
**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

ENFORCEMENT OF STATUTES, ORDERS,) Docket No. PL10-4-000
RULES, AND REGULATIONS)

**COMMENTS OF THE
NORTH AMERICAN ELECTRIC RELIABILITY CORPORATION
REGARDING THE PROPOSED POLICY STATEMENT ON PENALTY GUIDELINES**

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I. INTRODUCTION

The North American Electric Reliability Corporation (“NERC”)¹ appreciates the opportunity to provide these comments in response to the Federal Energy Regulatory Commission’s (“FERC” or “the Commission”) March 18, 2010 Policy Statement (“Policy Statement”) on Penalty Guidelines (“Penalty Guidelines”).² After holding three workshops in Washington, D.C., Houston, TX, and San Francisco, CA to discuss the interpretation and application of the Penalty Guidelines, the Commission properly determined that the public interest would be best served by allowing interested entities more opportunity to comment before the Penalty Guidelines were put into effect. As a result, the Commission suspended the Policy Statement and the application of the Penalty Guidelines and invited the public to submit comments on the Penalty Guidelines before it issues a final order and puts them into effect.³ NERC welcomes the Commission’s decision to suspend their use and to solicit additional public input prior to issuing final guidelines.

¹ The Federal Energy Regulatory Commission (“FERC” or “Commission”) certified NERC as the electric reliability organization (“ERO”) in its order issued on July 20, 2006 in Docket No. RR06-1-000. *North American Electric Reliability Corporation*, “Order Certifying North American Electric Reliability Corporation as the Electric Reliability Organization and Ordering Compliance Filing,” 116 FERC ¶ 61,062 (July 20, 2006).

² *Enforcement of Statutes, Orders, Rules, and Regulations*, “Policy Statement on Penalty Guidelines,” 130 FERC ¶ 61,220 (2010).

³ *Enforcement of Statutes, Orders, Rules, and Regulations*, “Order Regarding Policy Statement on Penalty Guidelines,” 131 FERC ¶ 61,040 (April 15, 2010) (“Order Suspending Penalty Guidelines”).

The stated purpose of the Penalty Guidelines is to add greater fairness, consistency, and transparency to the Commission's civil penalty determinations, including penalty determinations with respect to Reliability Standard violations. NERC supports fairness, consistency and transparency with respect to penalties and the criteria applied to determine penalties. However, for the reasons that follow, NERC urges the Commission not to apply the Penalty Guidelines to violations of Reliability Standards.

As the Commission acknowledges, the Penalty Guidelines represent a change in how FERC will determine civil penalties.⁴ While the Penalty Guidelines incorporate considerations from prior Policy Statements, including those embodied in NERC's own FERC-approved Sanction Guidelines, they raise a number of questions about how Commission-set penalties are applied in the context of Reliability Standard violations. Although the Penalty Guidelines are intended to offer transparency and predictability in the Commission's calculation of penalties, several crucial terms and criteria are unspecified or subjective, and a number of calculations with respect to penalty determinations for Reliability Standard violations remain unexplained.

The Penalty Guidelines also have the potential for large penalties for Reliability Standard violations, particularly if there is a loss of load. NERC is concerned that this could result in an industry shift to a compliance risk averse posture rather than a proactive reliability risk management posture, contrary to NERC's goals and the Commission's stated goals.

These concerns arise out of a number of aspects of the Penalty Guidelines. First and foremost, the Penalty Guidelines establish a second and very different scheme for calculation of Reliability Standard penalties. The Commission has provided no explanation or justification for applying the Penalty Guidelines to Reliability Standard violation matters. Indeed, the incentives

⁴Policy Statement at P 66 ("Although the Penalty Guidelines represent a change in the way we determine civil penalties, they incorporate many of our prior considerations and further our enforcement program goals by serving as a deterrent, encouraging compliance, and adding greater fairness, consistency, and transparency.").

generated by application of the Penalty Guidelines in day-to-day cases in the Reliability Standard context could prove detrimental to reliability in the long run. There is a workable scheme for assessing Reliability Standard violation penalties that has been in place for three years. Thus, NERC recommends that the Commission refrain from application of the Penalty Guidelines to Reliability Standard violations. If it does not take this proposed course, the Commission should limit any application to Commission-initiated proceedings under its Rule 1b authority and should decline to apply them in reviewing NERC notices of penalty.

Second, the Commission has modeled its Penalty Guidelines on the United States Sentencing Guidelines. The Commission has imported concepts from criminal law and applied them to regulatory violations in the civil context, without any explanation or justification, leading to further confusion. It did so while acknowledging that, even in the criminal context, the United States Sentencing Guidelines have been controversial and are not mandatory but rather are advisory only.⁵

Third, NERC is concerned with the emphasis on loss of load as a factor for assessing financial penalties. While it is appropriate to evaluate loss of load to assess the seriousness of the violation, the value of actual or potential loss of load should not be included in the penalty calculation. Otherwise, NERC is concerned that entities will be driven to manage compliance risk rather than to mitigate reliability risk. That is, the threat of very large penalties could have the unintended consequence of seriously jeopardizing system reliability by causing system operators to be reluctant to shed load when that is the appropriate operating measure to prevent a widespread cascading outage on the bulk power system. In fact, Recommendation 8 of the Final Report on the August 14, 2003 Blackout in the United States and Canada, stated that operators who initiate load shedding pursuant to approved guidelines are not indications of operator failure

⁵ Policy Statement at PP 19-20.

and should be shielded from liability or retaliation. Recommendation 8 notes that, had timely load shedding been implemented on August 14, the spread of the blackout would have been prevented. Further, as the report states, organizations and individual operators may hesitate to initiate needed load shedding in appropriate circumstances without assurances that they will not be subject to liability suits or other forms of retaliation. As such, the inclusion of loss of load in the Penalty Guidelines seems totally inconsistent with this recommendation.

The specter of possibly larger penalties based on criminal guidelines also could significantly erode incentives to self report and self correct, which are key features of a robust compliance program. To promote a culture of reliability excellence and compliance with Reliability Standards, it takes more than penalties to deter violations, even if they are firm and fair. Reliability performance will improve only if entities also perform ongoing and rigorous self-evaluations and promptly take proactive remediation.

The Commission has long recognized the importance of self reports and self correction and has made corresponding adjustments in enforcement proceedings. According to its Revised Policy Statement on Enforcement, “[o]ne of the highlights of the Commission’s post-EPA 2005 enforcement program has been the now common practice of companies submitting self-reports of possible violations.”⁶ The Commission reported that “between 2005 and 2007 . . . more than half of the self-reports submitted to Enforcement staff were closed with no action.” The Commission explained that it places “great value on self-reporting, particularly when it points to a strong compliance program.”⁷ The Commission reiterated that “[i]n the cases where a self-report did result in enforcement action, the penalties reflected mitigation credit for the self-

⁶ *Enforcement of Statutes, Regulations and Orders*, “Revised Policy Statement on Enforcement,” 123 FERC ¶ 61,156 at P 61 (2008).

⁷ *Id.* at P 60.

reporting . . . [and] the penalties in these cases would have been greater absent self-reporting.”⁸

Penalties should be crafted to ensure that they not only deter and address non-compliance but also encourage comprehensive implementation of compliance measures and prompt self-reporting and remediation of violations.

Fourth, there are a number of places in the Penalty Guidelines that warrant additional information or clarification. For example, violations of Reliability Standards start with a base penalty amount of \$175,000 to \$350,000⁹, which is substantially higher than most penalties assessed by NERC and accepted by the Commission to date. The base level of 16, which is applied to Reliability Standard violations, is higher than the base level of 6 applied to all other violations subject to the Penalty Guidelines, including instances of fraud, by almost a factor of three. Violations of Reliability Standards have involved issues with respect to negligence and mistake.

While there are certain “objective characteristics” and “uniform factors,” the Penalty Guidelines rely on many other undefined terms, subjective criteria and missing formulas in determining the penalties. If, contrary to NERC’s recommendation, the Commission does apply the Penalty Guidelines to violations of Reliability Standards, the Commission should ensure that these undefined terms, subjective criteria and missing formulas are addressed in any final action.

For all these reasons, NERC strongly recommends that the Commission not apply the Penalty Guidelines to violations of Reliability Standards. If contrary to NERC’s

⁸ *Id.* at P 61.

⁹ The Table in Part A – General Application Principles §1C2.2(b) of the Penalty Guidelines establishes a penalty of \$175,000 for a base violation level 16, the starting point for Reliability Standards violations, which is adjusted for seriousness factors including risk of loss of load. The Table in Part A – General Application Principles §1C2.4 of the Penalty Guidelines establishes a minimum multiplier of 1.00 and a maximum multiplier of 2.00 for a starting culpability score of 5. The “base penalty” is the greater of: (1) the dollar amount from the Table in Part A – General Application Principles of the Penalty Guidelines §1C2.2(b) that corresponds to the applicable violation level, to which adds for risk of loss take into account loss of load; (2) the pecuniary gain to the organization from the violation; or (3) the pecuniary loss from the violation caused by the organization, which also takes into account loss of load. *See also* Policy Statement at PP 37, 42.

recommendation, the Commission nonetheless chooses to apply the Penalty Guidelines to Reliability Standards, NERC urges that the Commission do so only with regard to matters the Commission investigates on its own authority, using Part 1b of the Commission's regulations. NERC understands that the Commission states in Paragraph 64 that the Penalty Guidelines will only be used to set penalties in Commission-initiated proceedings and that NERC will not be required to resort to the Penalty Guidelines in NERC proceedings. However, NERC also understands the Penalty Guidelines to say that the Commission does expect to use them to evaluate NERC-set penalties in "out-of-ordinary" cases (although "out-of-ordinary" is not defined).

II. NOTICES AND COMMUNICATIONS

Notices and communications with respect to this filing may be addressed to the following:

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III. COMMENTS

A. The Commission has not provided an adequate justification for application of the Penalty Guidelines to Reliability Standards.

Sections 215(e)(1) and (2) of the Federal Power Act give NERC the authority to establish and impose penalties as an appropriate implementation provision of the penalty provisions of Section 215.¹⁰ The Commission has approved NERC's Sanction Guidelines to be applied to Reliability Standard violations. NERC's Sanction Guidelines were designed to:

- Promote a culture of compliance excellence through education, transparency, information (lessons learned) and incentives, which includes penalties, sanctions and credit, as appropriate;
- Ensure effective monitoring by registered entities with respect to compliance with Reliability Standards;
- Improve quality and consistency of self-assessments;
- Encourage registered entities to engage in rigorous self-evaluation of compliance activities, system events and risk mitigation; and
- Promote reliable performance and tracking recommendations, such as through issuances of lessons learned.

While Section 215(e)(3) gives the Commission the authority “[o]n its own motion or on complaint,” to order compliance with Reliability Standards and to impose penalties for violations, the number of instances in which the Commission has taken such active involvement in reliability matters has been rare. To date, the Commission has approved two settlements arising out of an investigation of one event it initiated under its independent enforcement authority under Section 215 and Rule 1b, the settlements with Florida Power & Light and Florida Reliability Coordinating Council-Reliability Coordinator of matters related to the February 2008

¹⁰ *Rules Concerning Certification of the Electric Reliability Organization; and Procedures for the Establishment, Approval, and Enforcement of Electric Reliability Standards*, 114 FERC ¶ 61,104 (2006) (Order No. 672).

disturbance in Florida. Moreover, the Commission has allowed to take effect, without further action, a number of notices of penalty that NERC has filed with the Commission. Of 203 notices of penalty filed, the Commission has let stand 189 notices of penalty, which include 1,017 violations. Among those was one notice of penalty filing that contained more than 500 violations. To date, only 14 notices of penalty remain pending before the Commission. Of those, the Commission has initiated review of only one and extended the time to consider another, at this time.

NERC does not opine on whether the instant (or other) Penalty Guidelines are appropriate for violations related to other subject matters under the Commission's jurisdiction. However, given the working penalty scheme that is in place today under NERC's Rules of Procedure, the Commission has not supplied a sufficient justification for the Penalty Guidelines to be applied in the context of Reliability Standards. The Commission should allow the existing penalty framework for reliability to stand, because, as discussed herein, the new framework has a number of issues that must be addressed to ensure the transparency, consistency and fairness are achieved and to ensure that proper signals to manage enforcement risk and not reliability risk are sent.

Significantly, the NERC Sanction Guidelines were approved by the Commission through a lengthy and extensive notice and comment rulemaking proceeding, with reasoned consideration of industry input. As the Commission is well aware, the NERC Sanction Guidelines establish a penalty guideline scheme that takes into account the nature, scope, duration, potential and actual risk of harm of the violation, and mitigating and aggravating factors that apply. The NERC Sanction Guidelines are calibrated to the \$1 million/per day/per violation limitation imposed by the Energy Policy Act of 2005 for the most serious violations. NERC's Sanction Guidelines

have been working both to assure appropriate enforcement of the Reliability Standards and to further the goals of reliability of the bulk power system.

Congress established a very different framework with respect to the Commission's role in oversight of NERC's development and enforcement of Reliability Standards than the Commission follows for the rest of the matters subject to Commission jurisdiction. Moreover, the entities subject to Commission jurisdiction with respect to Reliability Standards violations cover a far broader spectrum ("users, owners and operators of the bulk power system") than those subject to the rest of the Commission's jurisdiction ("public utilities" or "electric utilities").

The Commission's prior orders implementing the Section 215 program respect these roles and establish a workable mechanism by which penalties are, and have been, assessed. To the extent the Commission seeks to employ a different penalty framework for Reliability Standard violations, it should do so in a rulemaking proceeding and not through a Policy Statement, as required by the Administrative Procedures Act.

The NERC Sanction Guidelines have been applied in all NERC and Regional Entity proceedings since 2007, as recognized by the Penalty Guidelines. As Paragraph 64 recognizes:

The North American Electric Reliability Corporation (NERC), acting as the Electric Reliability Organization, and Regional Entities (RE) impose penalties for violations of Commission-approved, mandatory Reliability Standards using penalty guidelines that employ a Base Penalty Amount Table. FPA section 215(e)(2) provides that a penalty imposed by NERC or an RE may take effect no earlier than 31 days after NERC files with the Commission a notice of penalty and the record of the proceeding.[] In the Notice of Penalty Policy Order, we established the general criteria the Commission will use to determine whether it will review a particular notice of penalty.[] The Commission stated that the more serious the violation described in the notice of penalty, the more likely it would be subject to Commission review.[] To date, the Commission has decided to further review only one of the 153 Notices NERC has filed. We are not modifying the approach set forth in the Notice of Penalty Policy Order. In our previous determinations on notices of penalty, our prior Policy Statements on Enforcement and the Policy Statement on Compliance were resources that informed our judgment whether to review the notices of penalty. We intend to use the Penalty

Guidelines in a similar manner. That is, while we do not anticipate applying the Penalty Guidelines when we look at most notices of penalty that we receive, for an out-of-ordinary notice of penalty describing a serious violation we may consider the results of applying the Penalty Guidelines—but these results would not be determinative of our decision to proceed with a further review.

In its April 7, 2010 Workshop, Commission staff explained that the Penalty Guidelines are separate from, and have no relationship to, NERC's civil penalty calculations under the NERC Sanction Guidelines. According to the Commission staff, the Penalty Guidelines will apply only in Part 1b Rules relating to investigations conducted by FERC's Office of Enforcement, and not in enforcement proceedings conducted by NERC or the Regional Entities. Yet, there are cases in which the Commission and NERC have concurrent Rule 1b and compliance violation investigation proceedings. In such cases, NERC expects that FERC and NERC will jointly work to determine the penalty.

NERC recognizes that the Penalty Guidelines do state the Commission's intent to limit application of the Penalty Guidelines when it reviews most notices of penalty that it receives from NERC and that, while it might consider the results of application of the Penalty Guidelines, such results would not be determinative of a decision to proceed with a further review. However, the Penalty Guidelines also state that the Commission may consider the results of applying the Penalty Guidelines for a notice of penalty that contains an "out of the ordinary" violation. This creates uncertainty with respect to the purpose and result of such consideration by the Commission. Moreover, the Commission has not defined what constitutes "out-of-ordinary" cases. NERC, the Regional Entities and the Registered Entities will be placed in the position of having penalties assessed under the NERC Sanction Guidelines, as required by NERC's Rules of Procedure, only to have that penalty reviewed by the Commission under the quite different regime set out in the Penalty Guidelines.

As noted above, to date, the NERC Sanction Guidelines have been successfully implemented. To resolve the issues identified herein, NERC recommends that the Commission not apply the Penalty Guidelines to Reliability Standard violations. In any event, NERC believes that the Commission should not expect NERC and the Regional Entities to adopt penalty guidelines comparable to the Commission's proposed Penalty Guidelines (particularly with respect to treatment of loss of load, as discussed in greater detail below).

In addition, the Commission has not explained the standard of review it would employ if it were to review a notice of penalty against the Penalty Guidelines. NERC believes that it is the Commission's intent that, in most cases, Commission review of notices of penalty filed by NERC will be the exception rather than the rule (*See* Paragraph 64 of Policy Statement). The Commission also stated that it does not expect to change most of the penalties filed under Section 215 of the Federal Power Act by NERC.¹¹ Further, the Commission stated that a penalty determination under its Penalty Guidelines would not be the deciding factor as to whether to review a notice of penalty by NERC.¹² The Commission also should clarify that it does not intend for the Penalty Guidelines to expand the scope of its Rule 1b or oversight activity beyond the current level of Commission activity today.

As noted above in the introduction, there are significant reasons why the Commission should not apply the Penalty Guidelines broadly with respect to Reliability Standard violations. In large part, widespread use of the Penalty Guidelines in the reliability context would undermine the carefully constructed incentives under NERC's Sanction Guidelines. The latter

¹¹ *North American Electric Reliability Corporation*, "Guidance Order on Reliability Notices of Penalty," 124 FERC ¶ 61,015 at P 8 (2008) citing to *Rules Concerning Certification of the Electric Reliability Organization; and Procedures for the Establishment, Approval, and Enforcement of Electric Reliability Standards*, "Statement Of Administrative Policy On Processing Reliability Notices Of Penalty And Order Revising Statement In Order No. 672," 123 FERC ¶ 61,046 at P 10 (2008).

¹² Policy Statement at P 64.

are designed and applied to foster a proactive reliability risk management posture. The NERC Sanction Guidelines do this by scaling base penalties to risks to the bulk power system and by using technical judgment in applying mitigating and aggravating factors to arrive at the ultimate penalty.

Moreover, the NERC Sanction Guidelines recognize that deciding on the appropriate response when there has been a reliability failure is a complex undertaking. One must balance the need for accountability with the goal of fostering behaviors that are supportive of maintaining and enhancing reliability. When an event occurs, it is in the interest of reliability to have those involved come forward with a description of what happened, and why. It is key to improving reliability for all industry stakeholders and others to learn from events, so that a recurrence of the circumstances that led to the event can be avoided. Moreover, the lessons are not just for the particular entity involved. It is necessary that the entire industry have access to the lessons learned and experiences gained.

The specter of very high, rapidly escalating penalties, as set out in the Penalty Guidelines, will cause entities to make compliance risk management more important than reliability risk management. For example, the threat of million dollar penalties for an inadvertent technician error during a routine relay change-out would likely and substantially undermine much of the incentive to install advanced relays that perform better and that improve overall reliability of the bulk power system. The first focus should be on reliability improvement and not penalty avoidance. Ultimately, such a risk averse posture will inure to the detriment of reliability of the bulk power system.

In addition, the possibility of larger penalties based on criminal guidelines could significantly erode incentives to self report and self correct, which are key features of a robust

compliance program. To promote a culture of excellence and compliance with Reliability Standards, it takes more than penalties to deter violations, even if they are firm and fair. Reliability performance will improve only if entities also perform ongoing and rigorous self-evaluations and promptly take proactive remediation.

NERC is not saying there should be no accountability. To the contrary, an absence of penalties, or a scheme that only imposes very minor penalties, could signal an “anything goes” mentality. That would not be conducive to maintaining and enhancing reliability either. There needs to be an appropriate balance between accountability and encouragement of behaviors that support and enhance reliability. The emphasis should be to promote taking necessary action and sharing lessons on improving reliability and safety. Users, owners and operators of the bulk power system should be encouraged to take actions that will improve the overall reliability of the system. Users, owners and operators of the bulk power system need to come forward with system events and near misses, so that all can learn the lessons that are there. If regulators are not careful, we may inadvertently provide perverse signals to people to manage their enforcement risk, instead of managing the reliability risk to the system. Ultimately, penalties should be crafted to both drive behavior as well as to encourage implementation of: (i) systems and protocols for monitoring, identifying, and correcting possible violations, (ii) a management culture that encourages compliance among company personnel, and (iii) tools and training sufficient to enable employees to comply with Commission requirements. They also should encourage self reports and proactive remediation.

B. The Commission has not justified the application of sentencing guidelines for criminal cases to matters involving regulatory offenses.

The Commission has modeled its Penalty Guidelines on the United States Sentencing Guidelines and has imported concepts from criminal law and applied them to regulatory

violations in the civil context, without any explanation or justification. It did so acknowledging that, even in the criminal context, the United States Sentencing Guidelines have been controversial.¹³ While the sentencing guidelines must be considered in a criminal proceeding, they are advisory only, not mandatory, even in that context.¹⁴

Notably, the United States Sentencing Guidelines, by design, have limited application with respect to regulatory violations. Therefore, the Commission's expanded use of the criminal penalty guidelines in a civil, regulatory violation context has created considerable confusion with respect to why this was considered appropriate.

In particular, in modeling its Penalty Guidelines on the United States Sentencing Guidelines, the Commission adopted the base violation level of 16 which applies to criminal violations committed by organizations. The Commission did not explain its selection of the base level of 16 rather than the base level of 6 it adopted for all of the other civil penalties to be determined under the Penalty Guidelines. The base violation level of 6 also corresponds with fraud, which carries an element of scienter. Violations of Reliability Standards have involved issues with respect to negligence and mistake.

Moreover, the Commission did not seem to take into account the very basic and fundamental distinctions between criminal and civil law, even as applied to organizations. For example, before sentencing a criminal defendant, there must be a finding that that the criminal defendant is guilty beyond a reasonable doubt. This is not the case in the context of a civil, regulatory proceeding, which requires a preponderance of the evidence. NERC would expect that the base violation level established for crimes committed by organizations taking into account scienter, evidentiary requirements and other relevant factors. The Commission has not

¹³ Policy Statement at P 20.

¹⁴ *Id.* at P 19.

explained why the same base level similar treatment is warranted in the context of regulatory violations.

C. The Penalty Guidelines’ reliance on the value of lost load as a basis for penalties for violations of NERC Reliability Standards may undermine, rather than promote, reliability.

The Penalty Guidelines establish a base penalty taking into account the value of loss of load. The result is higher and higher penalties if a Reliability Standard violation has associated load shedding or loss of load (which can include automatic or manual load shedding; collectively referred to herein as “loss of load”). For example, the Penalty Guidelines sets the base penalty as the greatest of a pre-determined table amount,¹⁵ pecuniary gain from the violation or pecuniary loss¹⁶ caused by the violation. The Penalty Guidelines use the terms “pecuniary loss” and “loss” interchangeably with respect to Reliability Standard violations.¹⁷

The following language in Chapter 2, *Illustrative Examples*, is instructive:

(C.1) High risk of minor harm

Example: A small utility registered as a Transmission Owner is three months behind on testing and maintaining 1% of its relays, all on its 115 kV radial transmission lines, meaning the entity faces a high risk of losing a small amount of radial load through an inability to isolate a fault in response to a contingency.

(C.2) Moderate risk of substantial harm

Example: Over a weekend when the system is lightly loaded, operating personnel for a small utility registered as a Transmission Operator fail to use three-part

¹⁵ Loss of load is reflected in the risk of harm and loss determinations that are used to establish the pre-determined table amount calculation, as explained in the Penalty Guidelines at §2A1.1.

¹⁶ “‘Pecuniary loss’ is equivalent to the term ‘loss’ as used in Chapter Two (Violation Conduct). In a case involving a violation of the Reliability Standards, the loss will be enhanced to the extent necessary to reflect any loss that the organization should have caused to prevent greater risk to the bulk power system. An example of such an enhancement to pecuniary loss would be the value of firm load that a balancing authority should have shed to resolve an emergency condition, but did not do so.” See Penalty Guidelines at §1A1.1 Application Notes 3(h).

¹⁷ See Penalty Guidelines at §2A1.1 (a) Base Violation Level: 16; and (b) Specific Violation Characteristics: (1) Risk of Loss. Apply the greatest of the following: (A) If the violation created a low risk of minor harm, no increase. (B) If the violation created either a moderate risk of minor harm OR a low risk of substantial harm, add 3. (C) If the violation created either a high risk of minor harm OR a moderate risk of substantial harm, add 5. (D) If the violation created either a high risk of substantial harm OR a low risk of major harm, add 7. (E) If the violation created a moderate risk of major harm, add 9. (F) If the violation created a high risk of major harm OR a low risk of extreme harm, add 12. (G) If the violation created a moderate risk of extreme harm, add 14. (H) If the violation created a high risk of extreme harm, add 16.

communication of directives, which leads to the wrong breaker being opened. Because there was sufficient capacity on a looped line, there was moderate risk that a substantial, otherwise unnecessary loss of load could occur because the breaker opened.

(D.1) High risk of substantial harm

Example: A medium to large utility registered as a Transmission Operator fails to have on duty NERC-certified operators for 50 hours per month for the last 2 years, placing the utility at an elevated risk of an operator error during any emergency while the non-certified operator is on duty that could lead to a substantial, otherwise unnecessary loss of load.

(E) Moderate risk of major harm

Example: A medium to large utility registered as a Balancing Authority has an event occur on its system and fails to take actions necessary to return its area control error (ACE) to zero for more than 15 minutes, and while it has the necessary amount of reserves through a reserve sharing group, the full amount of reserves cannot be delivered to the BA due to transmission constraints resulting from the event. This violation threatens unnecessary losses of load within the Balancing Authority and in neighboring Balancing Authorities should another contingency occur.

(G) Moderate risk of extreme harm

Example: A medium-sized utility that serves native load and is registered as a Balancing Authority and Transmission Operator does not have sufficient manually-operated load shedding capability to shed load within fifteen minutes in the amount of the Balancing Authority's most severe single contingency. The failure to shed sufficient load as a last resort in an emergency could cause the utility to lean on the Interconnection for too long and, were an Adjacent Balancing Authority to have a contingency, it could lead to widespread blackouts in either or both Balancing Authority Areas.

(F.1) High risk of major harm

Example: A large Transmission Owner has a transmission vegetation management program that requires foot, vehicle and aerial patrols annually along rights-of-way for transmission lines having a capacity of 138 kV and above. The Transmission Owner decides to save \$2 million by deferring the annual aerial patrols for two years. During that time period, a tree located within the right-of-way of a 500 kV line grew sufficiently to contact the line. An aerial patrol timely would have identified the tree as a potential threat of a vegetation contact or flashover that would cause an outage of the line. Such an outage likely would result in major harm through significant, unnecessary losses of load, as well as severe transmission constraints between neighboring Transmission Operators and Balancing Authorities.

(F.2) Low risk of extreme harm

Example: A utility registered as a Balancing Authority does not have any required procedures for the recognition of and for making its operating personnel aware of sabotage events on its facilities and multi-site sabotage affecting larger portions of the Interconnection, and its operating personnel have received no training on recognizing sabotage events. Because of the Balancing Authority's configuration and facilities, its lack of these procedures and training make it more likely that a large-scale sabotage attempt focused on the Balancing Authority's facilities would be successful, causing widespread, unnecessary losses of load on the systems of the Balancing Authority and its neighboring Balancing Authorities. See Penalty Guidelines at § 21A.1

The Penalty Guidelines state that the fact that loss of load occurred is not, by itself, evidence that the violation involved a low or moderate risk.

The focus on load shedding and loss of load in setting penalties is harmful to reliability because it creates the wrong incentive. Using loss of load in the calculation of penalties for Reliability Standard violations provides a disincentive for effective prevention of widespread cascading outages of the bulk power system, which is one of the fundamental reliability tenets. It shifts the focus of the system operator from the task of managing the risk to bulk power system reliability in real-time to managing the risk of enforcement consequences of his or her actions.¹⁸ Penalties are at best a blunt *ex post* tool for driving behavior. In the operational context, it is much better to let precise standards, developed after consideration of technical input from subject matter experts, define the appropriate behaviors for operators in advance. Precise standards also provide a more effective and efficient basis for training operators than penalty determinations.

The staff and committees of NERC and the Regional Entities have worked for decades to educate utility management and their system operators on the importance of shedding load in a timely fashion when that is indicated to protect the integrity of the bulk power system. The

¹⁸ A system operator will, on occasion, disconnect customers from the Interconnection to maintain its integrity or protect generators or transmission facilities from severe damage, NERC Reliability Standards clearly require system operators to do so on a pre- or post-contingency basis. Failure to maintain Interconnection integrity and protect generation and transmission equipment can result in blackouts, long restoration times, or electric service curtailments.

failure to shed load on a timely basis to protect overall system integrity was the root cause of the July 1977 blackout in New York City. The July 1996 WECC Blackout, August 2003 Northeast Blackout, the 2008 Florida Blackout, and other islanding and system separation events also illustrate the need for operators to take action to protect the bulk power system from widespread cascading outages, even if it means a controlled shedding of customer load to do it. The system also includes automatic load-shedding equipment that operates if frequency or voltage gets too low. That equipment is designed to protect against widespread voltage collapse or to stabilize an islanded portion of the system and to make it easier to re-connect that island to the remainder of the interconnection. Load shedding also may occur manually.

Recommendation 8 from the Final Report on the 2003 Blackout states:

Shield operators who initiate load shedding pursuant to approved guidelines from liability or retaliation.[] – Legislative bodies and regulators should: 1) establish that operators (whether organizations or individuals) who initiate load shedding pursuant to operational guidelines are not subject to liability suits; and 2) affirm publicly that actions to shed load pursuant to such guidelines are not indicative of operator failure.¹⁹

System operators do not shed load lightly – it is one of the last steps they wish to take. Yet, when shedding load is called for, it must be done without hesitation or fear of penalty or other recrimination. The existence of Penalty Guidelines that emphasize increased penalties for shedding load could well have a chilling effect on system operators’ willingness to exercise their authority to shed load when that is called for. A reluctance to shed load could place the reliability of the bulk power system in serious jeopardy.

The Penalty Guidelines should not use loss of load in setting penalties. At the April 7, 2010 workshop, the Commission staff clarified that penalty “enhancements” for load shedding would only occur if there was a Reliability Standard violation. Yet, this is an after-the-fact

¹⁹ See Final Report on 2003 Blackout at p. 147. <https://reports.energy.gov/BlackoutFinal-Web.pdf>

determination that can be made only after extensive forensics. A system operator would be put in the precarious position of trying to ascertain if a violation occurred and thus whether or not he or she should shed load, in a span of time that requires decisions to be made in minutes or seconds. At the time the operator needs to act, he or she will know that something on the system calls for action, but will not know what occasioned the need for that action. When lines trip without sufficient time to recover between contingencies placing the system in an insecure operating state (through instantaneous loading of transmission lines and frequency disturbances), operators must respond by taking immediate actions to restore the integrity of the bulk power system.

An operator's concern that communications and actions will lead to an increased penalty (in the event of loss of load) would also impede the control actions between multiple entities where the failure to act quickly was not a violation of a Reliability Standard but within the discretion of the operator. The incentive would be for the system operator to take additional time first to make sure there was no possible violation of a Reliability Standard, or in the alternative, to fail to timely shed load, thereby shifting risk to its neighbors. This would have significant adverse ramifications for the reliability of the bulk power system. The Penalty Guidelines state that if an operator fails to shed load when s/he should have, then that too will be an aggravating factor and increase the size of the penalty. The difficulty of the Penalty Guidelines is that its evaluations are made with the luxury of time and 20/20 hindsight, while the system operator must make decisions in real time.

As the Commission is aware, NERC has a number of Reliability Standards, including FAC, IRO, TOP, TPL, EOP, and COM Reliability Standards, that address load shedding and loss of load due to system disturbances. Because these Standards already address loss of load, it is

inappropriate and duplicative to fashion and collect penalties based on loss of load. Incentives for specific actions or conduct, including the appropriate use of load shedding or actions taken to prevent unnecessary loss of load, are more effectively addressed through NERC's Standards Development Process set forth in Section 300 and Appendix 3A of the NERC Rules of Procedure.

NERC also has mechanisms to effectively address conduct related to load loss after-the-fact without the unintended consequences of the Penalty Guidelines. These include event analysis, spot checks, audits, compliance violation investigations, and other procedural rules. These mechanisms allow for thorough analysis of the causes and detection of situations that may lead to a loss of load. Regulating conduct, through the setting of Reliability Standards and requirements, with the appropriate mechanisms to verify on-going conduct (*i.e.*, spot-checks, audits, self-reports, and event-sharing) is more likely to meet the desired result of preventing unintended load loss than penalizing for loss of load after-the-fact.

Even if loss of load were a legitimate factor to consider in establishing penalties, it is not clear how the Commission would calculate the value of lost load for purposes of applying the Penalty Guidelines. The example provided with respect to application of the Penalty Guidelines to Reliability Standard violations used a \$15 million value for loss of load. As discussed herein, the Commission did not explain the basis or formula applied to derive this figure. Indeed, the Commission did not state whether it would take into account the value of loss of load that may be precluded from recovery in private right of action cases. Given the profound effect it has in the base penalty and the adders, the Commission should ensure the Penalty Guidelines do not employ a highly subjective determination of the value of loss of load.

D. If retained, the Penalty Guidelines require clarification and modification to achieve the goals articulated by the Commission for greater fairness, transparency and consistency, even if applied only in the context of a Rule 1b proceeding.

The Policy Statement asserts that the Penalty Guidelines incorporate certain “objective characteristics” and “uniform factors.” Significantly, there are a number of places in the Penalty Guidelines that rely on undefined terms, subjective criteria and missing formulas to make penalty determinations. Failure to address these could lead to inconsistency and confusion in the application of the Penalty Guidelines. A number of examples are provided below.

The term “low risk” is one such example of a lack of clarity. According to the Penalty Guidelines, “‘low risk’ is not meant to include cases where there was virtually no risk of harm. It is meant to apply to cases where there was a significant, albeit small, chance of the relevant level of harm.” Use of the terms “significant” and “small” when describing the chance of relevant harm is confusing. Does the Commission mean that “low risk” is when there is a significant chance of relevant harm, or does it mean there is a small chance of relevant harm? Alternatively, did the Commission intend a small chance of a significant risk of harm? This should be clarified.

In addition, the Commission introduces four new terms related to the level of harm—minor, substantial, major and extreme. These terms are different than the Violation Risk Factor terms of Lower, Medium and High and the Violation Severity Levels of Lower, Moderate, High and Severe that NERC uses to evaluate particular violations. The Penalty Guidelines provide no explanation for why different terms were needed for reliability violations. The Penalty Guidelines do not define these four new terms nor do they provide criteria to evaluate the risk of harm. Rather, they provide only illustrative examples for each level of the nature of harm.

NERC is concerned that the absence of uniform criteria will necessarily lead to inconsistent application of the Penalty Guidelines.

Of particular concern, while loss of load is a significant factor for increasing the magnitude of penalties under the Penalty Guidelines, those Guidelines do not provide the basis for calculating the value of lost load. While the Penalty Guidelines allow the value of the loss of load to be estimated, there is no formula for the calculation or estimation of the value of the loss of load. The duration date is not identified in the Reliability Standard example, and it is not clear as to whether the proposed penalty range is a per day penalty or a cumulative penalty. It also is not clear as to how the per diem issues are reflected in the penalty amount.

By way of illustration, the minimum penalty range for the Reliability Standard violation is \$12 million for a seven hour outage. In paragraph 61 of the Policy Statement, FERC notes that “where the minimum guideline penalty is greater than the maximum penalty authorized by our \$1 million per day, per violation statutory authority, then the guideline penalty will be reduced to the maximum penalty authorized by statute.” The Commission should explain the factors underlying the \$12 million and whether it was, or would be, reduced to \$1 million. The Commission should provide more information on the duration of the violation as compared to the duration of the outage.

The Commission also should explain whether the Reliability Standard loss of load figure includes direct, indirect, special, consequential losses and any other losses or damages. The Commission further should explain whether and how it took into account state and federal limitations of liability with respect to outage costs, including those that preclude recovery of losses for lost profit and spoiled food.

NERC requests that the Commission address the following questions in its final action. Are penalties going to be developed and applied on a per Reliability Standard violation basis? If not, how will they be developed and applied? Would a bell-curve approach be used with regard to penalty assignments if a penalty results in a disparity?

Consider the following examples, where single day violations are statutorily reduced to \$1 million:

- “Violation #1” results in a minimum penalty of \$900,000, and
- “Violation #2” a minimum penalty of \$2 million, and
- “Violation #3” a minimum penalty of \$25 million.

NERC also requests clarification of how the Commission intends to differentiate, in the base penalty, documentary violations and significant violations.

Moreover, as noted above, the Commission stated that it would generally consider the Penalty Guidelines when reviewing “out-of-ordinary” violations embodied in NERC notices of penalty. However, this term is not defined and introduces uncertainty as to when the Commission would conduct such review.

While the Commission states that it does not intend to depart from the Penalty Guidelines regularly, it states that it will not always adhere to a rigid application of them.²⁰ This raises questions about what criteria the Commission will consider in making such a determination. It also raises questions about whether the guidelines will be consistently applied if the Commission were to routinely depart from their application.

According to the NERC Sanction Guidelines, if “a violator has had repetitive infractions of the same or a closely-related reliability standard requirement, particularly within a time frame defined within the standard(s) or deemed appropriate by NERC or the regional entity in the

²⁰ Policy Statement at P 32.

absence of the standard(s) defining the time frame, NERC or the regional entity shall consider some increase to the penalty.”²¹ The Penalty Guidelines do not appear to make the distinction to require violations to be the same or closely related standard in determining if they are repeat violations. The Commission should clarify if it is making changes with respect to treating all prior violations as repeat history. NERC does not mean, however, that prior history, even if unrelated, not be considered by a compliance enforcement authority. The entity’s prior compliance history is taken into account when considering a culture of compliance or robustness of a compliance program.

In the Penalty Guidelines, certain of the credits appear to be bundled. Credit is afforded to self-reports under FERC’s process, but it is folded into the factor on cooperation and settlement under Section C.2(g)(1). It is not clear what credit is afforded to self-reports in the absence of either full cooperation and/or settlement. NERC submits that the following items warrant independent credit when assessing penalties:

- self-reports;
- cooperation;
- settlement;
- acceptance of responsibility; and
- remediation.

In addition, the Penalty Guidelines only address credit for “full” cooperation. The Commission also should explain what credit is provided in a case of exemplary cooperation. NERC also seeks clarification and criteria on what is considered to be an “unreasonable” delay in reporting a violation to governmental authorities.

²¹ NERC Rules of Procedure, Appendix 4B at Section 4.3.1 at p. 13.

IV. CONCLUSION

For the reasons set forth in this filing, NERC strongly recommends that the Commission not apply the proposed Penalty Guidelines to violations of Reliability Standards. If, contrary to NERC's recommendation, the Commission does apply the Penalty Guidelines to violations of Reliability Standards, then NERC urges that the Commission restrict use of the guidelines only to cases where the Commission has initiated its own investigation under Part 1b of its regulations.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have served a copy of the foregoing document upon all parties listed on the official service list compiled by the Secretary in this proceeding.

Dated at Washington, D.C. this 14th day of June, 2010.

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