

The "Conduct Police" – The Changing Nature of FERC Regulation

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History: FERC regulation, 1933 - 1992

- Cost of service rate regulation.
- Review of utility mergers.
- Federal Power Act's forfeiture and penalty provisions were unused.
- Occasional and generally unsuccessful "prudence" reviews.

History: Energy Policy Act of 1992

- Allowed an entity to apply to FERC for an order compelling it to provide transmission service.
- Provided for fines of up to \$10,000/day for violations of the transmission provision, interconnection requirements, and the requirement that exempt wholesale generators not obtain preferential treatment from affiliates.

1992 – 1994: Dawning of the New Era

- Independent generators.
- Market-based rates.
- Inter-utility sales
- AEP order on undue discrimination began the movement to open access transmission.

2006: The Transformation from Rate Regulator to “Conduct Police”

- Rate cases are nearly non-existent (but may be coming back into style).
- Standards of Conduct.
- Market power evaluation.
- Code of Conduct.
- Market Behavior Rules.
- Rules for affiliate transactions.
- Oversight of utility interlocks.
- Enhanced penalty authority.

Implications of the Transformation of the FERC

- Oversight of day-to-day operations.
- The tyranny of discretionary enforcement.
- Open-ended refund liability.
- Loss of "rights".
- Huge criminal and civil penalties.

Standards of Conduct – Overview

- Gas and electric transmission employees must function separately from merchant employees.
- The transmission provider must not discriminate against third party customers or give preferential treatment to its own marketing function or energy affiliates.



**Standards of
Conduct**
Thou shalt not
Thou shalt ...

Standards of Conduct – Developments

- Order 889 – 5 pages of regulations for the electric industry.
- Following Order 889, the FERC issued more than 60 orders addressing hundreds of issues.
- Order No. 2004: Consolidation of rules for gas and electric utilities.
- A synopsis of the requirements as interpreted by FERC is more than 140 pages long.

Standards of Conduct – Implementation Details

- Independent functioning:
 - ✓ Separate operations
 - ✓ Rules for physical access
 - ✓ Requirements for protection of electronic files and data bases.
 - ✓ Emergency operations.
 - ✓ Support employees.
 - ✓ Management employees.
 - ✓ Posting of corporate organizational charts.
 - ✓ Posting of functional organizational charts.
 - ✓ Posting of employee transfers.

Standards of Conduct – Implementation Details continued

➤ Non-discrimination

- ✓ Access to transmission information; OASIS postings.
- ✓ Access to customer information.
- ✓ “No conduit” rule.
- ✓ Posting of information disclosed in violation of standards.
- ✓ Rules for generation dispatch and system reliability.
- ✓ Tariff administration.
- ✓ Log of discretionary actions.
- ✓ Discounting rules.

Standards of Conduct – FERC Audits

- “Random” audits of utilities under Order No. 889.
- Additional audits as matters were brought to FERC’s attention.
- Phase I audits of compliance with Order No. 2004: OASIS/Internet postings.
- Phase II audits announced in February 2005.

Standard of Conduct Audits: Recent Results

- Tucson Electric: Refunds of payments in excess of transmission O&M in connection with preferential sales to a marketer.
- Idaho Power: \$200,000 in repayments, \$5.8 million transferred from marketing affiliate to utility and \$110,000 in civil penalties for violation of § 203 of the Federal Power Act.
- CLECO: Payments of \$750,000, refunds of \$2.1 million, termination of market-based rate authority and extensive FERC oversight/compliance program.

Standard of Conduct Audits: Recent Results continued

- Texas Eastern/Duke marketing affiliates: \$500,000 payment for improper access to gas transportation and shipper information.
- Dominion Resources: \$500,000 civil penalty and \$4.5 million in refunds resulting from improper access to gas storage information.
- Arizona Public Service: \$4 million damages for unauthorized use of point-to-point service.
- AEP: \$21 million civil penalty for providing a marketing affiliate preferential gas storage service and improper access to storage information.

Standard of Conduct Audits: Recent Results continued

- Duke and Mid American: Utilities must transfer tariff administration to an independent transmission service coordinator.

Standards of Conduct: Utility Reactions

- Extensive training programs.
- Internal compliance audits.
- Substantial efforts to understand the rules and how they are interpreted.

Standards of Conduct: Problems and Pitfalls

- The trap of self-audits.
- The dilemma of self-reporting.
- The tyranny of discretionary enforcement:
 - ✓ Regulations.
 - ✓ Orders.
 - ✓ Auditor interpretations.

Standards of Conduct: Problems and Pitfalls continued

➤ Recent FERC actions

- ✓ No audit reports issued recently.
- ✓ Chairman Kelliher appears to understand the need for clear standards and consistent enforcement.
- ✓ FERC says that it will be more careful to make the punishment fit the crime.

Market Power Evaluations

- In the mid-1980s FERC adopted a “hub and spoke” test for market power.
- In November 2001 it adopted the Supply Margin Assessment:
 - ✓ Does the applicant own or control generation that is less than the supply margin (the amount by which generation exceeds the load in the market)?

Market Power Evaluations *continued*

- In April 2004 it adopted the Pivotal Supplier Assessment and Wholesale Market Share Assessment:
 - ✓ PSA: Is seller's uncommitted capacity needed to serve load in the control area market at the time of the annual peak?
 - ✓ WMSA: For each of the four seasons, does the supplier have a dominant position in the market (20%) based on the supplier's uncommitted capacity and the uncommitted capacity of the market, taking into consideration simultaneous import capability?
 - ✓ Delivered Price Test for applicants that fail PSA or WMSA.
- In April 2004 FERC also opened an inquiry into a further modification of its market power analysis tool.

Market Power Evaluations continued

- In May 2006, FERC issued a Notice of Proposed Rulemaking in which it codified its policies concerning the evaluation of market power.
- FERC also asked for comment on whether it should prohibit utilities with market power on their own systems from selling power at market-based rates on neighboring systems.

Code of Conduct

- Marketing affiliates must operate separately from operating utilities to the maximum extent practicable.
- Market information shared between the operating utility and the marketing affiliate must be disclosed simultaneously to the public.
- Sales of non-power goods and services by the operating company to the marketing affiliate must be at the higher of cost or the market price.
- Sales of non-power goods or services by the marketing affiliate to the operating company must not be above market price.

Code of Conduct continued

- If the operating company brokers power for the marketing affiliate it must market its own power first; it will charge the affiliate the higher of cost or the market price for brokering; and it will simultaneously make public any market information shared with the marketing affiliate.
- Unlike the Standards of Conduct FERC has issued no orders interpreting the Code of Conduct and provided no informal guidance. However, it is conducting audits of compliance with the Code of Conduct in conjunction with Standards of Conduct audits.

Market Behavior Rules: Post-Enron Requirements (November 17, 2003)

- **Unit Operation:** Seller must operate and schedule generation in a manner that complies with FERC approved rules.
- **Market Manipulation:** Actions without a legitimate business purpose or that are intended to or that foreseeably could manipulate the market are prohibited. This includes wash trades, transactions predicated on false data, transactions based on artificial congestion and collusive behavior.
- **Communications:** Sellers must provide accurate and factual information to FERC, market monitors, ISOs, RTOs and other transmission providers.

Market Behavior Rules: Post Enron Requirements (November 17, 2003) continued

- **Reporting:** Transactions reported to publishers of price indices must be accurate and factual.
- **Record retention:** Data on sales and reports to publishers of price indices must be retained for three years.
- **Violations:** Violations of the rules constitute violations of the market-based rate tariff and can subject the seller to disgorgement of profits and termination of market-based rate authority.

Energy Policy Act of 2005

- The Act added Section 220 to the Federal Power Act.
- The Act directs the Commission to facilitate price transparency in energy markets and authorizes it to prescribe rules to achieve transparency.
- The Commission is authorized to establish an electronic information system if it determines that existing price publications are not adequate.
- The Commission is required to conclude a memorandum of understanding with the Commodity Futures Trading Commission concerning the sharing of information.

Energy Policy Act of 2005 continued

- The filing of false information is prohibited.
- The use of any manipulative or deceptive device (as defined in Section 10(b)(5) of the Securities and Exchange Act) in connection with the purchase or sale of energy or the sale of FERC-jurisdictional transmission service is prohibited.

Regulations on the Prohibition of Energy Market Manipulation

- In January 2006, the Commission issued regulations that prohibit the manipulation of gas and energy markets, 18 C.F.R. §§ 1.c.1 and 1.c.2.
- The regulations make it unlawful to:
 - ✓ use any device, scheme or artifice to defraud;
 - ✓ make any untrue statement of material fact or omit any material fact; or
 - ✓ engage in any act that would operate as a fraud or deceit.
- The regulation is patterned after Section 10(b)(5) of the Securities and Exchange Act and the Commission intends to apply Section 10(b)(5) case law to these regulations.

Codification of Market Behavior Rules

- In February 2006, the Commission codified four of the market behavior rules at 18 C.F.R. § 35.37 and rescinded Market Behavior Rules 2 (market manipulation) and 6 (penalties) as unnecessary.

Affiliate Transactions: FERC's Expanding Oversight

- In 1991, FERC rejected market-based power sale to Boston Edison by Edgar Energy, an affiliate, on the ground that the utility had not demonstrated that there was no potential for affiliate abuse.
 - ✓ FERC held that a utility could demonstrate the reasonableness of the contract based on head-to-head competition, prices paid for similar services or benchmark evidence of all comparable sales in the market.

Affiliate Transactions: FERC's Expanding Oversight continued

- In early 2004 FERC held that it would expand Edgar to all sales by affiliates to utilities, including sales at cost.
- In mid-2004, FERC established criteria for evaluating the reasonableness of an affiliate contract that is awarded following an RFP (the *Allegheny Energy Standards*).
 - ✓ **Transparency** in the solicitation and competition.
 - ✓ **Definition** of the product sought must be precise and non-discriminatory.
 - ✓ **Evaluation** criteria must be standardized, public and applied equally.
 - ✓ **Oversight** of the process should be conducted by an independent entity.

FERC Decisions Applying the New Standards

- FERC set for hearing Delmarva Power & Light's award of a power purchase contract to CESI, its affiliate.
 - ✓ The solicitation was for service to retail load.
 - ✓ The solicitation used the same process that FERC had approved for *Allegheny Energy*.
 - ✓ No one protested to FERC.
 - ✓ Then-Commissioner Kelliher dissented, saying that the *Allegheny Energy* criteria should be guidelines, not bright lines.

FERC Decisions Applying the New Standards *continued*

- FERC set for hearing Wisconsin Public Service's sale of power to its regulated affiliate, Upper Peninsula Power.
 - ✓ UPPCO is in a transmission constrained area.
 - ✓ No bidders other than WPSC had responded to three earlier RFPs.
 - ✓ WPSC proposed to renegotiate UPPCO's cost-based contract by extending it and lowering the price.
 - ✓ Following failure of settlement discussions the parties are engaging in massive pre-hearing discovery.

- FERC held an 80-day hearing on whether Entergy had unfairly favored its affiliate in awarding a contract following an RFP.

Affiliate Transactions – Lessons Learned

- FERC will not give deference to state commission determinations even where the solicitation is for energy to serve retail native load.
- FERC is evaluating affiliate contracts in a “lower of cost or market” framework.
- FERC will set for hearing all affiliate transactions that do not meet *Allegheny Energy* criteria.
- FERC’s decision may implicate holding company transactions.
- FERC is hostile to affiliate transactions due to its desire to enhance competition.

Utility Interlocks – The Rules

- FERC approval is required for an officer or director of a public utility to hold the position of officer or director of:
 - ✓ An electrical equipment supplier of the utility;
 - ✓ Another public utility;
 - ✓ A bank or other firm authorized to underwrite or participate in the marketing of the securities of a utility.

Utility Interlocks – Past FERC Practice

- The bank interlock provisions have been amended to make them mostly inapplicable.
- FERC authorized interlocks with utility affiliates automatically upon the filing of an informational report.
- FERC essentially waived the requirement for marketing affiliates upon the filing of minimal information.
- FERC gave interlocks virtually no attention.

Utility Interlocks – Current FERC Action

- In June 2004 FERC warned utilities that applications must be filed within 30 days after election or appointment and that it does not look favorably on untimely applications.
- It also stated that it would consider remedial action, where appropriate, for persons who fail to get prior approval of interlocks.
- The FERC denied an application by the Chairman of KCPL to be a director of an electric equipment supplier.

Utility Interlocks – Current FERC Action continued

- FERC denied an application by the Group President of Caterpillar, Inc. to be a director of several Ameren Companies.
 - ✓ Commissioner Kelliher stated that the director had violated the Federal Power Act by not making a timely filing and that he would have denied the application solely on that ground.

- FERC also denied a late-filed application by the President and CEO of Unitil to be a director of the Southwest Power Pool.
 - ✓ Commission Kelliher stated that he would have found the applicant in violation of the Federal Power Act since he had knowingly served as the director of two utilities.
 - ✓ Kelliher also stated that the applicant's failure to file a notice of an interlock with affiliate companies is a violation for which a penalty is appropriate.

Utility Interlocks – Current FERC Action continued

- Willful and knowing violations can be the subject of criminal penalties. There are no civil penalties that apply to individuals.
- FERC also revised its regulations to require filings before the position is filled and to provide for denial of late-filed applications. Applications are deemed granted if action is not taken within 60 days of filing.
- The Commission also eliminated the partial waiver for marketing affiliates.

Other FERC Actions

- In October 2005, FERC issued a Policy Statement on Enforcement in which it discussed the factors it will consider in determining the severity of penalties for violations.
- FERC stated that it would consider:
 - ✓ harm;
 - ✓ willfulness;
 - ✓ repeat offenses;
 - ✓ involvement of senior management;
 - ✓ self-investigating, self-reporting, and cooperation;
 - ✓ impact of penalties on financial viability.

Other FERC Actions *continued*

- In November 2005 the FERC initiated a process allowing utilities to file request for no-action letters.
 - ✓ No action letter requests are non-public until the Commission issues a response.
 - ✓ No action letters are not precedential, but a statement that the General Counsel or Staff will or will not recommend enforcement action should be reasonably relied upon by the applicant.
- In February 2006, FERC issued regulations codifying the rights of utilities to challenge audit findings before the issuance of a Commission order on the merits.

Criminal and Civil Penalty Authority

- Criminal penalties have been increased from \$5,000 to \$1,000,000 and from two years imprisonment to five years.
- Civil penalties have been increased from \$10,000 per day of violation to \$1,000,000 per day.
- FERC has restructured and beefed up its enforcement staff.

Evaluation of FERC's Role as Conduct Police

- Utilities have complained most about “creep” in the Standards of Conduct:
 - ✓ Auditors find violations where the regulations do not.
 - ✓ Auditors disregard relevant FERC orders.
 - ✓ Auditors and the Commission blur the distinction between a minimum requirement and a best practice.
- Concern with self-reporting of violations: Does FERC give incentive to self-reporters?
- Concern with self-auditing: is it an invitation to FERC penalties?

Evaluation of FERC's Role as Conduct Police continued

- Concern with constantly-changing standards and potential retroactive remedial action.
- Utilities and some state commissions attempted to find ways around FERC regulation on the grounds that FERC is too zealous.
 - ✓ Entergy-Perryville.
 - ✓ Rollback of open access.
 - ✓ Congressional pressure.

Conclusion

- FERC will continue to expand its role as “Conduct Police.”
- FERC appears to be attempting to make its enforcement more uniform.
- It appears that FERC’s enforcement efforts are maturing into a more traditional role in which enforcement is taken only of violation of clearly defined standards.
- The extent to which this will in fact occur probably will become clear within the next six months.