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FERC Proposes to Simplify Affiliate Standards of Conduct

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On March 21, 2008, the Federal Energy Regulatory Commission (FERC) issued a Notice of Proposed Rulemaking (NOPR) on standards of conduct governing relations between transmission providers for both electricity and natural gas and their affiliates. The proposed rules vastly simplify prior rules and concentrate on three principles as the way to prevent affiliate abuse.

In November 2006, the U.S. Court of Appeals for the D.C. Circuit invalidated many aspects of the standards embodied in FERC's Order 2004 rules, particularly with respect to applying the rules to "Energy Affiliates" of gas pipelines. In response, in January 2007, FERC issued both a new set of interim affiliate rules based on existing precedents and a set of proposed new rules to replace the interim rules. The January 2007 NOPR was subject to extensive comments.

Normally, FERC would have issued final rules that would be based largely on the January 2007 NOPR and the comments. However, in its March 2008 NOPR, FERC reversed itself, abandoning the January 2007 NOPR, substituting a simpler set of proposed rules for public comment, and eliminating completely the concept of Energy Affiliates which had been struck down. FERC cited, as a basis for changing direction, testimony regarding the substantial difficulty parties had in determining how to comply with the rules. FERC noted that it had received 107 requests for waivers of the existing rules.

FERC encapsulated in the March 2008 NOPR three core principles. The main elements of the new rule are (i) an "independent functioning" rule, (ii) a "no conduit" rule, and (iii) a "transparency" rule. All three rules have been in place in one form or another for quite some time. For example, the independent functioning rule has its origin in Order 497 on the gas side and Order 889 on the electricity side. In implementing these three principles, FERC continues the path that began in Order 2004, believing that a single set of rules for both electricity and gas is necessary, anticipating convergence between those two industries. While the convergence has not yet occurred, FERC is still seeking consistency across the industries.

Independent Functioning

The independent functioning test replaces a similar set of rules in Order 2004 and elsewhere that require the merchant function to be separate from the transmission function. The 2007 NOPR relied on an employee's position in the organization chart rather than on the employee's actual function in the job. Transmission employees must continue to function independently from marketing employees or marketing affiliates, but the new NOPR would apply the independent function standard based on an employee's particular job function and not on the employee's place in the organization. In order to be defined as a marketing function employee, the employee must be actively involved in marketing gas or electricity, including offers to buy or sell natural gas or electric energy or capacity, as well as financial transmission transactions.

Similarly, only an employee of the transmission company who is actually actively engaged in the transmission function would be designated as a "transmission function employee." This retains the principle of separation of function, which has been at the heart of FERC's affiliate conduct rules for two decades, while avoiding an excessive reliance on corporate form and organization. The general prohibition against transmission function employees also conducting marketing activities or providing discriminatory access to marketing affiliates continues in place, as well as a prohibition on marketing function employees conducting transmission functions, but the new NOPR clarifies that supervisors are neither marketing nor transmission function employees unless their own activities happen to fall into those areas.

The new NOPR eliminates the proposal in the 2007 NOPR to apply the rules across the board to asset managers, and instead applies the rules only to employees of asset managers actually engaged in marketing. Reflecting the importance of reliability in the Energy Policy Act of 2005, the NOPR makes an exception for the exchange of certain limited information regarding generation dispatch and transmission information to maintain or restore operation of the transmission system. Records must be kept of such exchanges qualifying under these exemptions, except for emergency circumstances where the record could be made after the fact.

No-Conduit

The second change is to the "no-conduit" rule. FERC proposes to strengthen the proscription against the exchange of prohibited information. In addition to the current prohibition against transmission function employees disclosing non-public transmission function information to marketing function employees, FERC proposes to prohibit market function employees from receiving non-public transmission information from *any* source. In addition, FERC proposes to prohibit both an employee of a transmission provider and an employee of an affiliate engaged in marketing from disclosing non-public transmission function information to marketing function employees.

This expansion of the existing no-conduit rule is designed to reach all sources of a prohibited information exchange. The intent is to cover both information and employees not falling within the scope of the independent function rule. For example, although there is no general requirement that lawyers employed by transmission providers need to function independently of the company's marketing function employees, lawyers must nevertheless avoid serving as a conduit for passing transmission function information to marketing function employees. The same exemptions for generation dispatch or to maintain or restore operation of the transmission system also apply here.

The existing rules mandate that transmission providers designate a Chief Compliance Officer. FERC continues the proposal from the 2007 NOPR that the transmission provider post the name of the Chief Compliance Officer on its Open Access Same Time Information System (OASIS) or internet website. FERC also retains the requirement that transmission providers train their employees on compliance with the standards at least annually.

Transparency

The third piece of FERC's new NOPR is the "transparency" rule. A transmission provider may comply with the prohibition on passing transmission function information to marketing function employees by making such information publicly available. Moreover, as provided in the existing regulations, if prohibited information is inadvertently passed to an ineligible employee, the violation can be cured by immediately posting such information on the transmission provider's OASIS or internet website.

The new NOPR also proposes modifications to the posting requirement for transmission providers. Specifically, FERC proposes to eliminate the requirement to post an organization chart. In addition, the rule provides for temporary suspension of posting requirements in the case of emergency, such as a hurricane. The NOPR proposes to carry forward the existing regulations regarding the non-discrimination and non-preference requirements for transmission providers.

A troublesome issue in Order 2004 was the question of when a pipeline becomes subject to the standards. Under Order 497, a natural gas transmission provider became subject to the standards when it commenced transportation transactions through its marketing and brokering affiliates. In Order 2004-B, FERC stated that a new interstate pipeline should observe the standards as soon as the pipeline accepts the Certificate of Public Convenience and Necessity. Conceding that there is not any evidence that affiliate abuse occurred in the time period before a pipeline begin transmission, FERC now proposes to make the standards applicable when a pipeline begins service.

In this NOPR, FERC admitted that the standards of conduct had become too complex and overly broad, making compliance and enforcement difficult. Because of this burden, and in light of FERC's authority to assess penalties under the Energy Policy Act of 2005 of up to $1 million per day, per violation, FERC determined it was necessary to provide greater clarity and has attempted to do so in this new NOPR. However, transmission providers and their affiliates for both electricity and natural gas should review the NOPR to ensure that sufficient clarity exists and, if not, consider filing comments. Comments on the NOPR are due May 12.

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