

Front and Center

Energy industry leaders talk about the state of their compliance efforts today — and where they need to be tomorrow



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Introduction

Regulatory compliance issues remain front and center for U.S. energy companies. Major shifts in the regulatory landscape are affecting everything from commodity transacting to infrastructure reliability; yet, there is still a lot of uncertainty about the specific requirements and key focus areas for compliance. Regulations and policies continue to evolve, and tools and technologies are not providing the silver bullet that many companies were hoping for. Additionally, there seems to be a growing emphasis on companies conducting their own self-policing and oversight management as regulators look to maximize their impact with limited budgets (which also raises expectations that companies will be more proactive in managing their own compliance obligations.)

What are energy companies doing to address their compliance challenges, and how can they stay ahead of regulatory trends and requirements without creating unnecessary drag on the business? To answer these questions, Deloitte recently conducted its fifth annual *Energy Regulatory Compliance Survey*, which looked at the compliance activities of major energy companies across North America.

Fifty-two companies participated in the survey, including major oil companies, integrated utility companies, independent power producers, independent system operators and municipal utilities. Respondents included Chief Compliance Officers, Senior Compliance Directors/Managers and Associate/General Counsels. The commercial footprint of the participating companies spanned more than 40 states and half of the Canadian provinces.

As in the past, this year's survey focused on four main areas:

- Enterprise compliance
- NERC compliance
- CFTC compliance
- FERC compliance

Here's a closer look at some of the key findings in each of these areas.

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Enterprise compliance

Effective regulatory compliance requires a coordinated effort across the enterprise. While the past few years have seen a steady increase in the number of companies centralizing their compliance operations under a single Chief Compliance Officer, it appears many energy companies are still using a traditional, siloed approach to compliance. In fact, legacy compliance programs that target relatively narrow compliance risk areas remain common among the surveyed companies.

Metrics

Performance metrics for regulatory compliance continue to be a hot topic in the energy industry. Energy companies are trying to determine the best metrics to track and are beginning to explore forward-looking approaches, such as analyzing regulatory trends for clues about where to focus their improvement efforts and investments, monitoring questions raised by employees in business functions that are being targeted by regulators, and tracking the extent to which existing issue resolution efforts are sufficient (i.e., have the solutions been implemented and are they preventing problems from recurring?).

Performance metrics seem to be focusing less on fines and more on self-reporting and training. This is interesting because fines have historically been the driving force for regulatory compliance efforts. The shift might be related to the fact that NERC and other regulators are looking for companies to be more pro-active: identifying and resolving problems before they happen (or at least before they happen again), and applying a risk-based approach to compliance management.

Companies are also looking for ways to motivate people — especially leaders — and to hold them accountable for complying with regulatory requirements and openly addressing regulatory issues. To that end, this year's survey results show a larger number of companies are linking performance metrics to variable compensation for operations leadership. (See figure 1.)

At the workforce level, efforts to link compliance-related performance metrics to compensation are holding steady. (See figure 2.) This suggests existing efforts may have

reached the saturation point, or that companies are waiting for more effective practices and/or metrics to emerge. It might also reflect a concern that linking compensation to compliance-related metrics could have the negative effect of encouraging employees to cover up potential issues — rather than raise them — out of fear their compensation might somehow suffer.

Figure 1. Does senior operations leadership (exclusive of compliance leadership) have any variable compensation linked to regulatory compliance performance metrics?

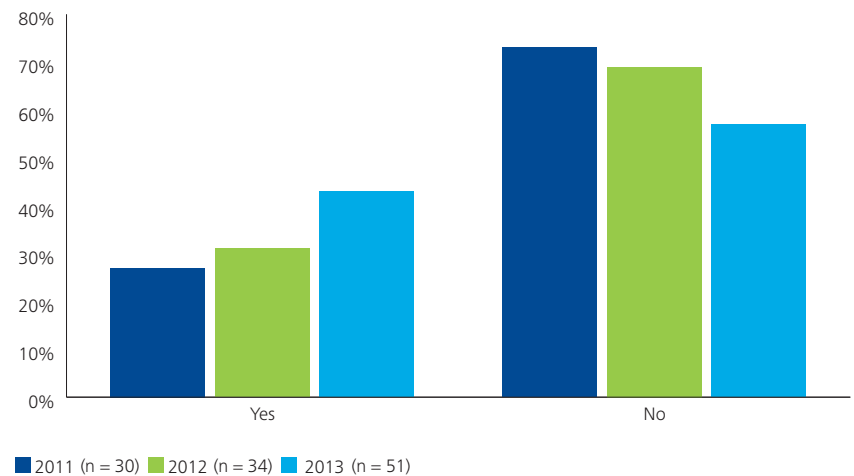
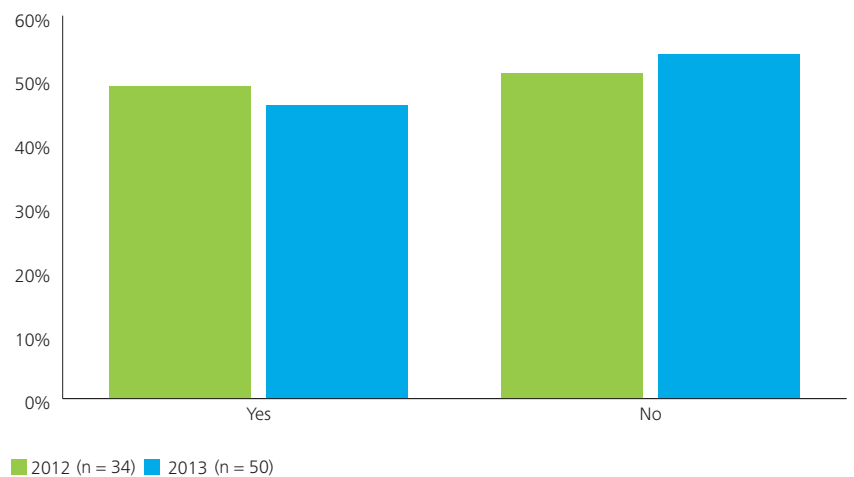


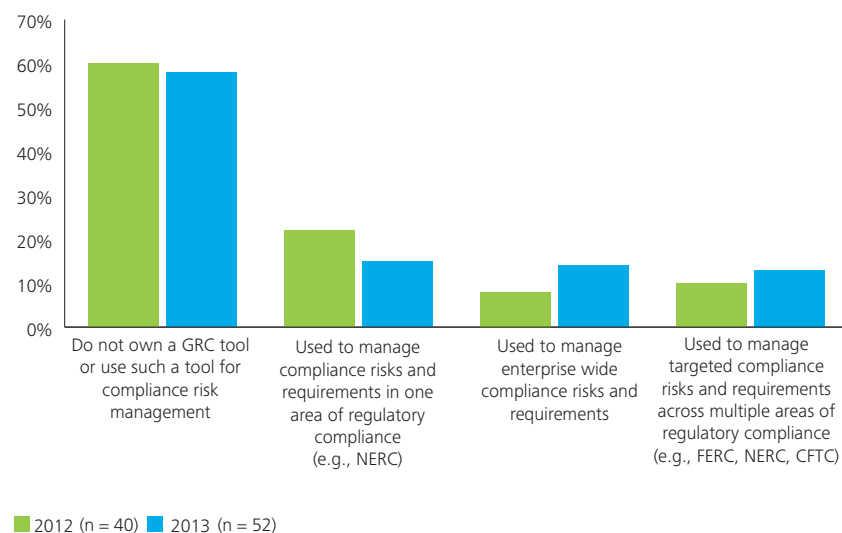
Figure 2. Do operations staff personnel (non management) have any variable compensation linked to regulatory compliance performance metrics?



Governance, Risk and Compliance (GRC) tools

GRC systems can help companies manage their compliance activities more efficiently and effectively by providing key capabilities such as workflow management, document management, and clear assignment and tracking of roles and responsibilities. However, the rate of adoption continues to be slow, and a dominant solution has yet to emerge. Sixty percent of the surveyed companies don't have a GRC system, and those that do seem to be using them for a variety of purposes and not relying on a single dominant vendor. (See figure 3.) This suggests that companies are still trying to figure out what the tools can do, and how to use them effectively. Also, many companies are using GRC tools for very targeted areas of compliance — e.g., just for NERC compliance, or just for document management — rather than taking a fully integrated, enterprise-wide approach that includes areas such as finance (Sarbanes-Oxley compliance) and enterprise risk management. In the short term, this could be limiting the value that companies obtain from these tools. A recent poll of participants in Deloitte's Power and Utilities Enterprise Risk Management (ERM) Roundtable found that among companies with GRC systems, only 20% see those systems as delivering "significant value," while 30% see "very little value" and 50% see only "some value."

Figure 3. If your company owns a GRC tool, how is it used?



Key takeaways

- To promote good behavior, look for opportunities to link metrics to compensation — but with a positive spin. For example, reward employees for reporting potential violations, and for implementing mitigation plans in a timely manner. Stay away from negative incentives — such as reducing compensation when violations are reported — as negative incentives may encourage people to hide problems, which could make things worse.
- Use on-the-job performance metrics to adjust the company's training program from one year to the next. Don't just measure how many classes were held, or how many people showed up. Focus on results.
- Survey operations personnel about what areas they want to receive better training. This helps make the training more interactive and desirable, and not just a check-the-box exercise. Front-line employees often have the best insights about what problems need to be addressed; you just need to ask.
- When selecting a GRC system, develop a strong business case that clearly defines what problems you are trying to solve. Too many organizations purchase a tool thinking it will magically solve all of their problems and enable the automation of most compliance processes. It's important to understand what you need, what the business case is, and what the tool is actually capable of doing (versus what you expect it to do).
- GRC systems are most effective when used to integrate many or most compliance-related activities — including compliance monitoring and reporting, risk management, and financial reporting — across numerous parts of the business. Yet the survey results show that most companies don't have a GRC system, and those that do tend to follow a piecemeal, siloed approach to deployment. Such an approach does not harness the true value of a GRC system.

NERC compliance

For most power and utility companies surveyed, satisfying NERC’s requirements related to the reliability of the bulk electric system is the biggest reported compliance challenge.

Budget and resources

Of the three regulatory areas covered in this survey (CFTC, NERC and FERC), NERC has the highest average budget. NERC compliance encompasses over a thousand requirements, and dealing with a NERC audit can be a time-consuming task that requires major amounts of prep work. More than half of respondents have annual NERC compliance budgets in excess of \$1M (see figure 4), and nearly half increased those budgets over the past year, in some cases by more than 20%. Among respondents that increased their NERC budgets, nearly half attributed it to changes in regulatory requirements.

A shifting regulatory landscape

NERC’s move to a risk-based approach is likely to alter the compliance landscape by shifting how registered entities, regional entities, and NERC interact with one another. In the past, the prevailing philosophy was more or less one-size-fits-all, meaning the areas of focus during a regulatory audit were consistent regardless of size, function, risk exposure, etc., and that even minor issues received the same degree of rigor and attention as more significant issues. Prioritizing risks based on their potential impact is a leading practice, and eases the burden for regulators and energy companies alike. With this new risk-based approach, minor risks are still identified and addressed, but the response is proportionate to the impact and risk.

With regard to NERC’s Reliability Assurance Initiative (RAI), more than half of the responding companies say they are taking actions ranging from “maintaining awareness” to “performing moderate planning,” and roughly a quarter say they are aggressively implementing against the proposed changes. (See figure 5.) This is interesting, since the details of RAI are still being defined. However, it appears many companies believe the basic principles provide enough general direction to start aggressively developing and adopting a more risk-oriented structure and approach for compliance.

Figure 4. What is the approximate annual budget for NERC compliance management activities, including salaries?

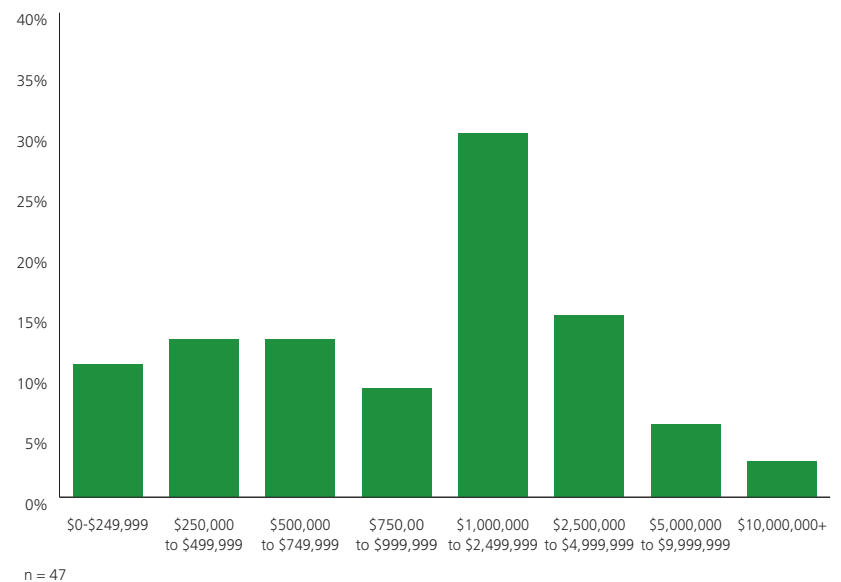
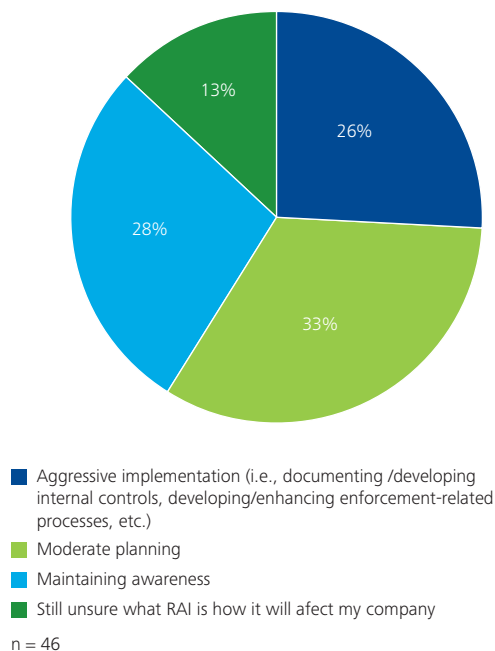


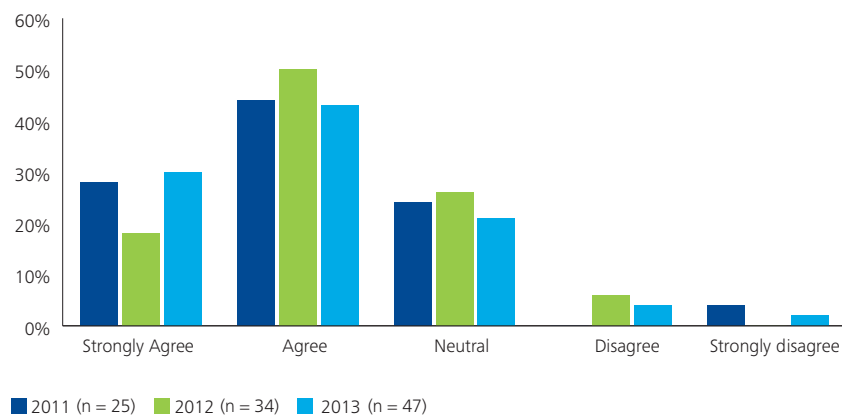
Figure 5. How would you describe your company’s approach to preparing for the upcoming changes that NERC’s RAI is focused on?



Among the companies surveyed, 73% “agree” or “strongly agree” that their compliance controls relative to NERC are well documented. (See figure 6.) This is a positive sign that suggests companies are fairly confident about their existing controls. However, since NERC’s expectations for internal controls are still being defined within the context of RAI, at some point there will likely be a need to align controls with future requirements.

In the area of Critical Infrastructure Protection (CIP), this year’s survey found that most companies have either delayed or suspended implementation of version 4 in anticipation of version 5.

Figure 6. My organization’s compliance controls related to NERC requirements are well documented



Key takeaways

- Although many NERC initiatives are still in progress, there are actions you can take now to start preparing and avoid a last minute scramble. For example, with RAI, you can start thinking about how best to design and implement certain controls, particularly in areas of high risk or frequent violation. Many organizations already have controls in place for NERC, so it might just be a matter of documenting and periodically testing them. However, the primary purpose of strong internal controls isn’t to appease NERC and the regional entities; it’s to make operations more reliable by detecting and preventing potential problems before they occur. Controls help to limit risks and may reduce audit scrutiny.
- Don’t underestimate NERC CIP version 5; start planning for it as soon as possible. Under version 5, many companies expect at least a ten-fold increase in the number of in-scope devices, which will dwarf almost all existing NERC CIP compliance programs. Also, if the potential effective date at the end of Q1 2016 holds up, companies have less than two years to achieve compliance.
- Based on one-on-one discussions with a handful of the survey participants, people skilled with NERC CIP are not readily available in the marketplace. Consider developing in-house expertise now so that when the detailed implementation work for CIP version 5 begins, you’ll have the right resources in place.

CFTC compliance

For the energy companies surveyed, the financial burden associated with CFTC compliance — specifically, complying with the requirements of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) — appears to be less than expected. However, it will be interesting to see how energy companies respond once enforcement begins.

Budget spend

Most of the companies we surveyed are spending less than previously expected on Dodd-Frank compliance; however, that trend will likely shift once the CFTC starts to exercise enforcement upon the derivatives market participants it oversees. A large majority of respondents (70%) have less than \$500K budgeted for CFTC compliance activities, and 92% have budgeted less than \$1M. (See figure 7.)

Moreover, the spend seems to be leveling out, with 70% of respondents not changing their CFTC compliance budget over the past 12 months. In terms of total spending on Dodd-Frank, 50% have spent less than \$500K to-date, and 44% do not expect to exceed \$500K in total to handle their Dodd-Frank obligations. (See figure 8.)

Roles and responsibilities

This year's survey results show a general need for companies to strengthen the assignment of ownership and responsibility for complying with Dodd-Frank's requirements. This is not surprising, since Dodd-Frank compliance is a relatively new area compared to NERC and FERC compliance, which companies have been dealing with for years.

Figure 7. What is the approximate annual budget for CFTC compliance management activities, including salaries?

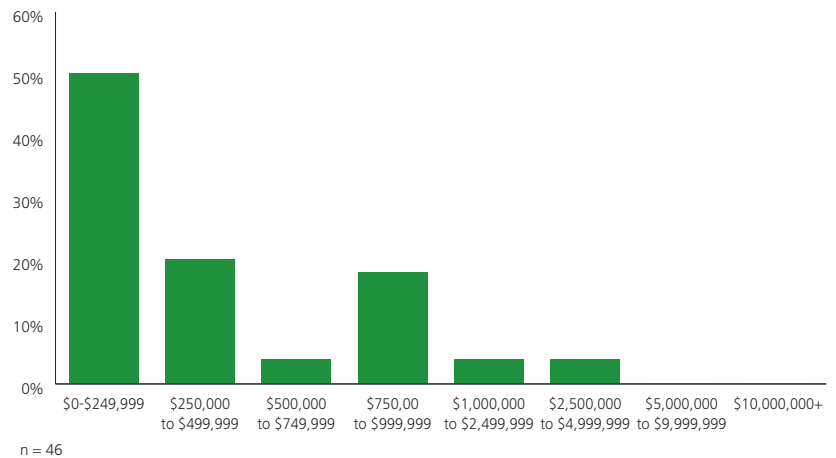
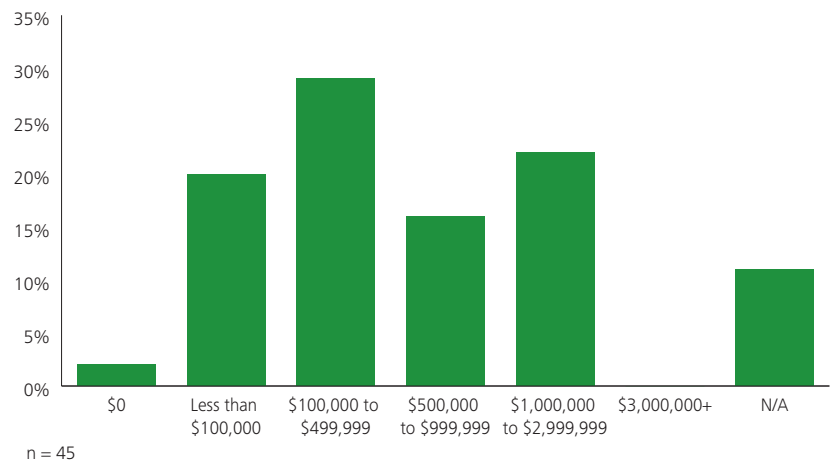


Figure 8. What is your company's approximate total spend to-date on your efforts to prepare for managing Dodd-Frank compliance obligations (e.g., IT, legal support, consulting, internal resource time)?

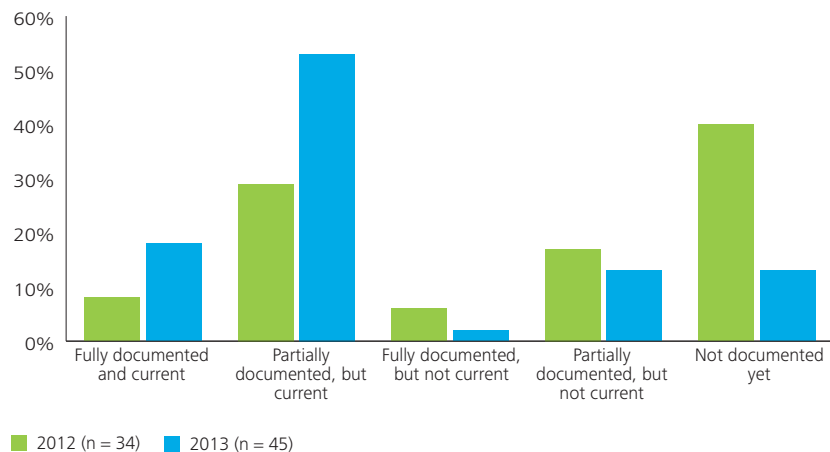


Preparation activities

This year's survey results show that energy companies have made great strides in their Dodd-Frank compliance efforts. Since last year, the number of respondents who have documented their policies and procedures rose by a factor of two, while the number of respondents who have no documentation fell by a factor of three. However, nearly half of the surveyed companies (45%) are still in the planning stages or are still assessing the requirements associated with Dodd-Frank. This number is surprisingly high given that many of Dodd-Frank's reporting obligations and requirements are already in effect.

In terms of compliance controls, the survey data shows companies have made significant strides to build out their Dodd-Frank control environment. However, more than half of respondents are not sure their operations, controls and procedures are adequate, which suggests a continued need for improvement.

Figure 9. How would you describe the current state of your compliance policies and procedures for complying with rules and requirements enforced by CFTC?



Key takeaways

- To get ahead of the curve, strengthen your policies and controls, and then follow up with relevant training. Also, begin to establish an integrated control framework that provides a clear line of sight between operational activities and regulatory risks — backed up by rigorous documentation of controls, policies and procedures.
- Having clearly assigned and documented roles and responsibilities is especially important. It helps drive accountability, reduces ambiguity, and enables targeted training (as opposed to training everyone on everything). It also enables better alignment between performance metrics and compensation, as well as better alignment of individual goals. Many organizations have group goals, but in many cases it is more effective to establish goals and incentives at the individual level.

FERC compliance

FERC's stepped-up approach to enforcement and fines has been making headlines. However, the underlying regulations and requirements have not really changed and most companies seem comfortable with their current level of effort and investment in FERC-related compliance activities.

Budget and resources

FERC remains the most stable area of compliance in terms of budget and resources, with the majority of respondents indicating no change in their investments and staffing. (See figure 10.) Over half of our respondents have an annual budget for FERC compliance of less than \$500K, and 70 percent have only 1-4 FTEs supporting FERC oversight activities.

Perception of FERC

The pool of respondents expressed mixed feelings about FERC's increased focus on enforcement, with responses distributed more or less evenly across the full range from "improvement" to "problematic" to "very disconcerting." However, for most companies (73%) FERC's change in focus has not led to a material change in operating behaviors. According to the survey results, the top concern for companies is FERC's attempt to crack down on market manipulation. (See figure 11.)

Recording trader communications

The large majority of survey respondents (72%) are recording trader communications, and a growing number are not just focusing on phone calls but other types of communication as well — including e-mails, instant messages and texts — all of which are becoming increasingly common throughout the transaction life-cycle.

Figure 10. Has the company's staffing of FERC compliance resources stayed at the same level, increased or declined over the past 12 months?

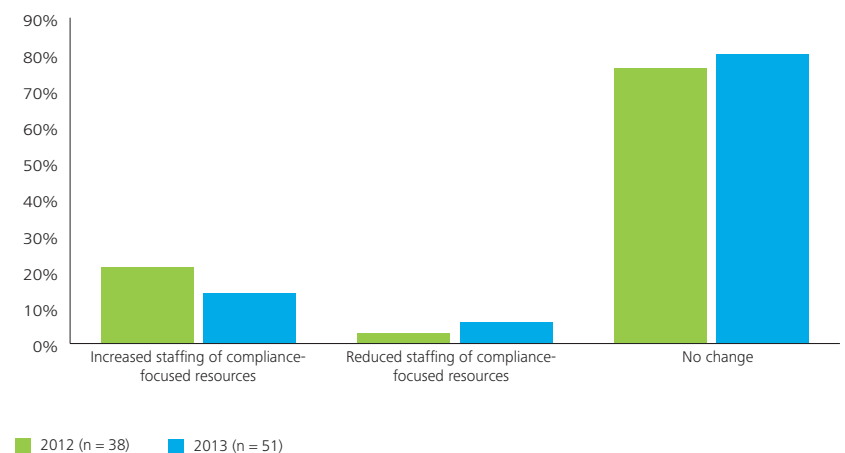
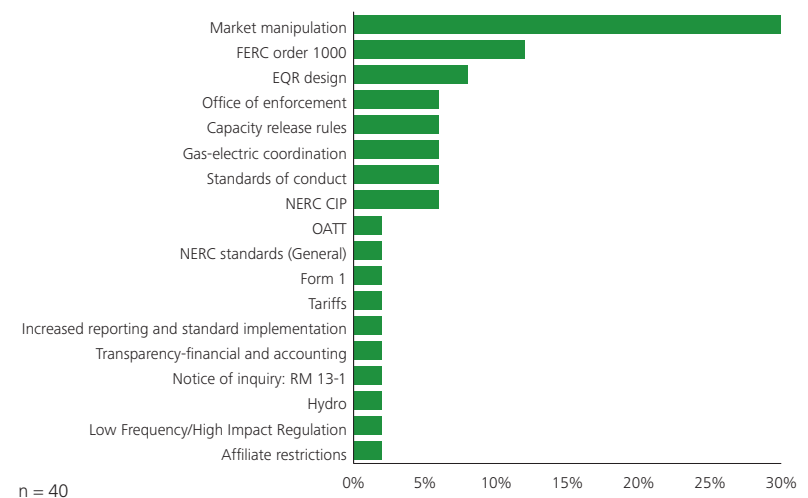


Figure 11. What FERC regulation (or anticipated regulation) concerns you the most?



Key takeaways

- Most survey respondents seem to have a good handle on FERC compliance. In fact, many companies are shifting some of their compliance resources from FERC to Dodd-Frank. So it could potentially be a red flag if your organization finds itself spending more time, money and resources in this area.
- To combat market manipulation, FERC is scrutinizing how energy companies are behaving in the marketplace with regard to (1) transaction activities for physical commodities, and (2) bidding practices into organized markets (such as independent system operators (ISOs) and regional transmission organizations (RTOs)). To stay out of trouble, companies must be prepared to defend the commercial intent of their transaction activities.

Front and Center

Regulatory compliance is a significant risk area that needs to be addressed proactively. Relying on a reactive approach can lead to heavy fines, but perhaps even more important, it may require a frenzy of corrective action that distracts the organization from its core business. To avoid problems and last minute fire drills, companies need to stay abreast of changes in the regulatory landscape and take action before risks develop into crises. The findings from this year's survey provide critical insights about what companies and regulators are focusing on, and what the top compliance priorities should be.

For an opportunity to participate in future versions of the survey, please contact us at energyregulatorycompliance@deloitte.com. Participants receive a comprehensive report of the survey results with additional findings and insights about important regulatory trends.

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