years of existence were largely organizational. After that point, the evolution of mission began, with legislation, court decisions, and rulemaking. Mile-markers rising across that evolution represent attempts by the federal government to protect consumers and right energy markets.

Generally, early action centered on protecting consumers in monopoly markets. Congress granted the Commission the power to regulate the sale and transportation of electricity and natural gas with the Federal Power Act of 1935 and the Natural Gas Act of 1938. Amendments to the Gas Act in 1940 authorized the Commission to certify and regulate natural gas facilities.

In 1954 and 1964 decisions, the U.S. Supreme Court ruled that the Commission had jurisdiction over facilities producing gas sold in interstate commerce and over intrastate sales of power that had been transmitted across state lines. In 1967, jurisdiction extended to intrastate utilities that tied their supply lines to those in other states.

The FPC was reorganized in 1977 as FERC, with establishment of the Department of Energy, and the regulation of oil pipelines added to its duties. FERC quickly initiated three decades of deregulation, restructuring the natural gas and electric industries. The next year, intrastate

November 2009

and interstate gas markets were made one under the National Gas Policy Act, revising regulation of gas sales to correct see-sawing supplies, induced by more than 20 years of price controls. Also in 1978, amid concerns about the security of the nation's electricity supply, the Public Utility Regulatory Policies Act opened wholesale power markets to nonutility producers of electricity. The Energy Policy Act of 1992 further facilitated competition in that arena.

In addition to jurisdictional market-based sellers, natural gas pipelines, and holders of blanket certificates, for example, it (FERC) now wields power over capacity holders, natural gas sellers, and natural gas buyers.

A series of firestorms burst across energy markets from 2000 to 2003. An energy crisis shook up the West in 2000-2001, and FERC ultimately traced it, in part, to widespread manipulation of the electricity and natural gas markets by Enron and 30 other energy companies. Around the same time, it became clear that there had been false price reporting to gas and electricity price indexes, the energy-trading yardsticks.

The crises spurred Congress to arm FERC with additional enforcement authority in the Energy Policy Act of 2005, signed into law on August 8, 2005. FERC was not required to do anything with its new authority, but felt compelled to act in the face of the crises. In January 2006, FERC issued Order No. 670, authorizing the Commission to prohibit market manipulation by any entity in connection with the purchase or sale of natural gas or electricity. This authority encompassed companies that had not previously fallen under FERC jurisdiction, including end users.

FERC reacts

EPAct 2005 amended the Natural Gas Act and the Federal Power Act to bar manipulation or deception in the purchase or sale of natural gas and electric energy and in their transportation or transmission. The amendments mimic the language of section 10(b) of the Securities and Exchange Act of 1934. As a result, the Commission modeled implementing Order No. 670 after SEC Rule 10b-5, which put into place that section of the Exchange Act.

Specifically, the EPAct amendments make it illegal to:

- Use or employ any device, scheme, or artifice to defraud
- Make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading
- Engage in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any person

EPAct extended FERC's reach as well, authorizing the Commission to obtain information from "any market participant." That affects entities not previously directly under FERC's regulatory thumb. In addition to jurisdictional market-based sellers, natural gas pipelines, and holders of blanket certificates, for example, it now wields power over capacity holders, natural gas sellers, and natural gas buyers. In addition to regulated utilities, its reach takes in governmental utilities.

To assist FERC in effectively wielding its new power, EPAct dramatically increased its penalty authority. The Commission may impose civil penalties of up to $1 million per day per violation. The criminal penalty is up to $1 million and/or up to five years in jail. FERC may also force disgorgement of "unjust profits," loss of trading privileges, and payment of investigation and defense costs.

The Commission has been aggressive in using its new penalty authority, largely in the natural gas arena. Violations of "down in the weeds" FERC rules and regulations, including tariff violations, have resulted in millions of dollars in penalties.

Guidance – Civil Enforcement
- Policy Statement on Enforcement (Oct. 20, 2005)
- Revised Policy Statement on Enforcement (May 15, 2008)
- Policy Statement on Compliance (Oct. 16, 2008)
- Statement of Administrative Policy Regarding the Process for Assessing Civil Penalties (Dec. 21, 2006)
- 2008 Report on Enforcement (Oct. 31, 2008)
- 2007 Report on Enforcement (Nov. 14, 2007)

Guidance – Criminal Enforcement
"We do, of course, reserve the right … to refer a violation for criminal prosecution if the facts of the case so warrant …. We will take all factors into account in deciding what cases should be referred for criminal prosecution, including the seriousness of the violation, the extent of the harm done, the evidence of willful behavior, and the strength of the evidence of wrongdoing."

Policy Statement on Enforcement (2005)

Criminal Referrals
- FERC authorized to refer cases to DOJ
- To institute criminal proceedings
- Subject to discretion of DOJ prosecutors
  - NGA § 20(a), 15 U.S.C. § 717s(a)
  - NGPA § 504(b)(5), 15 U.S.C. § 3414(b)(5)
  - FPA § 314(a), 16 U.S.C. § 825m(a)

Criminal Provisions
- Willful and knowing violations of statutes
  - Maximum sentence = $1 million fine and 5 years' imprisonment
- Willful and knowing violations of rules, regulations, or orders
  - Maximum penalty = $50,000 fine per day of offense
    - NGA § 21, 15 U.S.C. § 717t ("General Penalties")
    - NGPA § 504(c), 15 U.S.C. § 3414(c)
  - Maximum penalty = $25,000 fine per day of offense
    - FPA § 316, 16 U.S.C. § 825o.

Regarding criminal charges, the Natural Gas Policy Act defines "knowingly" to require only "constructive knowledge deemed to be possessed by a reasonable individual who acts under similar circumstances." The FERC Rule on Energy Market Manipulation provides that recklessness satisfies the "knowingly" element. Under the NGA and FPA, prohibited conduct includes doing a prohibited act or omitting or failing to do a required act or "cause or suffer such omission or failure."

Capacity release

The capacity release area shows the expansion of FERC's regulatory reach and how it is flexing enforcement muscle. The capacity release program is considered central to FERC's natural gas regulation. Furthermore, EPAct directed FERC "to facilitate price transparency in the markets for the sale or transportation of physical natural gas," authorizing it to obtain information from "any market participant" in that mission. That brought capacity holders into FERC's regulatory arena.

Transparency is key to FERC's detection of market manipulation as well as its ability to assess market forces. Regulators need to know who is holding capacity in order to monitor its movement and guard against wildly fluctuating supply and demand.

Shippers possessing excess capacity may temporarily or permanently release capacity to replacement shippers through an open posting and bidding process. This provides the means for reallocating unused capacity, creates transparency, and encourages nondiscriminatory treatment.

Three core principles are involved:
- The shipper-must-have-title requirement
- The prohibition on buy/sells
- The prohibition on tying arrangements

The shipper-must-have-title requirement prevents a capacity holder from allowing a third party to use its capacity to move the third party's gas. It also prevents shippers from providing unregulated transportation services, and promotes transparency and allocation to the shipper that values the capacity the most. Shipper-must-have-title violations carry significant penalties.

The prohibition on buy/sells often exists when an entity holds title to gas before and after, but not during, the use of transportation or storage capacity. It keeps capacity holders from circumventing shipper-must-have-title rules and also promotes transparency and allocation to the shipper that values the capacity the most. Again, violations carry significant penalties.

FERC prohibits tying release of capacity to "any extraneous conditions." Such release is usually allowed when it is necessary to enable a releasing shipper to exit the natural gas business in an orderly fashion. Bona fide Asset Management Agreements are exempt from tying prohibition. Finally, most case law involves parties seeking waivers of the prohibition and there don't appear to have been penalties associated with tying.

Under the posting and bidding process, a releasing shipper may designate a replacement shipper to receive capacity. The designated shipper will have an opportunity to match the highest bid for a specific tranche of capacity. With certain exceptions, this process is still subject to FERC's posting and bidding requirements.

One violation of posting requirements is "flipping," which entails repeated short-term releases of discounted rate capacity to two or more affiliated replacement shippers on an alternating monthly basis. Flipping also violates competitive bidding requirements. It has drawn severe penalties from FERC, including $7 million levied against BP in fall 2007.

Electricity markets

Recently, FERC's enforcement activity has focused more on the natural gas side than the electric. But players in the electricity markets should not be lulled. Compliance programs remain crucial.

Here are some highlights of recent enforcement activity:

- In July 2009, FERC issued an order finding no manipulation or tariff violations by NYISO market participants who submitted circuitous schedules that increased Lake Erie loop flow and associated congestion within NYISO.
- In an April 2009 order, FERC declined to take enforcement action, consistent with the Office of Enforcement's report, on two of the allegations set forth in a PJM Interconnection, LLC, complaint. Other allegations were set for hearing.
- Recently, the Commission set for hearing, under Sections 306 and 307 of the Federal Power Act, the issue of the intent of certain marketers in submitting high-priced energy offers for associated imports of capacity from NYISO to ISO New England.

Highlights from last year include the following:

- Duquesne Light received a $250,000 civil penalty (and must designate at least $1 million for a comprehensive compliance plan) due to violations of FERC cost allocation procedures, the electric quarterly report filing requirement, and the standards of conduct.
- Edison Mission Energy received a $7,000,000 civil penalty (and must designate at least $2 million for a comprehensive compliance plan) due to violations of 18 C.F.R. § 35.41(b) (2007), which imposes a duty to provide accurate, factual, and complete information in communications with the Commission upon electric power sellers authorized to engage in sales for resale of electric energy at market-based rates.

Another significant area of potential exposure for operators of generation and transmission facilities is violation of the mandatory electric reliability standards administered by the North American Electric Reliability Corporation (NERC). NERC oversees daily enforcement of the reliability standards related to the integrity of the bulk power system, and, in important cases, FERC can undertake joint enforcement with NERC and, when called for, impose civil penalties of up to $1 million per violation per day, as authorized by EPAct 2005.

On October 8, 2009, FERC issued its first civil penalty assessment under its electric reliability standards in its first joint enforcement effort with NERC as part of a settlement with Florida Power & Light Company. The settlement, stemming from a major South Florida blackout in February 2008, comprised a $25 million civil penalty and a broad program of required remedial measures to enhance the FPL system and operations.

Best practices

Some suggest that market participants are facing a classic "Catch-22" dilemma with regard to their compliance programs. FERC and other regulators have been under political pressure to be more effective "police" of energy markets, but they have not offered prescriptive program direction, instead being quick to note what is not adequate.

As a result, companies have been largely left on their own in determining the "proper fit" in a compliance program, a dilemma that comes down to compliance vs. risk. Internally, they are wrestling with how far to go in building out and sustaining their compliance programs in the absence of issues.

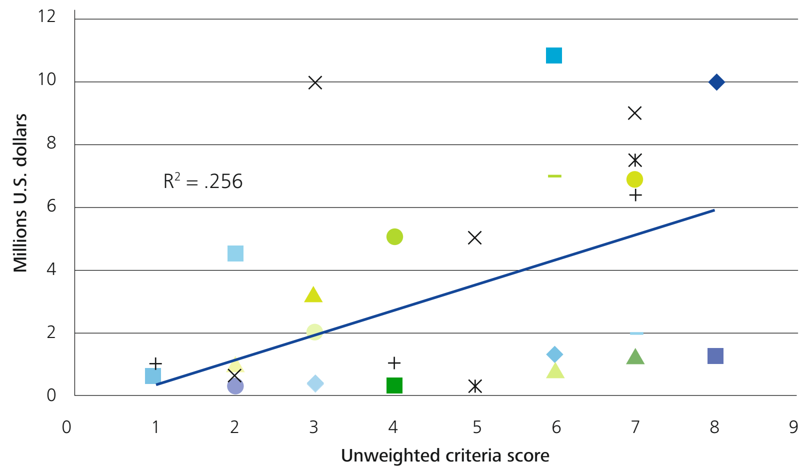
Enforcement activities, meanwhile, have raised more questions than they have answered in terms of what matters or helps in mitigating the risk of noncompliance. Other than deliberate noncompliance, what matters to FERC remains somewhat of an enigma. The question is how much weight is given to factors including:

- Deliberateness of the alleged violations
- Seriousness of the violation, its impact on the system or competition
- Duration of the violation, i.e., days vs. many months
- Volume of commodity in question
- Speed with which the company acts to remediate alleged activities
- Engagement of senior management in the compliance program and compliance oversight at the company

However, the pattern of settlements provides some evidence of the value of finding the right balance in the compliance-risk equation.

Additionally, what FERC will be looking for can be drawn from policy statements, which indicate support for the strong integration of program components.

Chart 1: FERC settlements plotted against penalty criteria (total of 36 settlements)



Source: FERC; Deloitte Analysis
Note: Excludes the $30 million ETP settlement and $25 million FPL settlement

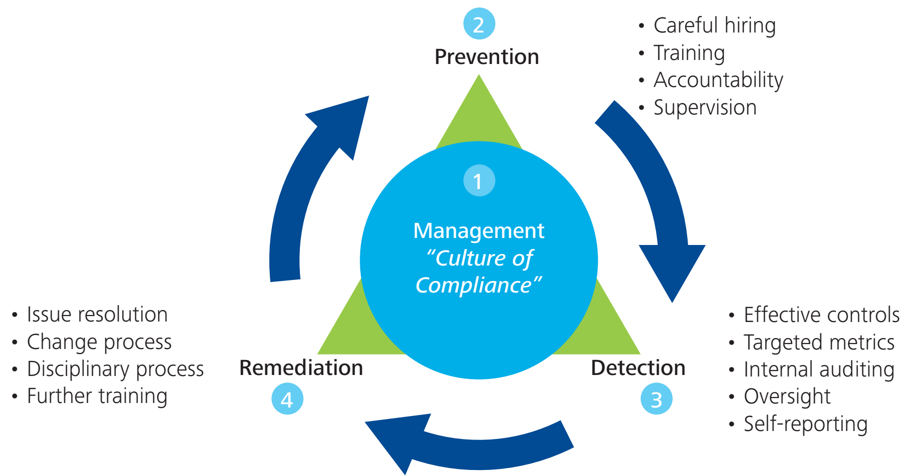
Criteria Score Inputs

Self-reporting
Deliberateness of the activity
Demonstrated compliance commitment
Severity of market impact
Duration of the activity

Chart 2: Total settlement dollars since 2005 — $135 Million

Source: FERC; Deloitte Analysis
Note: Figures are in nominal dollars and are unweighted excludes the $25 million penalty for FPL

Chart 3: FERC's view of model compliance programs



Beyond existing settlements, there are a number of other factors that can be considered in self-assessing the culture of compliance, including the:

- Presence of compliance goals in top-level corporate goals
- Variable compensation linked to compliance metrics for more than just compliance and legal personnel
- Senior-level management communications to employees on compliance commitments
- Board and senior management engagement in reviewing/discussing compliance performance
- Breadth and diversity of the training program required for employees
- Processes in place for remediating identified compliance questions and/or incidents

Effectively balancing the compliance-risk equation can be achieved by establishing a program of breadth and depth. Such a program would be enterprise-wide, with a transparent and coordinated view of risk and functional accountability.

It would entail compliance- and quality-assurance testing procedures, the elimination of redundant oversight and monitoring responsibilities, and a risk-based testing approach. Automated preventive controls and KPIs/KRIs would free up resources, as would the elimination of unnecessary activities.

The infrastructure for such a program would include:

- Standardized risk, controls, and test procedures
- Risk and control assessment process
- Test and assessment strategy with the capability to assess once, test once, satisfy many
- Data and technology architecture

Potential starting points for building out or streamlining compliance programs include:

- Considering whether an existing governance structure demonstrates a commitment to compliance and provides senior-level transparency on compliance performance
- Developing an inventory of regulatory compliance obligations relevant to the company and conducting a baseline risk assessment/audit
- Building out an internal audit program around key areas of compliance risk for the company
- Evaluating the adequacy of existing compliance-related training that goes beyond the basic standards of conduct training

Conclusion

EPAct 2005 held out new authority and enforcement power to FERC. Stung by such embarrassments as Enron, the Western energy crisis, and false price reporting to the index publishers, FERC grabbed the offer. As a result, it is behaving more like a cop on the beat than the passive regulator of years past.

So, what should players in energy markets look for from the “new” FERC?

To start off, they should presume regulatory expectations of finding a “culture of compliance” in place. Regulators will be seeking tangible evidence of a commitment to compliance, where actual practices reflect stated procedures. It would be wise for those companies that don’t have a compliance program to begin building one. Those with programs in place should review them and ensure that they permeate all levels, including the leadership ranks of the organization; that they are more than window dressing; and that they work.

Penalties will continue to be imposed for noncompliance, with increases particularly acute in cases of noncompliance in system reliability and critical infrastructure protection. Focus will sharpen on the adequacy of overall regulatory compliance programs, given FERC’s audit goals for 2014: to be able to deem 70 percent of programs adequate.

Also expected are sanctions against companies for noncompliance on other rules for which there have yet to be settlements, e.g., material contract deviations, interlocking directorates, and market-based rate authority requirements.

Finally, as compliance programs are established and improved, it is expected that there will be further clarification on the value of self-reporting vs. not reporting. If FERC is to be believed, if it is genuinely interested in compliance and not in locking up bad guys, it should continue using decisions, annual enforcement reports, and settlement documents to guide market participants to consistently meet regulatory compliance expectations.

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