

**REMARKS OF  
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**RELIABILITY PRIMER FOR LAWYERS AND ENERGY PROFESSIONALS  
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Introduction

I appreciate the opportunity to discuss reliability regulation with you today. In my remarks, I offer two perspectives – the perspective of a former reliability regulator and the perspective of someone who now is on the receiving end of reliability regulation.

There is an imperfect understanding among the Federal Energy Regulatory Commission (FERC), the North American Electric Reliability Corporation (NERC), and the regulated community on fundamental issues regarding the nature of reliability regulation. I have had some surprises since I left FERC – some FERC actions that I believed were well explained are not well understood by the regulated community. And there are some things that industry thinks are obvious that are not recognized at FERC. I did not fully appreciate the restiveness within the regulated community towards reliability regulation until I left FERC.

I would like to address the state of reliability regulation, why FERC has implemented reliability regulation the way it has, the FERC and NERC roles in reliability regulation, and review some of the challenges in reliability regulation. I will also offer some comments on the implications of the FERC March 2010 reliability orders.

FERC Role In Reliability Regulation

The FERC role in reliability regulation is much larger than many expected when the Energy Policy Act of 2005 was enacted. Many expected the FERC role would be limited to approving reliability standards proposed by NERC and hearing appeals of NERC and RE penalty decisions by registered entities. Those expectations have not come to pass – FERC has asserted a much larger role – directing NERC to develop new reliability standards and

modifications, initiating its own investigations, developing a large reliability staff, participating in standards development and audits. I do not expect FERC to accept a reduced role in the near future and the March reliability orders suggest that if anything the FERC role may be expanding.

Many in the regulated community assume FERC asserted this larger role out of some desire for increased regulatory power. In my view, FERC asserted this larger role out of a sense of duty – to provide for effective reliability regulation. However, this larger FERC role was intended as a temporary measure only.

If you do not like the significant FERC role in reliability regulation you can blame me to some extent. The key decisions on the FERC role were made in August 2005 when I was chairman. It was my view that reliability regulation would not succeed without a strong Electric Reliability Organization (ERO). However, in August 2005 NERC was not seen as a strong organization – NERC historically had been dominated by the regional reliability councils (RRCs). FERC adopted a large regulatory role in part to secure a strong ERO that was not controlled by RRCs – now Regional Entities – or by stakeholders.

That goal has been achieved – NERC is independent of the regional entities and stakeholders – but at the price of calling into question NERC's independence from FERC itself. It was my intention that the FERC role would recede when NERC fully established itself. One of my surprises since leaving FERC is the realization that FERC's reasons for temporarily asserting a large role in reliability regulation and its intention to recede were not well understood – I thought we had explained our reasons and intentions.

### FERC-NERC Relationship

The March reliability orders loudly suggest FERC does not believe NERC has established itself as a strong organization. I always believed the relationship between FERC and NERC would not be static – it would wax and wane based on the level of confidence FERC had in NERC. That is consistent with the experience of the securities self regulatory model that was the basis for the ERO. The relationship between the Securities and Exchange Commission (SEC) and the New York Stock Exchange waxes and wanes based on the relative confidence of SEC in the Exchange.

But what does it mean for FERC to have confidence in NERC? How can NERC demonstrate it is a “strong organization”? Those are not easy concepts

to define or demonstrate, and the test seems inherently subjective. Those questions are best answered by the current Commission, not me. But I will hazard a guess at the measures FERC might apply:

- Whether NERC is seen as constantly seeking to improve the quality and efficiency of reliability regulation – showing initiative and solving problems rather than merely responding to FERC direction.
- Whether NERC encourages development of new standards and modifications to existing standards that improve reliability – even where FERC has not directed such changes.
- Whether FERC has confidence NERC and RE enforcement will be vigilant and active, even without FERC involvement and oversight.
- Whether NERC efficiently manages development of new standards and modifications.
- Whether NERC avoids a large backlog in penalty decisions.

In my view, NERC has made strides in many of these areas.

FERC should be clearer in what its expectations are from NERC, what it means for NERC to be a strong organization; under what circumstances FERC will adopt a reduced role, and whether FERC still intends its larger role to be a temporary measure. Frankly, there is frustration that FERC asserts too much control over NERC and a growing suspicion the larger FERC role may not be temporary.

### NERC Role in Reliability Regulation

NERC is a self-regulatory organization – not a regulated utility – NERC is a quasi-governmental body vested with delegated powers from the United States Government. Under the statute, the purpose of the ERO is “establish and enforce reliability standards for the bulk power system” - standards development is charged to the ERO. Legislation to provide FERC with direct authority to set reliability standards was considered by Congress – and rejected. However, the ERO is also subject to FERC oversight.

I would like to review the role of NERC and FERC in the substance of reliability standards and the development of reliability standards and modifications. When FERC approved the first batch of 83 reliability standards in 2007 it directed NERC to develop modifications to 58 of the approved standards. Some of these modifications were designed to raise the level of standards, others were designed to clarify ambiguities in standards. FERC relied on its authority under section 215(d)(5).

One of the big questions relating to reliability regulation that has been developing for awhile and is brought to a head by the March orders is the nature of FERC authority under section 215(d)(5) and what discretion NERC has in response to any such FERC directives.

The March orders declare that FERC believes NERC has no choice but to submit the specific standard or modification desired by FERC on a timeline established by FERC. But I do not think that follows from a reading of the statute. Section 215(d)(5) authorizes FERC to order the ERO to submit a proposed reliability standard or modification that “addresses a specific matter” if FERC considers such a standard or modification “appropriate”. The threshold for FERC to issue a directive is low – FERC need only find that a standard or modification is "appropriate", a low hurdle under the Federal Power Act.

But the statutory language suggests FERC cannot actually direct NERC to submit a specific standard or modification; it can direct NERC to develop a standard or modification of NERC's design to "address a specific matter" identified by FERC. I think the best reading of the statutory language is that section 215(d)(5) authorizes FERC to identify a problem, a reliability gap to be filled by NERC.

FERC’s authority under section 215(d)(5) is very different from its authority in section 206, where FERC is authorized to directly set rates, terms and conditions where it has found current rates, terms and conditions are unjust and unreasonable or unduly discriminatory or preferential. Sometimes when FERC has issued a directive to NERC to develop a reliability standard or modification, it has proposed a standard or modification to NERC for its consideration. NERC should take this as a suggestion only, since FERC cannot directly require NERC to propose any particular standard or modification.

To the extent there is more than one satisfactory way to address a specific reliability problem or “matter” identified by FERC, the statutory language suggests that if NERC proposes an alternative standard or modification FERC cannot insist on its preferred approach, much as in the section 205 context FERC cannot substitute a just and reasonable tariff provision it prefers for a just and reasonable tariff proposal filed by a public utility, since NERC would have complied with FERC’s directive to “submit to the Commission a proposed standard or modification to a reliability standard that addresses a specific matter” identified by the Commission.

In my view, the ERO can also disagree with FERC on the need on the threshold question of whether there is a need to address the "specific matter" identified by FERC. In response to a FERC directive that suggests a specific standard or modification, NERC can file exactly what FERC suggested, but it should do so only if NERC agrees both on the need for a standard or modification and the merits of the standard or modification. Alternatively, NERC could propose a different standard or modification than that suggested by FERC, if NERC agrees with FERC on need but exercises its prerogative as ERO to propose a standard or modification that in its judgment best meets the statutory test.

But what should NERC do if it disagrees with FERC on the need to address the specific matter identified by FERC? The March orders suggest FERC believes NERC must submit exactly what FERC wants exactly when FERC wants it. That view seems to ignore NERC's distinct responsibilities as an SRO – I believe NERC has a duty to only file standards and modifications that it believes meet the statutory test. In my view, the test in section 215(d)(2) governs not only FERC's review of standards proposed by the ERO, but also the decision by the ERO on whether to file a standard. If the ERO does not believe a particular standard is "just, reasonable, not unduly discriminatory or preferential, and in the public interest" it should not file that standard with FERC – in fact it has a duty to withhold filing.

FERC has set deadlines for NERC to file specific standards or modifications. Assuming FERC denies rehearing and insists NERC file the precise standards desired by FERC by the respective deadlines, what should NERC do? NERC should only file standards and modifications and request approval if it is convinced they meet the statutory test. Under section 215(d)(1), the ERO is charged with filing reliability standards "that it proposes to be made effective" or enforceable. If NERC does not propose that a directed standard be made effective, it should not file it.

Conceivably, NERC could file the desired standards and modifications without a request that they be made effective – without recommendation – on the grounds it is impossible for NERC to determine whether the standard or modification desired by FERC meets the statutory test. NERC could make a filing and assert the filed standard or modification is unjust and unreasonable – a filing with a negative recommendation that the standard is unsupported by the record and based on NERC's technical expertise will not assure reliability.

The fundamental question is who was entrusted with the substance of reliability standards by the Energy Policy Act of 2005 – FERC or NERC?

I have voted for many FERC directive orders – these orders are a way to identify possible reliability gaps and force NERC to consider whether there is a need for a standard or modification. FERC directive orders push NERC to take a hard look at a reliability risk – but after taking that hard look NERC should be able to disagree on need for a standard or modification. Directive orders should not be used to compel NERC to file standards that it does not believe meet the statutory test.

It would completely circumvent the statutory scheme for standards development if FERC can order NERC to file a specific standard, regardless of whether NERC believes the standard meets the statutory test. It would be perverse if the statute barred FERC from modifying a standard proposed by NERC but allowed FERC to precisely dictate the content of a standard to be filed by NERC for FERC’s approval. If FERC could do that there would be no need for FERC to ever modify a NERC proposed standard.

### Current Challenges in Reliability Regulation

There are other challenges in reliability regulation – the existence of challenges is unremarkable – reliability regulation is a work in progress – it is something entirely new to the electricity industry. Reliability regulation will continue to unfold for years. Let me address a few of these issues.

I addressed one issue obliquely in discussion of the substance of reliability standards and NERC’s duty to only submit standards that meet the statutory test – namely what does “just and reasonable” mean in the reliability context? It must mean something different in the reliability context than in the rate context, but what exactly does it mean?

It is still an open question – it has not been defined precisely by FERC or the courts. In my view, a “just and reasonable” reliability standard is a requirement that governs operation of the bulk power system designed to prevent instability, uncontrolled separation, or cascading failures of the bulk power system whose content reflects the technical expertise of the ERO. But in a perfect world a just and reasonable reliability standard would be a standard that is also risk-based and considers cost considerations.

The Energy Policy Act of 2005 did not outlaw blackouts and the reliability provisions of section 215 do not promise perfect reliability at any

price. A just and reasonable reliability standard would quantify risk and reflect a balancing of risk and cost. A standard that imposes tremendous costs whose risk reduction is negligible is not just and reasonable. Current reliability standards are not risk-based and do not consider costs.

That has led to tension when FERC has directed a modification intended to improve reliability by some unquantified measure at some unknown cost. But I think it is unreasonable to expect that only when FERC directs a modification should risk and cost be considered – it should be integral to the entire standards development process. That will not be easy – it will take time – but I think there is a need to begin the transition to risk-based reliability standards.

Other challenges have existed since 2005 – without resolution. One is the need to address ambiguous reliability standards. Many of the existing reliability standards are ambiguous. Many of the standards produced by the stakeholder process and proposed to FERC were ambiguous, and FERC knew that when it approved them. I knew it when I voted for them.

FERC cannot modify proposed standards and is limited to approval or remand. In some cases, FERC has exercised its section 215(d)(5) authority to address ambiguities – many of the directives addressed ambiguities. But accepting that many current standards are ambiguous and it is a challenge to both comply with and enforce ambiguous standards – what is the best way to squeeze the ambiguity out of current standards?

I see four options. First, the current ambiguous standards could be replaced with replacement standards that are models of clarity. At the very least, that will take time, probably years, since the average length of a NERC standards development process is 3 years – some have taken much longer. Also, it is entirely possible that a replacement standard will introduce different ambiguity rather than perfect clarity. Standards development is dominated by engineers rather than lawyers.

Since it can take years for NERC to develop a modification, and it is unreasonable to expect FERC to forgo enforcement of an ambiguous standard, there is a need to clarify existing ambiguous standards – it is unfair to enforce ambiguous standards capable of multiple interpretations.

The second option is for NERC to issue interpretations of ambiguous standards – authorized by ERO rules - NERC has been issuing interpretations, now applying a strict construction standard. This process can take months,

close to year. But this is only a viable option if FERC tends to adopt the NERC interpretation. FERC has generally accepted NERC's interpretations – but there have been exceptions – most recently last month when FERC rejected NERC's interpretation of a transmission planning requirement and proposed to substitute its judgment for the technical expertise of the ERO.

A third option is for FERC to interpret a standard in a manner that allows due process – notice and comment, rehearing, judicial review. The FERC proposed rule on interpretation of the transmission planning requirement does allow due process. But the FERC interpretation effectively changes the standard – and FERC has no authority to modify standards.

A fourth option is for FERC to unilaterally interpret a standard in the course of an enforcement proceeding, in a settlement order that does not allow for due process – that is the worst way to clarify ambiguous standards, one I hope FERC will not resort to.

When a standard is interpreted, compliance with the newly interpreted standard should be prospective, not retroactive – and there should also be an opportunity to come into compliance.

There is a fundamental question – who is in the best position to clarify ambiguous standards – NERC or FERC? I think NERC is in the best position – the standards were developed under its auspices, and NERC is more familiar with the intent of the drafters than FERC. But it would be preferable if NERC issued interpretations with more dispatch.

Another challenge in reliability regulation is inconsistency in Regional Entity standards application and penalty decisions. This should come as no surprise – I fully expected differences in Regional Entity enforcement decisions – eight different organizations are exercising new roles, and seven of the eight had no experience in standards enforcement.

I was surprised when I left FERC to learn that NERC did not believe it was necessary that to actively police Regional Entity inconsistency. The hope was that Regional Entity consistency would be achieved through coordination among the REs themselves. But Regional Entity can only be achieved through NERC or FERC review. NERC is in a better position to perform this role, but if NERC will not police Regional Entity decisions for consistency it will be necessary for FERC to act, no matter how reluctantly.

## Conclusion

I have not addressed the entire panoply of reliability matters – for example, I did not discuss the implications of the proposed penalty guidelines on reliability regulation and enforcement.

I remain convinced FERC is committed to fairness in reliability regulation. But I believe FERC went beyond the pale in its March orders by seeking to assert control over the substance of reliability standards.

NERC was granted a special role by Congress in the Energy Policy Act of 2005. NERC is a self regulatory organization with independent statutory responsibilities – not an extension of FERC. As chairman, I was impressed with the commitment of NERC and the Regional Entities to their new role and responsibilities – I remain impressed.

I am also convinced the regulated community is fully committed to compliance with reliability standards – they ask for fairness, they ask for standards that are just and reasonable, and they want the regulatory regime to work as designed. Reliability regulation remains a work in progress.