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Forward look
Top regulatory trends for 2015 in energy

Produced by the Center for Regulatory Strategies

Foreword

This publication is part of the Deloitte Center for Regulatory Strategies' cross-industry series on the year's top regulatory trends. This annual series provides a forward look at some of the regulatory issues we anticipate will have a significant impact on the market and our clients' businesses in the upcoming year. For 2015, we provide our regulatory perspectives on the following industries and sectors: Banking, Securities, Insurance, Energy and Resources, and Life Sciences, and Healthcare.

The issues outlined in each of the six reports will serve as a starting point for the crucial dialogue surrounding the challenges and opportunities for the upcoming year and will assist executives in staying ahead of regulatory trends and requirements. We encourage you to share this whitepaper with the senior executive team at your company. In addition, please feel free to share your questions and feedback with us at centerregstrategies@deloitte.com.

Best regards,

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In 2014, the regulatory trends identified for the energy sector unfolded as we had anticipated in our Forward look top regulatory trends for 2014 in energy. The U.S. Commodity Futures Trading Commission (CFTC) strongly asserted its new role within the energy industry. The Federal Energy Regulatory Commission (FERC) started to tighten its focus on market manipulation and questionable hedging practices. Both FERC and the CFTC saw new leadership take the reins. The North American Electric Reliability Corporation (NERC) focused significant attention on implementing its Reliability Assurance Initiative (RAI), a risk-based approach for addressing potential issues in the bulk electric system. In general, government regulators significantly stepped up their enforcement efforts throughout the industry—forcing energy companies to learn how to operate even more effectively in an environment of increased regulation and regulatory scrutiny.

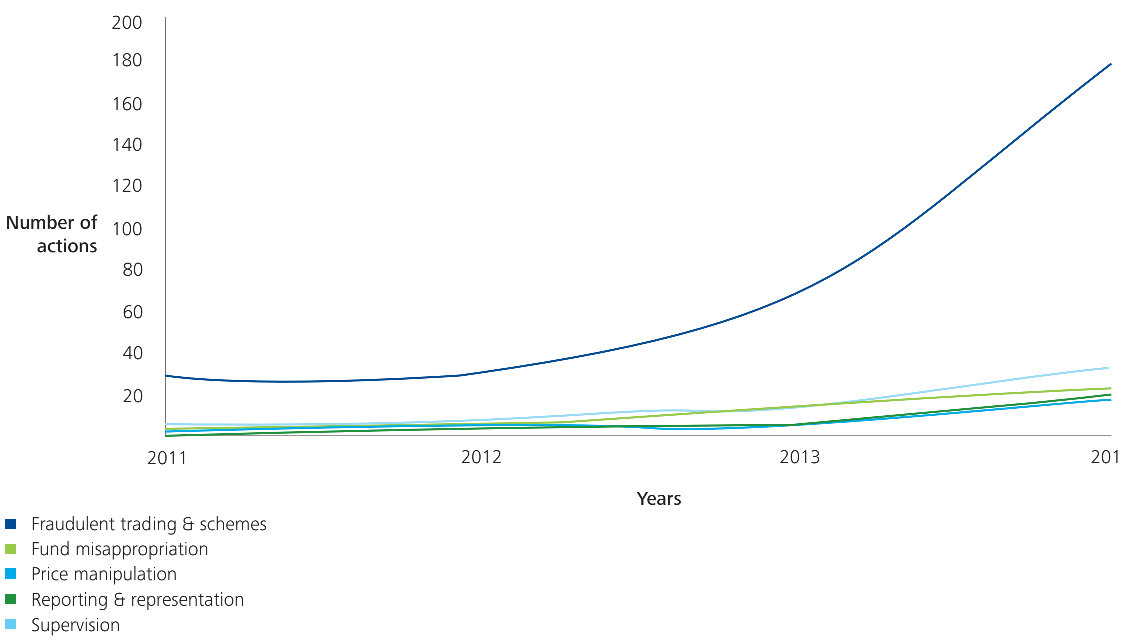
Over the next 12 months, we expect many of these trends to continue or even accelerate. We also expect some important new trends to emerge. Here's a quick look at the key trends energy companies will likely need to focus on in 2015.

1. Aggressive enforcement continues: *The level of regulatory enforcement in the energy industry will likely continue to increase over the next 12 months.*

Historically, the FERC and CFTC have increased their enforcement actions from year to year (Figure 1., Figure 2., Figure 3.):

Figure 1.

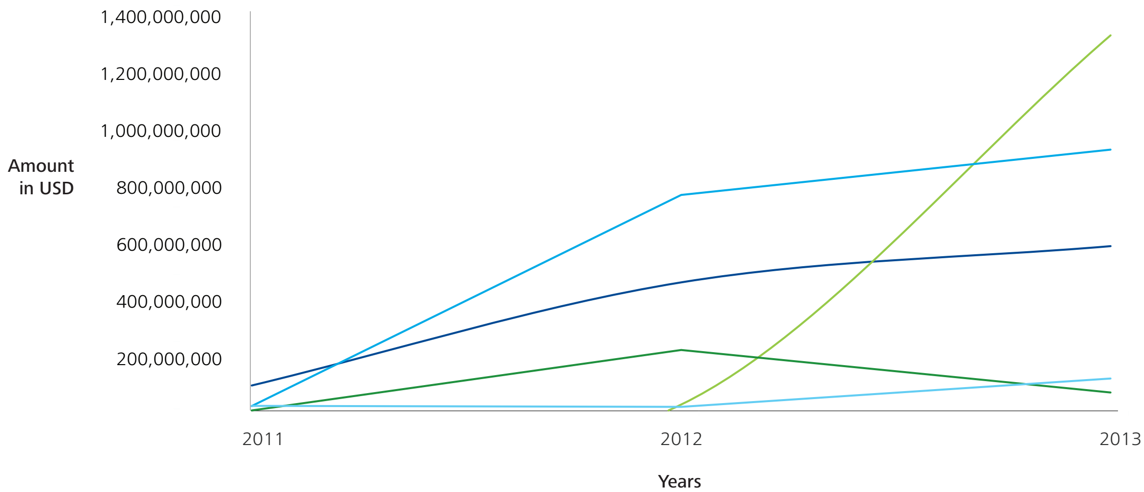
Number of actions taken by the CFTC



Source: www.CFTC.gov.

Figure 2.

Financial impact of actions taken by the CFTC

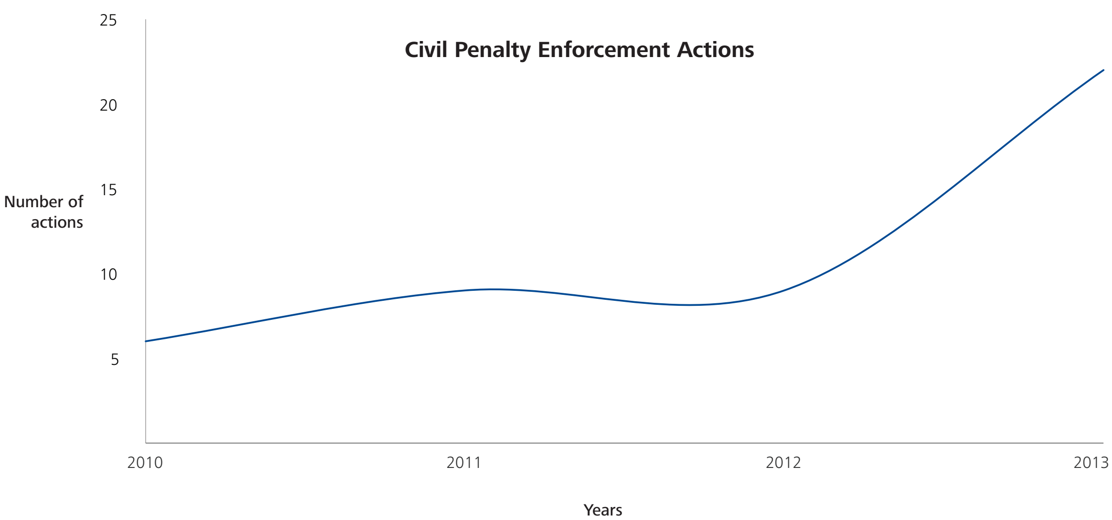


- Fraudulent trading & schemes
- Fund misappropriation
- Price manipulation
- Reporting & representation
- Supervision

Source: www.CFTC.gov.

Figure 3.

Number of actions taken by the FERC



- Civil Penalty Enforcement Actions

Source: www.FERC.gov.

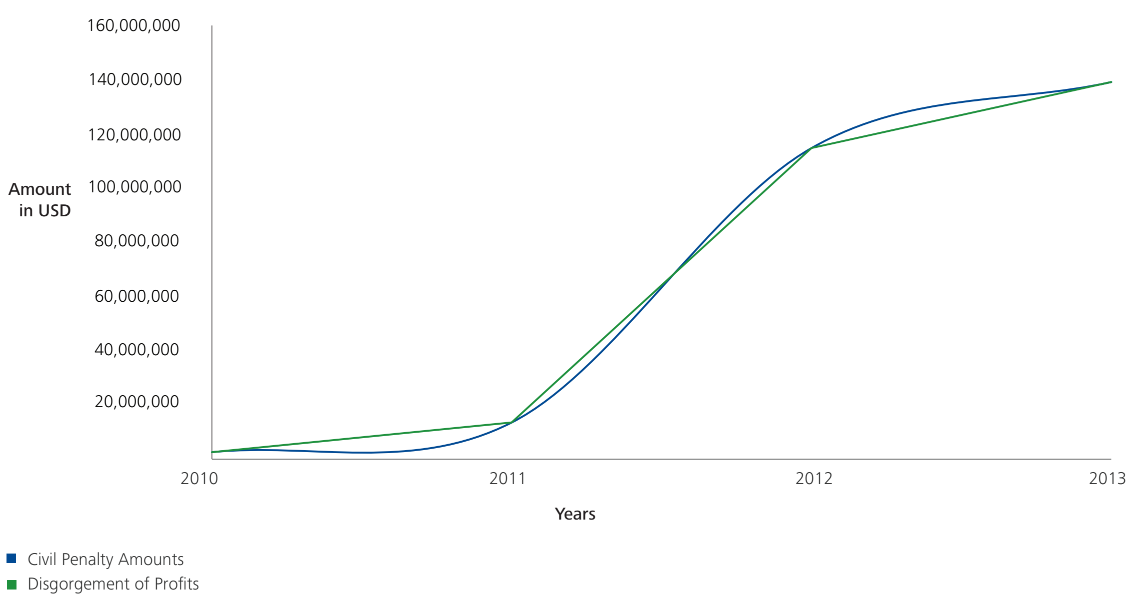
Note: 2014 data not available for supervision

In particular, the CFTC is expected to continue expanding its enforcement activities in the energy sector, creating new regulatory risks for companies involved in energy trading. Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) made the CFTC responsible for providing greater transparency in the over-the-counter derivatives market, which includes energy companies that use swap trades to hedge their risk exposures. The CFTC now oversees roughly 2,000 energy companies, many of which have little or no experience working with the commission and are still learning how it operates and enforces rules. In fiscal year (FY) 2014, the CFTC obtained a record $3.27 billion in monetary sanctions and filed 67 new enforcement actions. The $3.27 billion in sanctions includes over $1.8 billion in civil monetary penalties and over $1.4 billion in restitution and disgorgement. The CFTC's Division of Enforcement also opened more than 240 new investigations in FY 2014. In FY 2014, the CFTC also gave its first award under the Whistleblower Program, which Congress created as part of the Dodd-Frank Act. (Figure 2.)

To reduce the likelihood of problems, energy companies need clear processes for dealing with the CFTC and other regulators that oversee their businesses. However, developing these processes is not as simple as it sounds since the appropriate action can vary widely from one situation to the next. For example, although it is usually an effective practice to be cooperative and immediately responsive when handling regulator inquiries, in some cases it might be better to invest the time and resources necessary to clearly understand the purpose of the inquiry and substance of the request—as well as potential issues that may exist within the company—before responding. The good news is that most energy companies already know how to deal with regulatory enforcement because of their experience with the FERC, Securities and Exchange Commission (SEC) and Environmental Protection Agency (EPA), so this challenge should be quite manageable once companies figure out the right way to tackle it. Defensible programs require well documented commercial processes and a robust compliance infrastructure.

Figure 4.

FERC Financial Impact



Source: www.FERC.gov.

2. **Ongoing uncertainty about regulations and legislation:** *New leadership and direction in many areas is creating continued uncertainty about the future regulatory environment for energy.*

The FERC and CFTC have experienced significant changes and controversy surrounding nominees for vacant leadership positions created by expected and unexpected departures. The FERC saw its Chairmanship pass as planned from Jon Wellinghoff to Cheryl LaFleur on an interim basis; however, President Obama's original nominee to fill the position long-term, Ron Binz, withdrew his name from consideration. Eventually, the President nominated Norman Bay for the post, but with a provision that the nomination would only take effect after interim Chairman LeFleur stepped down in 2015. At the CFTC, departing Chairman Gary Gensler was replaced by Timothy Massad. In addition, the departures of Jill Sommers and Bart Chilton, while not completely unexpected, came at a time when the CFTC was fighting to finalize several controversial aspects of the Dodd-Frank Act (for example, position limits). Although it was rumored their replacements, Sharon Bowen and J. Christopher Giancarlo, might be filibustered, they were confirmed with little controversy. However, the subsequent and unexpected departure of Scott O'Malia left the Commission without one of its most vocal and public members. Factor in the shifting political landscape, which could have a significant impact in 2015 and beyond, and it seems likely that uncertainty will continue to be the norm for the FERC and CFTC.

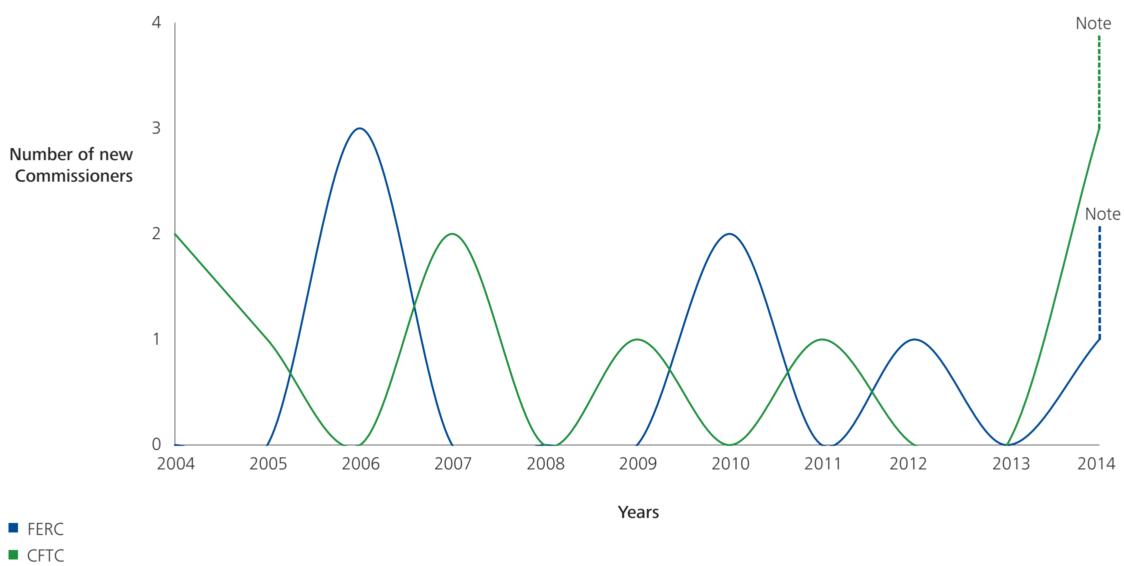
Similar uncertainty exists at other federal regulatory agencies, such as the Bureau of Ocean Energy Management (BOEM), which regulates offshore oil exploration and drilling. What's more, we are also starting to see significant uncertainty crop up at the state and local level. For example, in California the state regulatory commission is now mandating how utilities develop enterprise risk management programs, and how they incorporate those programs into their capital allocation programs. This change in regulatory approval is meant to modernize the rate-making process that accounts for the factors associated with capital expenditures. This change in regulatory review is a direct result of the San Bruno gas pipeline explosion and need to modernize existing infrastructure. The California state regulatory commission's model of capital recovery has historically been based on a traditional methodology based on miles of pipeline or power line. This methodology does not take into account factors to construction/replacement, such as location or age. The new risk-based approach is meant to better represent the differences in projects and better capture the actual cost of the project for the consumer.[1]

For many energy companies, this regulatory uncertainty is a major headache because they can't be sure how to approach compliance. Will energy regulations continue on their current trajectories, or will changes in leadership and/or regulatory focus lead to a different set of requirements? Energy companies need to pay close attention to such shifts as they happen. Also, until the uncertainty settles down, companies might want to make an extra effort to build flexibility into their compliance plans and associated programs.

[1] http://www.cpuc.ca.gov/PUC/safety/CPUC_Proceeding_to_Develop_a_Risk-Based_Decision-Making_Framework.htm.

Figure 5.

Number of New Commissioners at FERC and CFTC out of 5 Commission Seats



Source: http://www.cftc.gov/about/commissioners/index.htm, http://www.cftc.gov/About/Commissioners/FormerCommissioners/index.htm, http://www.ferc.gov/about/com-mem/prev-comm.asp.

Note: The FERC and CFTC each have a vacancy that, if filled before the end of the year, will bring the number of new Commissioners for 2014 to two and four, respectively.

3. Hedging practices remain under scrutiny: *FERC and the CFTC are tightening their focus on market manipulation in the energy industry; meanwhile, their focus is expanding to include a wider range of disruptive behaviors.*

Energy companies that have energy trading practices and perform cross-market hedging or trading faced increasing scrutiny in 2014—and the trend will likely continue in 2015.

The fundamental issue is whether it is acceptable for energy companies that conduct transactions in different markets to intentionally lose money on one position as they profit from another. Some companies have both physical and financial trading activities (for example, buying and selling physical natural gas, while also trading swaps and futures in those same gas markets). Regulators are concerned that energy companies involved in such trading activities could manipulate prices in both the physical and financial markets.

Despite the significant attention given to this issue in 2014, many energy companies are still trying to understand what regulators consider illegal and inappropriate behavior. Although hundreds of pages of guidance have been written on this topic, considerable room for interpretation remains—prompting many companies to address potential risks on a case-by-case basis. Also, the issue could become even more challenging in light of expected new rules on position limits and clearing requirements, both of which provide different definitions for hedge identification.

Improved transaction monitoring can help energy companies avoid potential problems without requiring a major investment of time and resources. By setting up some relatively simple screens for monitoring and surveillance, companies can quickly identify risky transactions that could create problems with regulators. Another relatively simple step that could reduce future compliance challenges would be to reconcile hedge definitions to take into account both accounting and risk guidance.

Figure 6.

Some recent FERC fines[2]		
Example 1	Civil Penalty:	$20,000,000
	Disgorgement of Profits:	$21,935
Example 2	Civil Penalty:	$4,072,257
	Disgorgement of Profits:	$3,334,000
Example 3	Civil Penalty:	$32,500
	Disgorgement of Profits:	$301,000
Example 4	Civil Penalty:	$28,000,000
	Disgorgement of Profits:	TBD
Example 5	Civil Penalty:	$3,250,000
	Mandatory Reliability and Compliance Enhancements	$1,250,000

4. NERC focuses on cyber-security: *In 2015, NERC is expected to focus significant attention on version 5 of its Critical Infrastructure Protection (CIP) reliability standards.*

In 2014, NERC's primary focus was on beefing up the nation's physical electric grid through its RAI. In 2015, the commission is expected to emphasize cyber-security by encouraging more companies to adopt CIP version 5. This version introduces a new methodology that categorizes cyber systems based on whether they have a low, medium or high impact on the operation of the Bulk Electric System (BES). Once a BES cyber system has been categorized, the responsible entity must comply with CIP version 5, which includes new cyber security controls ranging from *electronic security perimeters* and *systems security management* to *incident reporting*, *response planning* and *vulnerability assessments*.

Since CIP version 5 was approved during the implementation period for version 4, FERC has stated it will skip version 4 and that version 3 will remain in effect until the effective compliance date[3] for version 5.[4]

CIP version 5 introduces new terminology, along with new methods for determining which critical infrastructure components and systems affect a responsible party's BES. Also, version 5 redefines and clarifies critical concepts such as "external connectivity," and introduces the concept of a "defined physical boundary" (DPB). These changes have an important effect on access control, giving companies more flexibility when designing the physical security of critical cyber assets.

[2] http://www.ferc.gov/enforcement/civil-penalties/civil-penalty-action.asp.

[3] The Effective Date of Standard is April 1, 2016. http://www.nerc.com/pa/CI/Pages/Transition-Program.aspx.

[4] http://www.ferc.gov/whats-new/comm-meet/2013/112113/E-2.pdf.

5. Trade surveillance emerges as a basic need: *In an increasingly transparent regulatory environment, companies need data surveillance capabilities that help them identify problems before regulators do.*

Regulators now have almost total access to a company's trading data, enabling them to more quickly identify signs of market abuse and manipulation. Unfortunately, many companies do not currently have the surveillance capabilities necessary to systematically monitor their own data for inappropriate trading activities and breaches of internal trading policies. This capability gap exposes a company to unnecessary risk.

When regulators discover a problem first, the consequences tend to be much more severe than if the company discovered the problem itself and took corrective action. FERC strongly encourages voluntary reporting of potential violations, and most self-reported violations are dismissed without a penalty. FERC also gives companies credit for having an effective compliance and ethics program in place at the time of a violation. Conversely, small violations—or even perceived violations—that are deliberate or inadvertent but not detected internally can end up having big consequences.

To avoid trouble, companies should analyze their current risk exposure and then determine how robust their surveillance systems and programs need to be. The good news is that closing the gap doesn't have to be complicated or expensive. For businesses with low risk levels and transaction values, a simple solution that relies on manual processing might be a sufficient and cost-effective way to get the job done—at least until affordable, off-the-shelf solutions become more widely available.

6. Higher standards for compliance evidence management: *Maintaining complete and accurate records is only the beginning. The next step is reconciling the records with those of counter-parties.*

Various laws and regulations exist that require organizations to maintain complete and accurate data. For instance, the Dodd-Frank Act requires firms to capture specific terms of swap transactions and retain all records pertaining to the transactions. In addition, firms are required to ensure the accuracy of the data with counterparties and maintain the accuracy throughout the life of the transaction. Given these new requirements, how can organizations effectively manage their data to identify issues of compliance and non-compliance?

Analytics can provide a deeper understanding of existing data, improving overall business functionality as well as visibility into risks and opportunities. In particular, analytical tools can represent data visually, enabling an organization to:

- Drill down from function to process to sub-process
- Make changes to productivity using enablers such as automation and centralization
- Detect positive and negative trends across multiple data sets

High turnover within compliance departments can make it hard to evaluate their performance and effectiveness over time. Establishing common metrics and analytic methods for tracking performance and effectiveness—even if the metrics and methods rely on resources that are simple and already available internally—can help a company's compliance function deliver results that last.

Moving Forward

The specific trends highlighted above will likely require significant attention in 2015. However, another more general challenge for the energy industry is the lack of an easy way for organizations to share practices and compare performance related to regulatory compliance and risk management. To fill this gap, Deloitte is establishing an industry forum called the Risk Council that enables energy companies to learn from each other, and to benchmark the efficiency and effectiveness of their programs based on newly developed key performance indicators. To find out more about Deloitte's Risk Council and how to get involved, please contact Mike Prokop at mprokop@deloitte.com

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