

# AGA Gas Compliance Audits

August 17, 2009

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# Agenda

Overview

Compliance program elements

Key gas compliance issues

Trends in uses of technology

## Overview

# Compliance Risk Management: Why compliance?

- FERC enforcement authority—up to \$1 million per violation, per day—poses a substantial financial risk for compliance breaches
  - Emphasis on strong compliance programs
- Over \$61 million in settlements since 2005

"Our purpose is to provide firm but fair enforcement of our rules and regulations and to place entities subject to our jurisdiction on notice of the consequences of violating the statutes, orders, rules, and regulations we enforce. "

FERC Policy Statement  
On Enforcement

## Overview

# Compliance Risk Management: FERC enforcement 2005-present

	Company	Issue	Penalty (millions)
Settled Cases	Bangor Gas	Shipper-must-have-title (gas)	\$0.3
	BP	Capacity release (gas)	\$7.0
	Calpine	Shipper-must-have-title (gas)	\$4.5
	Cleco	Affiliate Code of Conduct (power)	\$2.0
	Constellation	Shipper-must-have-title, capacity release (gas)	\$5.0
	Columbia Gulf Transmission	Violation of Commission order (gas)	\$2.0
	Duquesne Light	Cost allocation, Standards of Conduct, EQR (power)	\$0.2
	Edison International	Misleading FERC investigation (power)	\$7.0
	Entergy	Shipper-must-have-title (gas)	\$0.4
	Entergy	OATT, OASIS posting (power)	\$3.0
	Gexa Energy	Market Basted Rate, EQR filing (power)	\$0.5
	Jetco	Capacity bid rigging	\$0.6
	Klabzuba Oil and Gas	Capacity bid rigging	\$0.3
	MGTC	Shipper-must-have-title (gas)	\$0.3
	Northwestern	OASIS Business Practice Stds. (power)	\$1.0
	NRG	Market behavior rules (power)	\$0.5
	ONEOK	Capacity bid rigging	\$4.5
	Otter Tail Power	OATT (power)	\$0.0
	Pacificorp	OATT, Standards of Conduct (power)	\$10.0
	SCANA	OATT (power)	\$9.0
Tenaska	Capacity bid rigging	\$3.0	
Outcome	Amaranth	Market manipulation (gas)	\$200.0
	ETP	Market manipulation (gas)	\$82.0
Pending	National Fuels Marketing	Capacity bid rigging	\$4.5
	Seminole	Capacity bid rigging	\$4.3

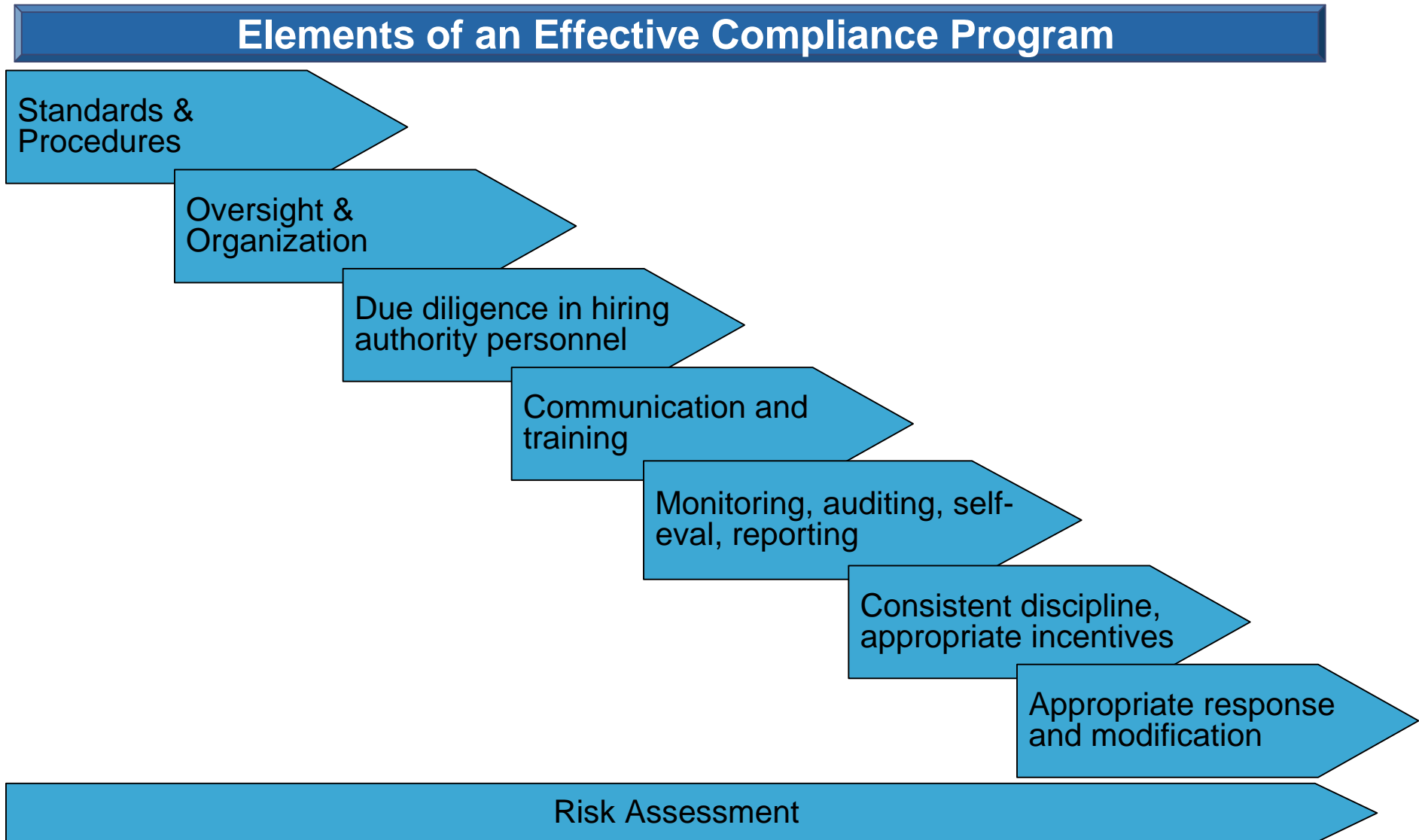
## Overview

# FERC Enforcement Trends

- Focus on “core” requirements (e.g., shipper-must-have-title, capacity release, standards of conduct).
- Highest penalties for cases that involve economic gain
- Most aggressive enforcement in cases where FERC believes intentional misconduct occurred—role of trader/marketer communications in establishing intent
- Belief among some in industry that self-reporting credit is elusive
- Inclusion of compliance program development as a remedy in settlement (i.e., Duquesne Light and Edison International)

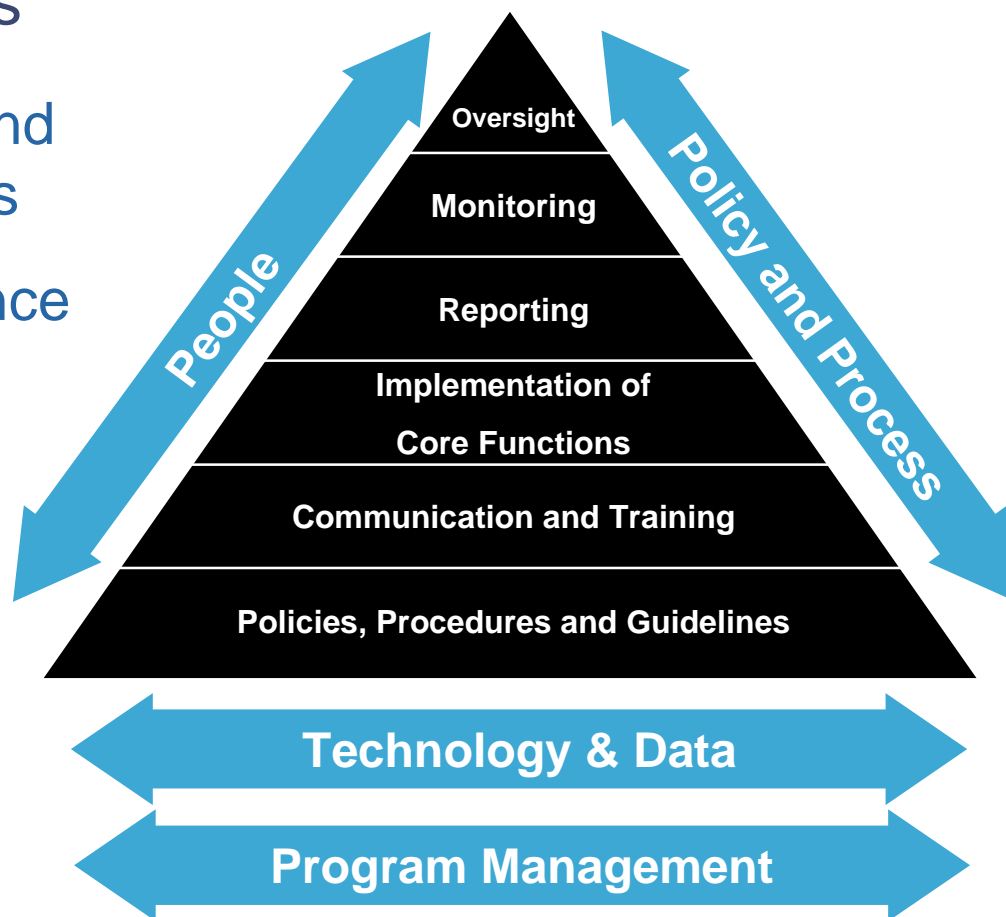
## Compliance Program Elements

Federal Sentencing Guidelines provide structure for compliance programs



A compliance and ethics framework can be assessed using a series of key process enablers

- The framework should reflect and enable roles and responsibilities
- Assess topics through compliance environment elements and enablers
- Clearly define where the compliance environment (structure, process and technology) requires enhancement



# How can internal audit scope a compliance review?

- Accurately scoping a compliance program review requires definition of several key scope drivers:
  - Breadth: What compliance requirements will be reviewed? What business units will be covered?
  - Depth: Will the review consider primarily the design of controls or testing of samples of data or transactions?
  - IT Systems: How much technical review of systems will be done? What will be the nature of testing? How much structured and unstructured data will be reviewed?
- We recommend a risk-based approach to define the scope of a review, reserving detailed testing for the highest-risk areas of compliance.

**A successful compliance review starts with a clear understanding of goals and objectives.**

# Prohibition of Market Manipulation

## Objective

- Prohibit manipulative or fraudulent transactions

## Applicability

- Any entity (person OR company) engaged in an artifice or fraud in association with FERC jurisdictional transactions

## Summary of Rules

### Order 670:

- Unlawful for any entity, directly or indirectly, in connection w/ purchase or sale of electric energy or natural gas or the purchase or sale of transmission or transportation services subject to Commission jurisdiction to:
  1. Defraud using any device, scheme or artifice (i.e., intentional or reckless conduct);
  2. Make any untrue statement or omit a material fact; or
  3. Engage in any act, practice or course of business that operates or would operate as a fraud or deceit.
- Modeled on SEC rule 10b-5
- More broadly applicable than comparable CFTC rule (for futures contract manipulation)

### Market Behavior Rules

- Operate and schedule generation in a manner that complies w/ rules and regulation of exchange/ISO
- Provide accurate and factual information in communication w/ FERC, market monitors, or similar
- Report prices accurately and factually in accordance w/ Policy Statement on Natural Gas and Electric Price Indices (if reporting)
- Retain data used to determine prices for three years

Related CFTC Rules: Consider both current rules related to futures contracts, and potential future regulation of energy derivatives

## Auditing considerations

- Analysis of transaction data for specific risks, such as
  - Wash trading
  - ISO bidding practices
  - Off-market trades
  - Unusual positions (relative to supply requirements, historical trends, or other company-specific measures)
- Communications recording/monitoring – potential source of data for establishing intent

# Transmission Capacity Management

## Objective

- Promote transparency and efficiency in allocation of pipeline capacity

## Applicability

- Holders of firm capacity on FERC-jurisdictional interstate gas pipelines

## Summary of Rule

### Capacity Release

- <31 days – can pre-arrange without posting/bidding, no rate cap
- < 1 year – must post to EBB in accordance w/ tariff, no rate cap
- > 1 year – subject to maximum rate cap per tariff
- Some conditions permitted (such as right to recall capacity)

Shipper-Must-Have-Title: Capacity holders must have title to the gas they ship (to prevent subletting of capacity)

Buy-Sell Transactions: Capacity holder cannot purchase gas at point of receipt and sell at point of delivery to same counterparty

### Tying

- Cannot condition capacity release on use of a specified source of supply or delivery to a specified party
- Conditioning release of storage capacity on purchase of stored gas, tying of capacity on adjacent pipeline segments permitted

Asset Management Agreements: Provide some exemptions from tying and bidding restrictions

## Auditing Considerations

- Capacity release patterns – “flipping” or other inappropriate behavior
- Data analysis: Relating transportation movements to corresponding purchase and sale transactions

# Price Reporting

## Objective

- Encourage accurate, good-faith reporting of transaction data to electric and natural gas price index publishers.

## Applicability

- Entities that voluntarily report price and transaction data to index publishers

## Summary of Rule

- Rule is also known as “Safe Harbor Rule” (i.e., entities that follow requirements of the policy will be presumed to be acting in good faith)
- Requires the following standards for reporting data to price index developers:
  - Code of conduct: Publicly available guidance for employees involved in buying and selling electricity or natural gas, and reporting prices
  - Source of data: Individuals responsible for reporting prices should be separate from trading function
  - Data reported: For non-affiliated company transactions, report a) price; b) volume; c) buy/sell indicator; d) delivery/receipt location; e) transaction date and time; f) term
  - Error resolution process: Documented and consistent with price index developer policy
  - Data retention and review: Retain all data for three years, independent review annually
- CCRO proposed Energy Data Hub – potential future enhancement
  - Reporting to Hub will be subject to same requirement as to price index developers

## Auditing Considerations

- Annual review requirement
- Business process controls
  - Procedures
  - Roles and responsibilities
  - Training
  - Periodic review
- Change controls over technology environment (e.g., queries used to extract transactions)
- Intercompany transactions

# FERC Form 552 – Annual Report of Natural Gas Transactions

## Objective

- Collect data for transparency and to provide tools for FERC to exercise oversight vis-à-vis fixed and index price transactions.

## Applicability

- Physical gas buyers and sellers who make use of a blanket sales certificate OR sales > 2.2 million MMBTU

## Summary of Rule

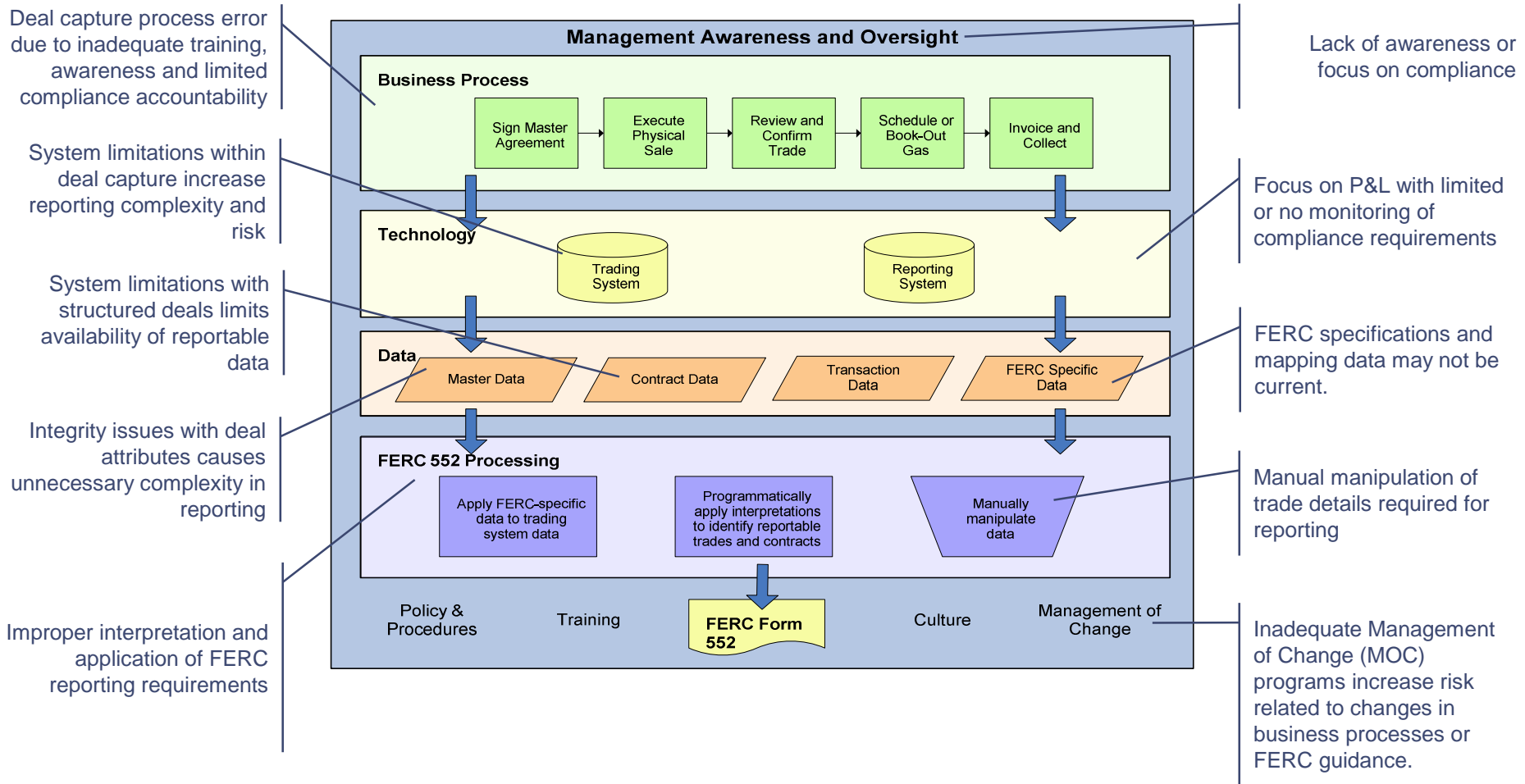
- Submit electronically
- File by May 1 for prior year
- Safe Harbor for 2008 data (filing deadline extended to July 1 due to questions/issues)

## Auditing Considerations

- Technical code used to extract data and generate filing
  - Aggregation
  - Filtering
  - Data transformation
- Mapping to correct field on form:

	Fixed	Index
Next-day		
Next-month		
Physical Basis		
Trigger Agreements (e.g., NYMEX Plus)		

# FERC Form 552 (continued)



# Affiliate Transactions

## Objective

- Protect captive customers and prevent affiliate abuse

## Applicability

- Holders of FERC market-based rate authority and their affiliated public utility companies

## Summary of Rule

### Order 697

- Governs relationship between a franchised public utility and market-based power sales affiliates
- Market-regulated power sales affiliate: “Any power seller affiliate other than a franchised electric utility, including a power seller affiliate, whose power sales are regulated in whole or in part at market-based rates”
- FERC must authorize power sales between franchised public utility with captive customers and any market-regulated power sales affiliate
- Sales of goods and services, pricing
  - Utility → Power Sales Affiliate: Greater of cost or market
  - Power Sales Affiliate → Utility: Not above market

## Auditing Considerations

- [Restrictions on information sharing](#)
- Information access restrictions
- Transactions sampling, testing
- Closely aligned with Standards of Conduct for Transmission Providers

# Standards of Conduct for Transmission Providers

## Objective

- Promote 1) independent functioning and 2) non-discriminatory operation of transmission system

## Applicability

- Transmission owners or operators with marketing affiliates

## Summary of Rule

### Order 717

- Independent functioning
  - Transmission function employees must function independently of marketing function employees
  - Physical separation of work areas
  - Access to hard-copy documents and IT systems
  - Restrictions on meetings (exceptions for bulk power system emergencies)
- No-conduit rule: Undesignated employees cannot disclose non-public transmission information to marketing function employees
- Transparency rule
  - If non-public information shared in violation of independent functioning/no-conduit rules, must post to OASIS (exceptions for CEII)
  - Posting of Standards of Conduct related information (e.g., compliance procedures, employee transfers, job descriptions, affiliates)
  - Recording and posting of information exchanges
- Training – Annual requirement (new employees within 30 days)

## Auditing Considerations

- EBB posting
- Training
- New employees (training and OASIS posting) is typically a challenge

# Distribution Integrity Management Program (DIMP)

## Objective

- Establish standards for LDCs' leak management programs

## Applicability

- Distribution system operators (applies to both transmission and distribution lines)

## Summary of Rule

### DOT

- Distribution system operations and maintenance plan
- Identify threats by category
  - Corrosion
  - Other outside force damage
  - Inappropriate operation
  - Natural forces
  - Material or weld failure
  - Other
  - Excavation damage
  - Equipment malfunction
- Evaluate and prioritize risks
- Implement measures to mitigate risks
- Measure performance
  - Number of hazardous leaks
  - Number of excess flow valves installed
  - Number of excavation damages
  - Number of leaks repaired/eliminated, by cause
  - Number of excavation tickets
  - Number of hazardous leaks repaired/eliminated
- Periodically evaluate and improve the program
- Report performance to federal and state agencies

## Auditing Considerations

- Distribution system data – asset management, work management, GIS
- Record management – completeness, accuracy, quality
- Timeframes for repair and rechecking of leaks
- Evaluate operational expertise – opportunity to utilize guest auditors

## Trends in Uses of Technology

Technology / data analysis is a component of many compliance audits

- Higher level of assurance and efficiency
- Examples
  - Trading
  - Payables
  - Security

## Data analysis may be classified by purpose and type of data

### Purpose

- **Investigation** : Fact-finding effort in response to a specific event (e.g., allegation of fraud, regulatory inquiry)
- **Ongoing Monitoring**: Routine internal monitoring as part of compliance controls

### Data Type

- **Unstructured**: Administrative documents or communication (e.g., emails, instant messages, word documents)
- **Structured** : Application-specific data (e.g., customer billing records, trading data, transmission service requests)

The analysis and objectives vary with data type and purpose

	Investigation	Ongoing Monitoring
Unstructured Data	<ul style="list-style-type: none"> <li>– Email, communication, or document searches</li> <li>– Minimal interpretation required</li> <li>– <u>Objective</u>: Identify all documents/communication related to a specific issue</li> </ul>	<ul style="list-style-type: none"> <li>– Analysis of recorded/archived communications--voice, email, or instant message</li> <li>– Can be time-intensive... technology can offset</li> <li>– <u>Objective</u>: ID potential inappropriate behavior</li> </ul>
Structured Data	<ul style="list-style-type: none"> <li>– Analysis of transaction data related to a specific issue</li> <li>– Significant interpretation and analysis required</li> <li>– <u>Objective</u>: Retrospectively evaluate market behavior</li> </ul>	<ul style="list-style-type: none"> <li>– May involve automation or manual analysis</li> <li>– Can sometimes leverage Risk Management tools</li> <li>– <u>Objective</u>: Detect unwanted behavior in time to take corrective action</li> </ul>

## Trends in Uses of Technology

# Communication monitoring considerations

	Investigation	Ongoing Monitoring
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- To record or not?
  - What are your counterparties' policies?
  - Other requirements (e.g., confirms or dispute resolution)?
- How to analyze
  - Random sampling
  - Risk-based searching
- Technologies
  - Email / IM (easier)
  - Voice (more difficult)
  - Dealing with attachments
  - Refining the filters and dealing with false positives

## Trends in Uses of Technology

# Analysis of transaction data presents challenges

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- Volume of data
  - Period of inquiry, type of transactions
  - Recent transmission operations project: > 3 terabytes, > 1 million transactions
- Integration
  - Multiple-source data
  - Examples: Trading and scheduling systems, physical and financial trading systems, OASIS and AFC calculation tools
- Team composition
  - Coordination between data and content specialists
  - Experience is key—time constraints often present a special challenge

## Trends in Uses of Technology

# Transaction monitoring can form a key component of a compliance program

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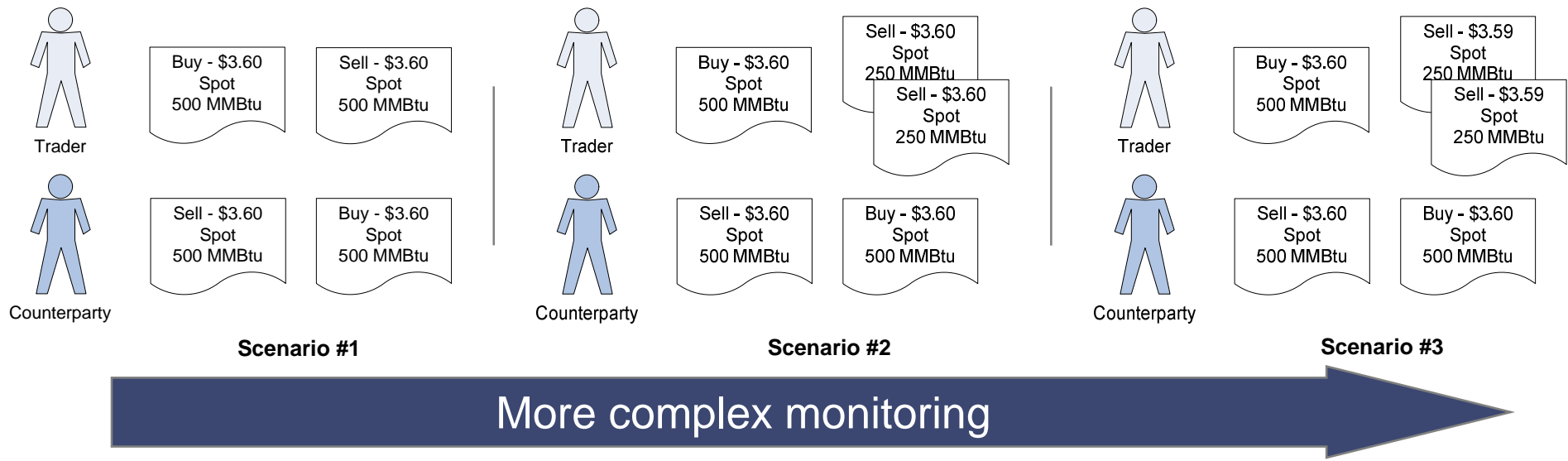
- Identify key risks and their “signatures”
  - What behaviors represent potential compliance breaches?
  - How would these manifest in transaction records (price, volume, position, counterparties, etc.)
- Create business rules to detect signatures
- Leverage mid-office / risk management technology
- Goal is to help focus limited compliance resources on areas of greatest concern
- Most companies start small, then expand as needed or as resources permit

# Trends in Uses of Technology

## Example – wash trade detection

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- Commonly-monitored risk
- Varying levels of sophistication are possible

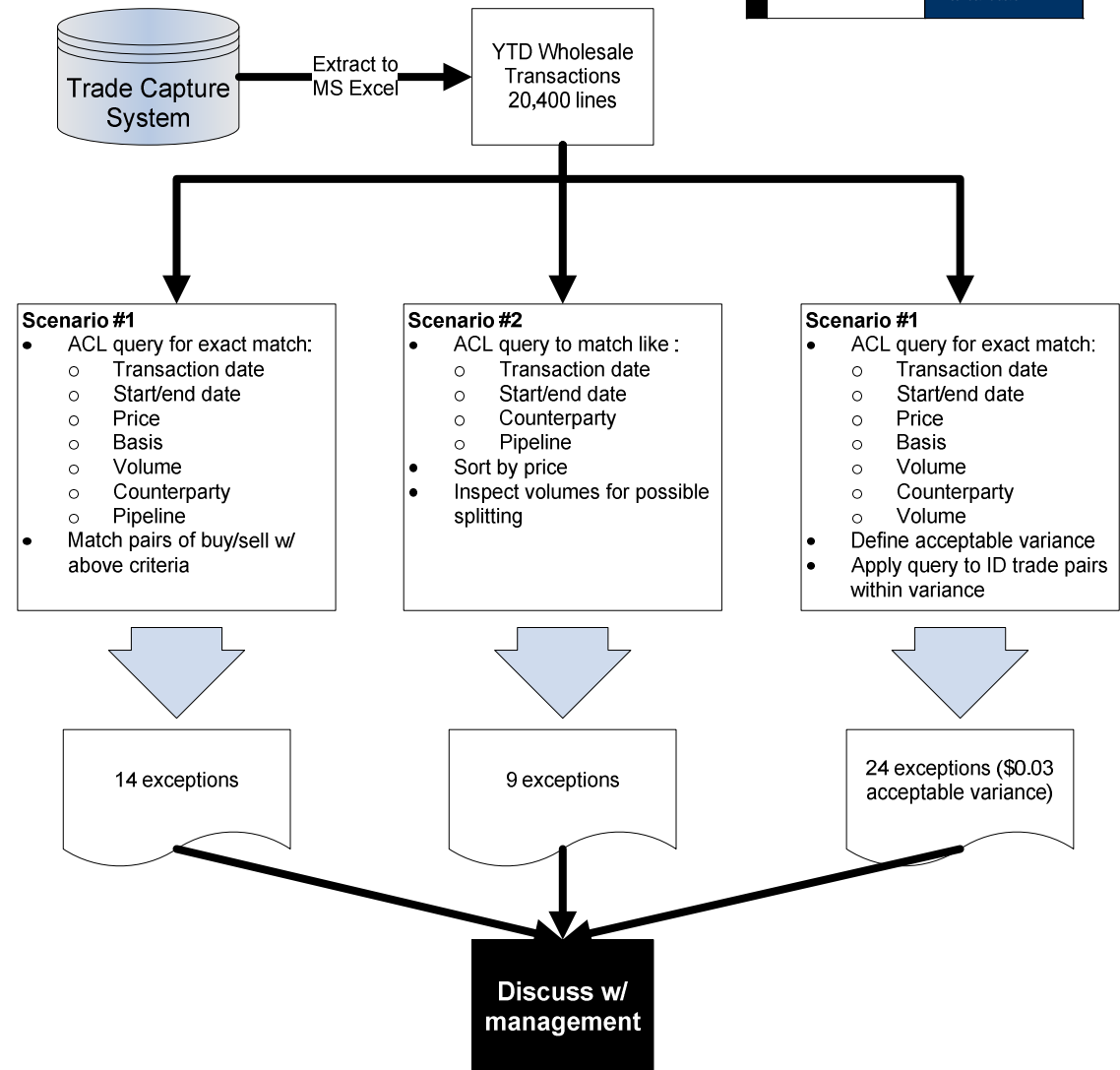


## Trends in Uses of Technology

### Example – wash trade detection (continued)

- Understand management controls
- Pre-meeting w/ refine data request
- Exception ≠ violation
- Data-driven approach critical: 0.2% exception rate!

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## Trends in Uses of Technology

### Questions to ask in evaluating your company's use of technology for compliance monitoring

- Does the compliance function understand reporting and data tools available for compliance monitoring?
- Have we identified signatures associated with key compliance risks?
- Have we automated compliance monitoring as much as practical (leveraging related programs)?
- What is our position on preserving transaction data, and how are we using it?
- Do our management reports reflect the most important risks to the company?

## Conclusion – thoughts for compliance auditing

- Address compliance topics during risk assessment process
- Communicate with law department
  - Subject matter expertise / interpretation of regulations
  - Protection of work papers and reports
  - How to handle confirmed exceptions (including potential self-reporting ramifications)
- Stay informed via industry groups and web resources
- Questions?

# Presenter

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*Mike is a leader in the Firm's Regulatory Compliance practice for energy and utility companies. In this role Mike helps clients develop risk-based programs to more effectively manage controls and mitigation. He has deep experience in helping assess, build, and operate their compliance programs.*

*He has led over a dozen ethics and compliance related projects for energy and utility companies. These projects have addressed clients' ethical compliance programs, and have also focused on a variety of specific regulatory topics. He has led projects related to CFTC and futures exchange compliance for a trading and marketing business; open access transmission compliance for a multi-state utility; fraud risk assessments; compliance risk assessments; and assessments of FERC Standards of Conduct compliance programs.*

*Mike is an active speaker on ethics and compliance topics within the energy and utility industry and has delivered presentations on ethics and compliance topics to the American Gas Association, Edison Electric Institute, Federal Energy Regulatory Commission, and Risk and Insurance Management Society. In addition, Mike instructs ethics and compliance related courses for PwC practitioners. Prior to joining PwC, Mike served as a Civil Engineer Officer in the U.S. Air Force.*