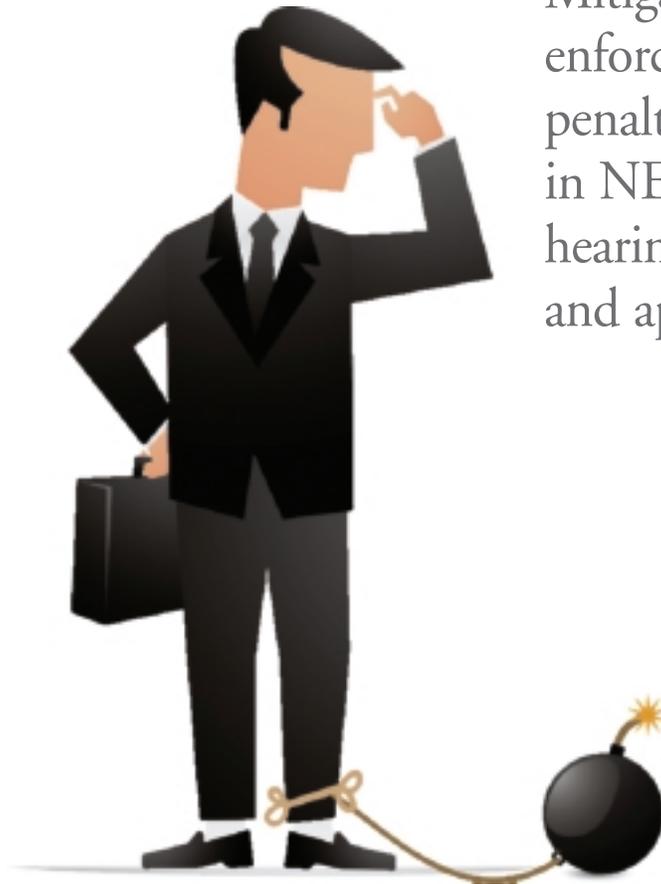


Preparing for The Inevitable

Mitigating
enforcement
penalties
in NERC
hearings
and appeals.



BY DANIEL E. FRANK & CAILEEN N. GAMACHE



ny entity that deals with power probably has procedures in place to ensure compliance with the requirements of agencies such as the Federal Energy Regulatory Commission (FERC) and the Commodity Futures Trading Commission (CFTC). But there's a relatively new kid on the block—the North American Electric Reliability Corporation (NERC)—that shouldn't be overlooked by compliance professionals.

NERC has been around for four decades now, but only recently has been granted authority and enforcement powers comparable to those of the other federal energy regulators. And like the other agencies, NERC isn't afraid to flex its regulatory muscles.

NERC's enforcement powers are substantial. As the FERC-designated electric reliability organization (ERO) for the U.S. bulk power system, NERC has authority over all bulk power system users, owners and operators, and is responsible for enforcing its mandatory reliability standards. NERC's enforcement powers include punishing violators with fines ranging from \$1,000 to \$1 million per day per violation, depending on the violation and the level of risk posed to the reliability of the electric grid. Violators also may be subject to non-monetary penalties, including being put on a watch list; being required to perform specific remedial actions; facing limits on activities, functions, or operations; and partaking in additional compliance and monitoring programs.

All of these are reasons to take measures now to assure compliance and preparedness—both to enhance the reliability of the power grid and also to protect the bottom line.

What's the Big Deal?

To date, NERC has assessed penalties for violations that generally have ranged from \$0 to \$250,000, with additional remediation and compliance costs. In the one civil penalty case in which FERC assessed a penalty for violations of the NERC reliability standards, the registered entity agreed to settle the case with a \$25 million penalty. While seemingly an outlier, that case indicates the potential severity of the threat of monetary penalties.

All but one of these penalties resulted from settlements between the registered entity subject to the penalty and NERC's regional entities, which have front-line responsibility for enforcing the reliability standards.¹ Nonetheless, with monetary penalties escalating in severity, it's only a matter of time before cases are litigated and the hearing and appeals process kicks in at full speed. But tools exist that will help compliance professionals

Utilities should avoid becoming the test case to see how strictly NERC's requirements will be enforced.

an understanding of the nuts and bolts of the hearing and appeals process, as well as keeping in mind practical tips to help avoid a finding of a violation and mitigate any penalties should a violation be found.

Notice of Violation

The first step on the path towards the hearing and appeals process is the violation notice. A violation notice will be issued once a potential violation of the reliability standards is discovered. NERC and the regional entities might uncover potential violations through a variety of means, including self-certifications, self-reports, compliance audits, spot checks, compliance violation investigations, periodic data submittals, exception reporting, and complaints.³ The means of discovery, however, doesn't affect the notice process.

It's important to distinguish between the types of notices that may be issued. An initial notice of alleged violation (INOAV) alerts the recipient that it is under investigation, but doesn't require the entity to take any action to preserve its rights. In contrast, a notice of alleged violation and proposed penalty or sanction (NAVAPS) starts the clock running for purposes of preserving the entity's right to a hearing or appeal. A recipient either must contest or respond within 30 days of receipt of the NAVAPS or it is deemed to have accepted the violation and the proposed penalty.⁴

Because there are no reported decisions on the issue, it remains unknown at this time whether the 30-day deadline for responding to the NAVAPS is immutable, or if it's waivable or subject to extension and, if so, under what circumstances. The prudent course is to treat the 30-day deadline as firm.

Substantively, an entity can respond to a violation in several different ways:⁵

navigate the NERC hearing and appeals process.²

Registered entities shouldn't wait until the eve of a hearing or appeal. It's imperative that registered entities understand the NERC hearing and appeals process in advance, and take steps now to enhance the chances of success in that process and avoid or minimize any penalties. Being prepared includes both acquiring

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■ An entity can agree with the alleged violation and accept the penalty; if the entity does so, it must submit a mitigation plan demonstrating how it will correct the violation;⁶

■ An entity can choose to accept the violation but dispute the penalty; in this situation, it also must file a mitigation plan;

■ An entity can submit a mitigation plan without waiving its right to contest the alleged violation or the proposed penalty or both; or

■ An entity can contest both the violation and the proposed penalty.

If the recipient entity chooses to contest either the alleged violation or the proposed penalty, the entity must submit a response to the regional entity explaining its position and supplying supporting information and documents.⁷ The regional entity then must schedule a meeting with the alleged violator, to discuss possible resolution, within 10 business days of receipt of the response.⁸

If the issue isn't resolved within 40 days following the alleged violator's response,⁹ then the registered entity may request a hearing. If no hearing is requested, the alleged violation will be deemed confirmed and the penalty final, and the violation and penalty will be filed with FERC.

Once the violation is filed with FERC, the agency can elect to hear an appeal or conduct a review of the alleged violation upon its own motion.¹⁰ If FERC doesn't review the notice and no appeal is filed, the penalty becomes final after 30 days.¹¹

The Hearing

An alleged violator may request a hearing within 40 days after its response to the notice of alleged violation, within 40 days of the rejection of a revised mitigation plan by the regional entity's compliance staff, or within two days of receiving a remedial action directive.¹² If a hearing is requested, the regional entity will conduct an evidentiary review to address issues such as whether there has been a violation, the appropriate penalty, and the terms of a mitigation plan.¹³

At the hearing, the regional entity's compliance staff must establish, by a preponderance of the evidence, that the non-compliance occurred and validate the reasonableness of the proposed penalty.¹⁴ In addition, if challenged, the staff must prove the insufficiency of any proposed mitigation plans and defend mandatory compliance with any remedial action directives.¹⁵ In this regard, the hearing process shifts the burden of persuasion from the registered entity to the regional entity.

In general, the hearing procedures aren't uncommon for administrative agency evidentiary hearings, but there are some important differences. As is typical, the procedures include rules on discovery, presentation of evidence, examination of witnesses, and admission of evidence, as well as pre-hearing and

post-hearing procedures.¹⁶ The more stringent traditional legal rules of evidence, however, don't apply, and the hearing officer may waive, suspend or modify the hearing procedures "for good cause shown."¹⁷ Any discretion under the procedures must be exercised to accomplish such goals as maintaining the integrity of the fact-finding process and ensuring fairness, independence, balanced decision-making, impartiality and expedition.¹⁸

Following the hearing, the hearing officer will issue an initial opinion on evidence presented and admitted into the record.¹⁹ The initial opinion will include the findings of fact, conclusions of law and reasons for them, as well as all recommended orders to dispose of the matter.²⁰ An appeal or exception to the initial opinion may be filed within 21 days after the initial opinion is issued.²¹ The regional entity's hearing body then will issue a final decision.²² The regional entity's ruling may be appealed to NERC within 21 days of the final decision.²³ The appeal must include the final decision, a concise statement of errors, a clear statement of the relief being sought, and supporting arguments.²⁴

The Appeal

The registered entity may appeal the regional entity's ruling directly to NERC. In general, this appeal process is envisioned to take 90 days from the time the appeal is filed to the issuance of a written decision. NERC's decision is final, subject to further appeal to FERC. NERC also may decide to remand the case to the regional entity if it wants the regional entity to examine other aspects of the case.²⁵ Once it issues its decision, NERC will file with FERC a record of the proceedings, along with any mitigation plans, settlements, and a notice of penalty for the violations.²⁶ The penalty cannot take effect earlier than 31 days after NERC files the notice of penalty with FERC.²⁷

There may be few opportunities to present additional evidence during the later appeal.

An entity subject to a notice of penalty may submit an application for review within 30 days of the date of the notice, before FERC's decision.²⁸ However, the filing of an application for review does not stay the penalty unless FERC orders otherwise.²⁹ If the penalty isn't appealed, and FERC doesn't initiate independent review, then the notice of penalty is deemed affirmed 30 days after the filing date.³⁰ FERC also has the authority to toll the period for action to determine whether to initiate review on its own motion. Once an appeal is initiated, FERC anticipates acting within 60 days, unless it determines another length of time is appropriate.³¹ FERC may decide to affirm, set aside, reinstate, or modify the penalty, or remand to NERC for further proceedings.³²

At least, that's the theory. No hearings or appeals have commenced yet. Still, it's likely that they will, and it's possible to identify some practical considerations that a registered entity should take into account both before and throughout the NERC hearing and appeals process in order to enhance the chances of success.

Practice Tips

A series of practices and actions can help utility companies manage their compliance obligations and avoid or minimize NERC-enforcement penalties.

■ **Mind the Timelines:** Each step of the hearing and appeals process is guided by specific timelines. For example, if the registered entity chooses to contest an alleged violation or proposed penalty, there are specified windows of time within which to request a hearing or file an appeal before the matter becomes uncontestable. Because there are no litigated cases yet, it is unclear how firm those deadlines are. But registered entities are cautioned to avoid being the test case to see how strictly these deadlines will be enforced, whether by the regional entities, NERC or FERC. Therefore, the registered entity should take careful note of the applicable deadlines.

■ **Follow Instructions:** If an entity comes under investigation, it is important to follow all instructions and expeditiously and accurately respond to requests. For example, the regional entity compliance audit teams are required to issue specific instructions to the audited entity and they expect concise—but complete—responses in return. This may seem obvious, but in light of the potential implications—including heightened scrutiny and negative inferences that the audited entity is uncooperative—it is an important practice guideline to mind.

■ **Be Cooperative:** One of NERC's penalty adjustment factors is the degree and quality of cooperation with violation investigations and in implementing remedial plans.³³ FERC also has recommended a proactive approach to reporting violations and cooperating in violation proceedings. In fact, FERC has stated that in some circumstances a company's proactive and cooperative approach to correcting violations and improving compliance could lead to a resolution that does not involve civil penalties.³⁴ As noted, such an approach extends to interactions with the regulators (*i.e.*, such as in responding to data requests, in negotiations, and in other contexts). Accordingly, to the extent feasible, exemplary cooperation is recommended.

■ **Develop a Thorough Record:** The record developed in the regional entity proceedings is the same record NERC and FERC will review should a matter be appealed. The record should be organized and effective, and every fact that might be important to the case should be developed and submitted at hearing. NERC and FERC have indicated that the hearing process is the forum for developing facts, and there might be

few opportunities to present additional evidence during the later appeal.³⁵

The evidence will vary, but generally the record should provide enough detail to provide the registered entity's side of the story regarding the violation and all remedial action taken. In particular, it's important to include: evidence on any factors that mitigate the seriousness of the violation, the risk to the bulk power system resulting from the alleged violation, whether the alleged violator discovered the alleged violation through voluntary self-review, whether corrective actions were promptly taken, the extent and cost of such actions, and similar factors.

All of these factors are relevant in the determination of the appropriate penalty, which by law must “bear a reasonable relation to the seriousness of the violation” and must take into consideration efforts undertaken to “remedy the violation in a timely manner.”³⁶

If no hearing is requested, the alleged violation will be deemed confirmed and the penalty final.

Importantly, in order to mitigate the potential penalty, many of these actions should, and in some cases only can, be taken before the violation occurs or is discovered.

Thus, for example, to get credit for self-reporting a potential violation or taking timely remediation efforts, the registered entity should have in place an effective compliance program that includes periodic self-assessments that would allow for timely detection and correction of potential violations. Accordingly, not only should a registered entity plan to present evidence on these matters should it find itself in a NERC hearing, but it must build such evidence in advance.

■ **Develop a Culture of Compliance:** FERC has advised that of all the factors considered, “the most important in determining the amount of the penalty are the seriousness of the offense and the strength of the entity's commitment to compliance.”³⁷ As recently as Nov. 13, 2009, FERC indicated that violations of the reliability standards that have minimal impact on reliability may merit a zero-dollar penalty—provided the registered entity has a demonstrated commitment to compliance.³⁸ A registered entity will have a much easier time showing a culture of compliance—and thus a much greater chance of avoiding violations and mitigating penalties—if it implements and documents its compliance measures.

Every registered entity should begin by creating a compliance plan as soon as possible. In fact, in almost all circumstances, the compliance staff will ask to see a copy of the plan. The plan should be designed to include provisions demonstrating active engagement by senior management, as well as preventative measures including training, discipline and (*Cont. on p. 50*)

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(Cont. from p. 31)

regular audits. Also the plan should include documented procedures to detect and report violations, and a list of remediation efforts in the event a violation does occur.

FERC and NERC also expect each regulated entity to invest appropriate time and resources to creating and monitoring effective internal compliance programs.³⁹ A few measures taken now can go a long way in avoiding violations and hefty penalties. An ounce of prevention truly is worth the investment.

To date no registered entities have invoked the NERC and regional entity hearing and appeals procedures. But with increasingly severe monetary penalties, it's only a matter of time before alleged violations and proposed penalties are challenged using the available procedures. Registered entities can take certain measures immediately to enhance their chances in these challenges. Taking those measures sooner rather than later will help avoid violations and mitigate penalties should violations occur—and might improve the reliability of the grid. **E**

ENDNOTES

1. The one exception is Baltimore Gas & Electric Co.'s acceptance of the penalty proposed by the regional entity. See *North American Electric Reliability Corp.*, "NERC Notice of Penalty regarding Baltimore Gas & Electric Company," FERC Docket No. NP08-1-000 (filed June 4, 2008).
2. This article focuses on the hearing and appeals process outlined in NERC's Compliance Monitoring and Enforcement Program (CMEP), Appendix 4C to the NERC Rules of Procedure (effective Oct. 2, 2009). Regional variations may apply.
3. CMEP at § 3.0.
4. *Id.* at § 5.2. A mitigation plan also is required within 30 days of the NAVAPS if the registered entity fails to contest the violation or proposed penalty. *Id.* at 6.4.
5. CMEP at § 5.1.
6. All mitigation plans are subject to approval by NERC. Once approved, the plan must be carried out immediately in accordance with its terms. NERC will forward the mitigation plan to FERC for additional review, but FERC's review doesn't stay the timeline in which the alleged violator must commence implementation of the plan. See *North American Electric Reliability Corp.*, 119 FERC ¶ 61,274 (2007) (order clarifying procedures).
7. CMEP at § 5.2.
8. *Id.* Settlement negotiations may take place at any time up until a notice of penalty is filed with FERC.
9. *Id.*
10. Federal Power Act (FPA) § 215(e)(2).
11. 18 C.F.R. § 39.7(e)(1) (2009). FERC also has its own independent enforcement authority beyond NERC's powers. If FERC chooses, it can conduct its own investigations and impose its own penalties, subject to notice and an opportunity for a hearing. FPA § 215(e)(3); 18 C.F.R. § 39.7(f) (2009).
12. CMEP at Att. 2, §§ 1.3.1, 1.9. A remedial action directive is intended to address immediate threats to the reliability of the bulk power system, and therefore the procedures for processing proposed remedial action directives and challenges to them are substantially shortened.
13. *Id.* at § 1.1.1.
14. *Id.*
15. *Id.*
16. See *id.* at §§ 1.5, 1.6, 1.7.
17. *Id.* at §§ 1.1.2, 1.6.11.
18. *Id.* at § 1.1.3.
19. *Id.* at § 1.7.4.
20. *Id.*
21. *Id.* at § 1.7.5.
22. *Id.* at § 1.7.8.
23. *Id.* at § 1.7.10; NERC Rule of Procedure § 410.
24. NERC Rule of Procedure § 410.
25. CMEP at § 5.5.
26. NERC CMEP, Attachment 2, p. 32.
27. FPA § 215(e)(2).
28. *Id.*
29. 18 C.F.R. § 39.7(e)(3) (2009).
30. 18 C.F.R. § 39.7(e)(1) (2009).
31. 18 C.F.R. § 39.7(e)(6) (2009).
32. FPA § 215(e)(2).
33. *Sanction Guidelines of the North American Electric Reliability Corporation*, Appendix 4B (Jan. 15, 2008) available at: http://www.nerc.com/files/Appendix4B_Sanctions_Guidelines_Effective_20080115.pdf (last visited Jan. 15, 2010).
34. See *Compliance with Statutes, Regulations, and Orders*, 125 FERC ¶ 61,058, at P 12 (2008) (Policy Statement on Compliance).
35. See, e.g., 18 C.F.R. § 39.7(e)(2) (2009) (allowing submission of evidence during appeals process).
36. FPA § 215(e)(6); 18 C.F.R. § 39.7(g) (2009).
37. *Enforcement of Statutes, Regulations and Orders*, 123 FERC ¶ 61,156, at P 54 (2008) (Revised Policy Statement on Enforcement).
38. See *North American Electric Reliability Corp.*, 129 FERC ¶ 61,119, at P 41 (2009).
39. *Supra*, note 34.

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