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Tensions in the Structure for Reliability Regulation

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There is, as Harvard's program description suggests, tension in the current system of reliability regulation. There is tension between NERC and FERC, tension between NERC and the regions, and tension between registered entities and their regulators.

Some of these tensions are unavoidable. It is, after all, the first self-regulatory structure overseen by FERC.

But some of the tension represents more than growing pains. It reflects different perspectives on how Section 215 should be implemented. This paper considers the more important tensions and how, if at all, they can be addressed.

Starting Off in Different Places

Virtually all stakeholders agree "why" Section 215 was enacted – mandatory standards were deemed necessary after the 2003 Blackout and its predecessors. But the agreement often ends there.

The industry envisioned Section 215 as a "self regulatory" model under which industry experts would draft standards and enforcement would be performed close to home (by the regions). Under this model, NERC would exist mainly to provide consistency and FERC would exist mainly to handle appeals.

This is certainly a plausible reading of the statute, but it did not work out that way. Why? The primary reason is that FERC had a different perspective.

Part of this difference in perspective was transitional. FERC had no experience with a self-regulatory structure. RTOs were the closest thing, but they had no enforcement authority and FERC was not required to "defer" to them.

But there were more fundamental reasons as well. First, FERC viewed the standard development process as flawed, sometimes producing standards that were watered down to gain votes. Second, it viewed NERC and the regions as having little experience in enforcement and therefore needing strong oversight (and, in some cases, intervention) from FERC.

Third, there was pressure from Congress. Congress views FERC as in charge of reliability, not the regions or the industry. Political accountability matters and FERC had little choice but to be responsive to Congress.

FERC therefore took a more aggressive approach from the start than many had expected. This, in essence, turned a "bottoms up" system – i.e., one that would rely heavily on the regions and industry experts – upside down. This affected both standards development and enforcement, each of which is discussed below.

Standards Development: Technical Expertise vs. Votes

The statute instructs FERC to give "due weight" to the "technical expertise" of NERC in reviewing proposed standards. Has this happened? Many would say no. Although FERC accepted most Version 1 standards, it ordered significant changes to 56 of them. It also ordered significant changes to the CIP standards.

Why? The answer has both policy and process components. As a matter of policy, FERC views its mission as strengthening reliability, not simply maintaining it. That is why it seeks continual improvement in the standards, even if they are good enough to be accepted.

As a matter of process, FERC is suspicious of stakeholder-created reliability rules. Industry volunteers possess technical expertise, but the NERC standards process also involves *voting*. FERC therefore worries that standards can be watered down to win votes (the so-called "least common denominator" issue).

Is this situation likely to change? In the long run, the conflicts may decline, as all sides re-align their expectations. But there will remain a recurring tension – namely, that the statutory basis for deference

("technical expertise") does not fit neatly with how the process actually works.

What do I mean by this? Although extraordinary technical expertise is used to draft standards, that expertise is often diluted in the record submitted to FERC. There is typically no "technical report"[1] to support the standards; rather the record mirrors the iterative nature of the process – *i.e.*, the drafting committee proposes a standard, the stakeholders submit comments on it, the drafting committee responds to each comment, the standard is then redrafted, comments are taken and so on.

This creates a large "record" – sometimes consisting of 500 pages or more – but not one particularly well suited produce to "deference." It is more like a "legislative history" – e.g., a collection of floor colloquies.

NERC has sought to address this issue when it files proposed standards by highlighting for FERC the parts of the record that merit attention. Its recent filing in support of WECC's proposed standards is a good example. NERC identified each issue previously raised by FERC and how it was resolved, as well as other issues raised by the stakeholders.

This approach helps to provide a stronger basis for deference, but there remains somewhat of a disconnect between how the statute was written and how the process actually works.

The focus on "technical expertise" also obscures other important reasons for deference. Consider the analogy of RTOs. Like NERC, RTOs use stakeholder processes to create rules and, like NERC, those rules are not usually accompanied by a technical report. Rather, like NERC, they are normally supported only by a legal pleading that describes, in general terms, the key issues and how they were addressed.

Yet FERC often defers to RTOs. There are many reasons for this, but one of them is FERC's belief that RTOs will be stronger if each RTO region is given some control over its own destiny. This is not unlike the principle underlying our federal system: the states are given substantial control not because they are "experts," but because local control itself is valued.

To be sure, this is, in some respects, a poor analogy for reliability regulation. The bulk power system is interconnected and therefore we do not want "local" control. But a similar issue is nonetheless presented: whether, in crafting *national* standards, we should provide more deference to those who are closer to the issues (e.g., the industry, the regions and NERC). Reasonable minds can differ on the answer, but it is an important debate that should not be lost in discussions over "technical" expertise.

Enforcement: Competing Principles and Priorities

The reliability enforcement process is relatively young and the debate thus far has focused mostly on transition issues, such as how to reduce the enforcement backlog, how to provide more transparency in regional enforcement processes, and whether the "penalty tool" should be made public.

But longer-term issues will soon appear. The issues will likely include (i) whether every violation should receive some penalty, (ii) whether adequate credit is being given for self-reports and compliance programs, (iii) whether penalties are being applied consistently across the regions, and (iv) whether FERC is focused on "clear" violations or, instead, is "pushing the envelope" by using enforcement to upgrade reliability.

One problem in addressing these issues is that the debate over enforcement often focuses on "results," not principles. Enforcement is *ad hoc* by nature because regulators do not control when violations occur or which ones. Policy is made one case at a time, not neatly in a rulemaking. And, since most cases involve settlements, that policy often cannot be articulated clearly, leaving the public to scour settlement documents to assess which factors were the most important.

All of this means we often do not step back and ask what our guiding principles should be. Conferences like this provide such an occasion, and I would suggest that two related principles should be paramount.

The first is that we should focus our scarce resources on the most serious violations, not every violation. This seems like a simple proposition, but is not yet happening. There are significant paperwork burdens even for small violations. And, if every violation receives a penalty (which could happen), this will further drain resources because it will require negotiation of penalty amounts even for small cases.

To put this issue in perspective, 57% of all violations involve documentation errors. With finite enforcement resources, it does not make sense for society to spend many resources on these cases. Nor should it spend many resources on other minor violations (e.g., those with a Lower VRF).

[1] This is not to say there are no technical papers. Recent examples include NERC's technical papers on vegetation management practices and in support of a new standard for system protection. (See the standards development portion of NERC's website.)

The second principle is that penalties should be set to bear a reasonable relation to social harm and the culpability of the violator. They should not be set to achieve "consistency" by formula, such as through rigid penalty schedules.

Why are all of these points related? It is because there is a relationship between the seriousness of the offense and the issue of consistency – specifically, the more serious the offense, the less likely another case will present the same facts. And, therefore, if we focus our resources on the most serious cases, we will soon find that achieving consistency through *ex ante* penalty schedules is elusive and we should instead be focused on applying consistent principles instead.

Gerry Cauley, CEO of SERC, recently made a similar point in a speech at Skadden's Enforcement and Compliance Conference:

"The reality is that every case is unique and there are thousands of possible perturbations in evaluating factors that might increase or decrease the penalty. . . . There should not be an expectation that two different regions or even two different groups within a region would look at the facts and circumstances and arrive at the same penalty, down to the dollar, in every case. What is important is that the results are reasonably consistent, given the facts and circumstances of the case and that there is a clear explanation of the factors considered in setting the penalty."

This, in my view, is the right approach and the history of the Federal Sentencing Guidelines – which are analogous in many respects to the reliability Penalty Matrix and Penalty Tool – teach us the same lesson.

The Sentencing Guidelines were constructed without agreement on guiding normative principles. The original Sentencing Commission grappled with two competing theories of penalties ("just deserts" and "social harm"). But it could not agree and therefore embraced neither. Instead, the Sentencing Commission created a mathematical construct to replicate past sentencing levels (but make them more consistent).[2]

We should avoid falling into this trap in the reliability area. It is better to have principles without numbers than numbers without principles.

Some elements of the current system do this and should be retained. For example, the Violation Risk Factors (VRFs) are useful because they help us distinguish between serious and minor violations. Not all violations are the same. Some harm the public; others do not. Some risk outages; others involve paperwork errors. The VRFs help us make those distinctions and, if they can be grounded in empirical data on prior outages or blackouts, they can provide us with intelligent, not arbitrary, distinctions.

But going further and trying to adopt *ex ante* penalty schedules for hundreds of different violations is problematic. It risks elevating consistency over accuracy and thereby leaving us with foolish consistencies.

In the end, we will be better served if we focus on the most serious violations, not every violation, and, when setting penalties, to focus on social harm and the culpability of the violator.

Resource Allocation and Prioritization

There is a common thread running through the prior discussion of standards development and enforcement. It is resource allocation. In both instances, we need to focus on the tasks with the greatest value, not every task.

The issue of resource allocation is particularly important for reliability regulation because it is so critical to society. Outages can cause significant economic harm and can even affect public safety.

There are many recent signs of resource strains:

- The debate over whether to discontinue readiness reviews;
- The increasing number of standards development projects and the slipping timelines for getting them done; and
- The significant documentation requirements for minor violations.

Some of these are simply growing pains, but the point remains: reliability is too important to devote our scarce resources to tasks that do not provide high value. We need to ask ourselves constantly whether we are spread too thin, focusing on everything rather than the most important things.

Contact Us

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[2] Stith and Cabranes, Fear of Judging: Sentencing Guidelines in the Federal Courts (U. of Chicago 1998).