

# Standards of Conduct: New Focus, New Challenges

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## I. Introduction

On Nov. 26, 2008, the Federal Energy Regulatory Commission's revised Standards of Conduct for Transmission Providers, promulgated in Order No. 717,<sup>1</sup> became effective. They replaced the Standards of Conduct for Transmission Providers promulgated in Order No. 2004.<sup>2</sup> Like its predecessor, Order No. 717 imposes behavioral measures intended to prevent interstate transmission providers of electricity and natural gas from granting undue preferences to, or discriminating in favor of, their marketing affiliates. Order No. 717's aspiration is to do it more efficiently. While on their face, the Order No. 717 Standards of Conduct would appear

to lessen the restrictions on transmission providers, they must be read as part of FERC's larger enforcement agenda, as outlined in its Policy Statement on Compliance,<sup>3</sup> issued the same day.

Order No. 2004 was sweeping and complex. It sought to impose independence requirements and restrict information exchanges across entire corporate groups in an attempt to preclude the possibility of conduct that might result in discrimination. Its breadth necessitated many exceptions, and in practice it proved to be unwieldy and difficult to implement, monitor or enforce. In contrast, Order No. 717 is lean and focuses on a much narrower population. It removes a number of barriers to the exchange of information necessary for operational and long-term planning needs. However, it imposes sharp divides with few exceptions at the interface between real-time transmission operations and marketers engaged in wholesale sales, where the Commission deems behavior that may result in discrimination or undue preference most likely to occur.

The revised Standards have rightly been widely hailed by transmission providers as a tremendous improvement. Although a substantial number of requests for rehearing have been filed, on the electric side, most



**Donna Attanasio**  
White & Case



**Earle H. O'Donnell**  
White & Case

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1. *Standards of Conduct for Transmission Providers*, Order No. 717, 73 Fed. Reg. 63,796 (Oct. 27, 2008), FERC Stats. & Regs. 31,280 (2008), *reh'g pending*.

2. *Standards of Conduct for Transmission Providers*, Order No. 2004, 68 Fed. Reg. 69,134 (Dec. 11, 2003), FERC Stats. & Regs. 31,155 (2003), *order on reh'g*, Order No. 2004-A, 69 Fed. Reg. 23,562 (Apr. 29, 2004), FERC Stats. & Regs. 31,161, *order on reh'g*, Order No. 2004-B, 69 Fed. Reg. 48,371 (Aug. 10, 2004), FERC Stats. & Regs. 31,166, *order*

*on reh'g*, Order No. 2004-C, 70 Fed. Reg. 284 (Jan. 4, 2005), FERC Stats. & Regs. 31,172 (2004), *order on reh'g and clarif.*, Order No. 2004-D, 110 FERC 61,320 (2005), *vacated in part and remanded sub nom. Nat'l Fuel Gas Supply Corp. v. FERC*, 468 F.3d 831 (D.C. Cir 2006).

3. *Compliance with Statutes, Regulations, and Orders; Policy Statement on Compliance*, 125 FERC 61,058 (2008).

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(but not all) merely seek clarification or refinement on specific points.<sup>4</sup> However, the transmission industry should not take lightly the fact that the revised Standards were issued on the same day as the Policy Statement on Compliance. Clear rules will facilitate FERC's enforcement efforts in accord with its vision of "firm but fair" regulation. Companies will need to overhaul their training programs to comply with Order No. 717. However, they should also heed the guidance in the Policy Statement on Compliance and take a hard look at their internal monitoring, auditing, and compliance incentive programs and determine if the efforts they are making to implement Order No. 717 and to comply with other FERC top priorities meet FERC's tougher standards for self-monitoring and self-policing.

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## II. Order No. 717 Overview

Order No. 717 retains Order No. 2004's approach of unifying the Standards of Conduct applicable to providers of electric transmission service and gas transportation. The new Standards focus on four core areas: nondiscrimination, independent functioning, limitations on communications, and transparency. These concepts are captured in the regulatory text as General Principles (18 C.F.R. § 358.2):

(a) A transmission provider must treat all transmission customers, affiliated and nonaffiliated, on a not unduly discriminatory basis, and must not make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage with respect to any transportation of natural gas or transmission of electric energy in interstate commerce, or with respect to the wholesale sale of natural gas or of electric energy in interstate commerce.

(b) A transmission provider's transmission function employees must function independently from its marketing function employees, except as permitted in this part or otherwise permitted by Commission order.

(c) A transmission provider and its employees, contractors, consultants and agents are prohibited from disclosing, or using a conduit to disclose, nonpublic transmission function information to the transmission provider's marketing function employees.

(d) A transmission provider must provide equal access to nonpublic transmission function information to all its transmission function customers, affiliated and nonaffiliated, except in the case of confidential customer information or Critical Energy Infrastructure Information.

Additional provisions detail the transmission provider's specific obligations with respect to these principles and set forth implementation requirements.

The Standards of Conduct will continue to require the placement of barriers to most nonpublic communications between a transmission provider's transmission function employees and marketing function employees and require the two groups to operate independently. But Order No. 717 deviates dramatically from Order No. 2004 in several significant respects.

### A. Order No. 717's sharper focus

The Standards of Conduct promulgated in Order No. 717 apply to a narrower subset of companies than those covered by Order No. 2004. The Commission determined that since pipelines operating under Part 157 of its regulations are restricted to serving only the shippers specified in their certificates, such pipelines do not have the discretion available under an open access tariff that would permit them to discriminate in favor of nonaffiliates.<sup>5</sup> Similarly, any transmission provider that does not transact with its marketing affiliates does not raise the issues of discrimination that the Standards are designed to address.<sup>6</sup> Accordingly, the revised rules apply to:

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4. A notable exception is the Transmission Access Policy Study Group which argues that the Commission's reforms are too broad and will enable transmission providers to provide undue preferences to their affiliates (*Standards of Conduct for Transmission Providers*, Docket No. RM07-1-001, Petition for Rehearing or Clarification of the Transmission Access Policy Study Group (filed Nov. 17, 2008)).

5. Order No. 717 at P 15.

6. *Id.* at PP 20, 23.

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- “[A]ny interstate natural gas pipeline that transports gas for others pursuant to subparts B or G of part 284 . . . and conducts transmission transactions with an affiliate that engages in marketing functions.”<sup>7</sup>
- “[A]ny public utility that owns, operates, or controls facilities used for the transmission of electric energy in interstate commerce and conducts transmission transactions with an affiliate that engages in marketing functions.”<sup>8</sup>

The Standards specifically exclude from their scope Commission-approved independent system operators and regional transmission organizations for the obvious reason that such entities, by their nature, do not have marketing affiliates. A transmission-owning member of an ISO or RTO may also be outside the scope of the rules, but only if it neither operates nor controls its transmission system *and* does not have access to information related to the day-to-day operations of the transmission system. In addition, waivers may be requested, for example, by entities that have only one customer which is also an affiliate. Transmission providers that were previously granted waiver from the Standards are still entitled to waiver (although in some cases, the need for waiver may be mooted by the narrowed applicability standards).

Within a company to which the Standards are applicable, the number of employees subject to restrictions on receiving nonpublic transmission information and required to function independently from the transmission function are also reduced. Order No. 717 rejects Order No. 2004’s “corporate separation” approach in favor of the “employee functional” approach that preexisted Order No. 2004. This focuses the rules and restrictions on employees based on their functions, rather than entire corporate departments. In addition, the concept of “energy affiliate,” which reached groups engaged in financial transactions and other tangential functions, has been eliminated.

Even the scope of employee functions affected is narrowed. “Marketing function” is now defined separately for public utilities and for interstate gas pipelines but, in both cases, the marketing function covers only wholesale sales, not purchases. Purchases for resales to retail load or made as part of a provider of last resort obligation are excluded. “Transmission functions” is defined as “the planning,

directing, organizing or carrying out of day-to-day transmission operations, including the granting and denying of transmission service requests.”<sup>9</sup> The Commission made it a point to specify that it intended to focus only on “short term real time operations, including those decisions made in advance of real time but directed at real time operations.”<sup>10</sup> The definition of transmission function employee is given a similarly narrow meaning. Thus, employees engaged in the function of purchasing power or long-term transmission or generation planning, including conducting system impact studies, are not within either of the two groups that must function independently. Rate design of transmission rates is no longer considered a transmission function either.<sup>11</sup>

Further, the employees within the scope of the definition of “marketing function employee” or “transmission function employee” are limited to those employees that are actively and personally engaged on a day-to-day basis in marketing or transmission functions, respectively. The Commission explained that the types of actions included within the scope of “day-to-day operations” of a transmission provider include: “[c]oordinating the actual physical flows of power or gas, balancing load with energy or capacity, isolating portions of the system to prevent cascades, imposing transmission loading relief, and the like,”<sup>12</sup> as well as granting and denying of service requests.

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### *Order No. 717 rejects Order No. 2004’s “corporate separation” approach in favor of the “employee functional” approach.*

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This change has the effect of releasing senior management, not otherwise engaged in day-to-day operations, from the barriers that otherwise limited their access to nonpublic transmission information. A senior manager exercising a duty of corporate oversight, such as executing power or gas purchase or sale contracts of significant value or approving capital budgets for the transmission group, will no longer need to fear classification as a marketing or transmission function employee by reason of exercising these responsibilities.

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7. 18 C.F.R. § 358.1(a) (emphasis added); *see id.* § 358.3(k)(2).

8. 18 C.F.R. § 358.1(b) (emphasis added); *see id.* § 358.3(k)(1).

9. 18 C.F.R. § 358.3(h).

10. Order No. 717 at P 40.

11. *Id.* at P 276.

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The overall effect of these changes — which focus the key provisions of the Standards on fewer companies, fewer departments, and fewer employees — is to home in on the employees that operate the transmission system and/or make decisions affecting real-time transmission service and to separate them physically and functionally from the personnel that transact in the wholesale markets as sellers. While, technically, an employee making purchases in the wholesale short-term market is not a “marketing function employee,” practically speaking, most traders in the short-term markets buy and sell and thus will be covered. But employees engaged in long-term purchases, such as those administering competitive procurements and negotiating structured long-term purchases with winning bidders, will no longer be barred from receiving nonpublic transmission information or required to function separately from transmission function employees.

So why is this good public policy? Because these changes remove barriers that impair a transmission provider’s ability to fully satisfy competing legal obligations.

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Under the Order No. 2004 Standards of Conduct, the barriers to the exchange of nonpublic transmission information inhibited certain internal company communications that were necessary to meet state-imposed requirements. In particular, many vertically integrated public utilities with retail load obligations must satisfy state mandates for integrated resource planning and renewable resource acquisition targets. Even those without specific obligations generally must demonstrate that procurement decisions meet a state-established cost standard — such as California’s “least-cost, best-fit” criteria.

Because communications regarding transmission planning were required to be public, a company had limited ability to gather information on the cost of transmission related to its power procurement options without disclosing to the market the options

under consideration and thereby compromising its commercial interests. For utilities with significant state-mandated renewable resource acquisition programs, the lack of ability to integrate transmission information and planning into their resource acquisition strategy was particularly troublesome since the evaluation of transmission availability and cost is such a significant aspect of renewable resource purchases. Order No. 717 permits a utility to evaluate its long-term transmission planning decisions and its long-term procurement decisions as a coherent whole.

In addition, the senior management of affected transmission providers chafed under the constraints Order No. 2004 placed on the internal flow of information at a time when greater emphasis on corporate oversight was being demanded, following numerous corporate scandals and the passage of Sarbanes-Oxley. Order No. 717 permits senior management to receive timely information regarding all aspects of the company’s operations, set policies and provide strategic direction without becoming isolated into a “transmission” or “marketing” box. Overall, the changes wrought by Order No. 717 were intended to, and should, restore some of the efficiencies of vertical integration that benefit retail and native load customers and facilitate internal oversight and management.

## B. Order No. 717’s sharper edge

Order No. 717 did not drop barriers without imposing limits. The Standards specify that nondiscrimination requires a transmission provider to enforce all the provisions of its tariff that do not permit discretion, exercise discretion in an even-handed manner, and “process all similar requests for transmission in the same manner and within the same period of time.”<sup>13</sup> The transmission function and the marketing function must be operated independently, and marketing function personnel affiliated with the transmission provider cannot have preferential access to areas where transmission functions are performed.

The new Standards continue the prohibition on use of a third party as a conduit to transmit nonpublic transmission function information to a marketing function employee. The prohibition also extends to the employees, contractors, consultants, or agents of a transmission provider or its affiliates. If nonpublic transmission function information is disclosed to a marketing function employee in contravention of the “no conduit rule,” then the information must

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12. *Id.* at P 122.

13. 18 C.F.R. § 358.4(d).

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be immediately publicly posted (the “contemporaneous disclosure requirement”).<sup>14</sup>

The Standards also include strict requirements for record keeping and additional posting to enhance transparency. For example, the permissible communications of nonpublic transmission information by transmission function employees to marketing function employees are severely limited. Only communications pertaining to compliance with Reliability Standards necessary to maintain or restore operation of the transmission system or generating units or that may affect dispatch of the units are permitted, and a contemporaneous record must be made of each such communication.<sup>15</sup> Another example is that any waiver of a transmission tariff provision granted to an affiliate must be posted on the transmission provider’s website, and a log of such waivers must be kept for five years.<sup>16</sup>

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### *Senior management of affected transmission providers chafed under the constraints of Order No. 2004.*

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Employers have the obligation to train “transmission function employees, marketing function employees, officers, directors, supervisory employees, and any other employees likely to become privy to transmission function information.”<sup>17</sup> In order to effectively implement and enforce the “no conduit rule,” transmission providers will have to give careful consideration to how extensively they must train “other employees,” within which category they have substantial discretion. Given varying organizational structures, it is hard to define a bright line (which is no doubt why discretion was granted), but a transmission provider who overlooks a group of employees that later prove problematic will bear the liability. Therefore, each transmission provider must give careful thought to its organizational structure and potential areas where violations could occur, and train accordingly.

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14. 18 C.F.R. § 358.7(a)(1).

15. 18 C.F.R. § 358.7(h).

16. 18 C.F.R. § 358.7(i).

17. 18 C.F.R. § 358.8(c)(1).

Perhaps the most important point is to remember that the Standards of Conduct are only one of the initiatives FERC is pursuing. For example, transmission providers should anticipate that greater freedom under the Standards of Conduct to engage in integrated resource planning will be circumscribed by increased emphasis on an open and transparent planning process as required pursuant to Order No. 890 to assure that nonaffiliates also receive the benefits of coordinated planning.<sup>18</sup> A reduction in the number of employees deemed to be marketing function employees does not affect a company’s obligations to vigilantly guard against market manipulation or acts of discrimination. In Order No. 717, FERC explicitly affirmed that “[i]t is possible that an entity might embark on a course of conduct not contemplated by the Standards, which could be found upon investigation to constitute a violation of the statutory undue preference prohibitions.”<sup>19</sup> In that same vein, adherence to the posting requirements of the Standards of Conduct does not provide a safe harbor for conduct that is otherwise prohibited. In fact, the Commission cautioned that notwithstanding the contemporaneous disclosure requirement “[p]osting the information does not change the fact that a violation occurred, but it would be a vital consideration that the Commission would certainly take into account in deciding whether any remedy or sanction would be appropriate.”<sup>20</sup> While Order No. 717 specifically requires training on the Standards of Conduct, effective instruction will go beyond the lightened requirements of the new Standards of Conduct to address the much broader context in which FERC will evaluate behavior.

The Standards are not flawless, and the array of issues raised on rehearing indicates that many points still need additional clarification. For example, the exact boundaries of what is or is not transmission information are still hazy, and the scope of permitted communications, particularly as related to dispatch, which seems permissive based on the regulatory text, are substantially narrowed nearly to the point of extinguishment by the implementing order. But additional clarity may yet emerge on rehearing, and even if transmission providers err toward caution by over-complying where uncertainty exists, compared to the predecessor Standards of

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18. *Preventing Undue Discrimination and Preference in Transmission Service*, Order No. 890, 72 Fed. Reg. 12,266 (Mar. 15, 2007), FERC Stats. & Regs. 31,241 at P 437 & *pro forma* Attachment K (Transmission Planning Process) (2007), *order on reh’g and clarif.*, Order No. 890-A, 73 Fed. Reg. 2984 (Jan. 16, 2008), FERC Stats. & Regs. 31,261 (2007), *order on reh’g and clarif.*, Order No. 890-B, 123 FERC 61,299 (2008), *reh’g pending*.

19. Order No. 717 at P 294.

20. *Id.* at P 295.

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Conduct, most transmission providers will find these Standards a welcome relief from unnecessary burdens.

### III. Next Steps

It is reasonable to anticipate that the industry will see a new wave of enforcement by FERC that encompasses the Standards of Conduct. The mere fact that the Standards are clearer and therefore in keeping with FERC's "firm but fair" doctrine, will facilitate enforcement.

However, the most important message regarding Order No. 717 may be that implied by its issuance on the same day as the Policy Statement on Compliance.<sup>21</sup> In the Policy Statement on Compliance, the Commission identified some of the elements of an effective compliance program. Among other things, it pointed to the need to allocate adequate funds and resources to compliance, the need for involvement and leadership by senior management to instill and cultivate a culture of compliance, and the importance of integrating compliance into the reporting and compensation structure of the organization. The Policy Statement on Compliance explains that FERC gives particular weight to four aspects of an effective compliance program when considering assessing penalties: "(1) the role of senior management in fostering compliance; (2) effective preventive measures to ensure compliance; (3) prompt detection, cessation, and reporting of violations; and (4) remediation efforts."<sup>22</sup>

Certainly each company subject to the Standards of Conduct as implemented through Order No. 717 should develop a checklist to ensure each specific obligation has been met, postings are made, and annual training is conducted. But an effective compliance program cannot end there. Each affected transmission provider should take a hard look at the overall structure of its compliance program as it relates to Order No. 717 and FERC's other top initiatives, including market behavior and market manipulation, tariff and OASIS administration, and NERC reliability. The measures for

internal auditing and enforcement of FERC's requirements should be integrated into the company's compliance and auditing structure as firmly as its anti fraud measures or insider trading prohibitions might be. Measures need to be taken to assure that questions can be raised and concerns reported and investigated. A single Chief Compliance Officer cannot carry the burden alone, and the Standards of Conduct cannot be implemented in isolation from other compliance obligations. Instead, the Standards of Conduct should be read in a broader context and integrated into the way the affected company conducts business. Most importantly, the identification and elimination of practices that result in undue discrimination and preferences must remain the overarching goal of a utility's Federal Power Act compliance program, because the Commission has been quite clear that adherence to the Standards is not a safe harbor against prosecution for conduct that is otherwise discriminatory.

### IV. Conclusion

The new Standards apply to fewer employees and require less information, which on its face would imply a lesser regulatory burden. However, when the Standards of Conduct are coupled with tough enforcement standards and understood as only one of many laws and regulations intended to level the playing field, Order No. 717 may not have lowered the barriers, but rather merely adjusted them and moved them into a position where FERC anticipates they will operate more effectively. Thus, transmission providers must focus and toughen their compliance programs accordingly.

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21. 125 FERC 61,058.

22. *Id.* at P 2.

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**Donna M. Attanasio** is a partner in White & Case LLP's Energy Markets and Regulatory Advice Practice, its Climate Change, Renewable Energy and Clean Technology Practice, and its Energy, Infrastructure, Project and Asset Finance Group. She advises electric utility companies and other market participants on compliance with the Federal Power Act, the Public Utility Holding Company Act, the Public Utility Regulatory Policies Act, and their implementing regulations, and represents clients seeking authorizations or to resolve disputes in connection with those laws. She regularly serves as a lead negotiator for power purchase and sale, tolling, and energy management agreements.

**Earle H. O'Donnell** is head of White & Case LLP's Energy Markets and Regulatory Advice Practice and a member of the Firm's Energy, Infrastructure, Project and Asset Finance Group. He represents US and international entities on a wide variety of advisory, litigation, and transactional matters including representation of applicants and interveners in mergers and acquisitions cases, RTO proceedings, transmission and interconnection matters, market-based rates, government audits and enforcement actions (both state and federal), and state and federal regulatory proceedings. He has extensive experience negotiating agreements for the purchase and sale of electric energy and related products, thermal energy, and natural gas.

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