FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D.C. 20426

In Reply Refer To:
Office of Enforcement
Docket No. FA11-21-000
May 4, 2012

Gerry Cauley, President and CEO
North American Electric Reliability Corporation
3353 Peachtree Road
Suite 600, North Tower
Atlanta, GA 30326-1001

Dear Mr. Cauley:

1. In this order, I approve uncontested audit findings and recommendations and notice contested audit findings and recommendation in the attached Audit Report (Report) prepared by the Division of Audits in the Office of Enforcement (OE). The Report contains audit staff's audit findings and recommendations with respect to the financial performance audit evaluating the North American Electric Reliability Corporation's (NERC) budget formulation, administration, and execution with a focus on the costs and resources used to achieve program objectives. The audit covered the period from August 23, 2006 to March 14, 2012.

2. The Division of Audits conducted numerous site visits to NERC headquarters and Washington, DC offices.[1] Representatives from the Division of Audits met with NERC officials on March 8, 2012, to discuss their audit findings and provide NERC with an opportunity to articulate its concerns. On March 23, 2012, audit staff informed NERC of the audit findings and recommendations in a draft audit report. Subsequently, NERC provided a response to the draft audit report on April 23, 2012.

3. In the Report, staff found eleven areas where performance could be enhanced:

[1] Staff conducted site visits to NERC headquarters on September 26-30, 2011, November 14-18, 2011, and January 23-27, 2012. Site visits to the Washington, DC office were conducted on November 10, 2011, and January 31, 2012.

A. *Retirement Plans* - NERC contributed 10 percent of the salary for each employee participating in the retirement plan, which is above energy sector norm. This 10 percent contribution was in addition to an up to 4.5 percent matching contribution for employees participating in NERC's 401(k) plan. In addition, NERC paid excess amounts above the allowable IRS limit for retirement contributions to certain employees as additional compensation when it should have maintained these amounts in a tax-deferred account;

B. *NERC Activities* - NERC did not have written criteria to determine whether activities should be funded under the Federal Power Act (FPA) section 215;[2]

C. *NERC Budget Process* - NERC's budget process did not provide sufficient transparency to allow the Commission, NERC's Board of Trustees (BOT), and stakeholders to efficiently and effectively evaluate annual budget requests and subsequent requests to change approved budgets;

D. *Time Reporting and Accounting System* - NERC's method for reporting and tracking employee time and expenses failed to track time and attendance on a project-specific basis, and properly classify expenses in its accounting system at a level that provided sufficient transparency to permit effective budget oversight;

E. *Employee Compensation* - NERC used studies to determine employee compensation levels that did not have adequate support to justify the reasonableness of compensation NERC paid its officers and staff;

F. *Board of Trustees Compensation and Expenses* - NERC did not support its shift to a flat-fee methodology of compensating its BOT with a time study based on actual time spent by the BOT on BOT activities or a representative study of the actual time spent on these activities. Also, NERC incurred various BOT-related member expenses outside the official BOT meetings.

G. *Standard for Determining the Reasonableness of Expenses* - NERC did not have a clear standard of reasonableness by which to judge expenses it or a staff member incurred. Also, NERC's expense review and approval process was decentralized and inefficient;

H. *NERC Critical Infrastructure Protection (CIP) Program* - NERC inadequately staffed for the needs of its CIP program;

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[2] 16 U.S.C. § 824o (2006).

I. *NERC as the Electric Information Sharing and Analysis Center (ES-ISAC)* - NERC's dual role as the ES-ISAC and as the Electric Reliability Organization raised significant challenges;

J. *Employee Entertainment* - NERC did not have adequate policies and procedures governing employee entertainment expenses; and

K. *NERC Oversight of Regional Entities' Budgets* - NERC's process of reviewing Regional Entity (RE) budgets was inadequate and lacked appropriate qualitative procedures to efficiently and effectively assess REs' annual budgets.

4. NERC's response to the draft audit report is included as an appendix to this report. In its response, NERC did not object to the audit finding associated with NERC's method of determining and funding its retirement plan (item A above), but did object to the ten audit findings related to NERC's activities, budget process, time reporting and accounting system, employee compensation, BOT compensation and expenses, standard for determining the reasonableness of expenses, CIP program, role as the ES-ISAC, employee entertainment, and oversight of the REs' budgets (items B-K above).

5. Based on the eleven audit findings, audit staff made forty-two audit recommendations. In its response NERC did not object to four of the forty-two audit recommendations. NERC submitted modifications to the remaining thirty-eighty audit recommendations. Audit staff accepted thirteen of NERC's proposed modifications. Of the forty-two initial audits recommendations twenty-five remain contested.

6. I hereby approve the uncontested audit finding and recommendations. Within 60 days of this letter order, NERC should submit a plan to comply with the uncontested recommendations. NERC should make quarterly filings describing how and when it plans to comply with the uncontested audit recommendations, including the completion dates for each audit recommendation. The filings should be made no later than 30 days after the end of each calendar quarter, beginning with the first quarter after this audit report is issued, and continuing until all of the audit recommendations are completed.

7. Pursuant to section 375.311(j) of the Commission's regulations,[3] this serves as notification of the opportunity for hearing. Within 30 days of the issuance of this order, NERC may notify the Commission as to whether it requests Commission review of the contested issues. The Commission will assign the proceeding for hearing, such as a paper hearing or trial type hearing, as provided by subpart E of part 385 of the Commission's regulations.[4] If NERC does not notify the Commission of its request for review within

[3] 18 C.F.R. § 375.311(j) (2011).

[4] 18 C.F.R. pt. 385 (2011).

days, NERC may be deemed to have acquiesced to the audit findings and recommendations, in which case the Commission may forthwith dispose of the matter upon the basis of the pleadings and other submittals and the studies and recommendations of the staff as provided in subpart H of part 385 of the Commission's regulations.[5]

8. The Commission delegated the authority to act on this matter to the Director of OE under section 375.311 of the Commission's regulations.[6] This letter order constitutes final agency action with respect to all uncontested audit findings and recommendations. NERC may file a request for rehearing on the uncontested audit findings and recommendations with the Commission within 30 days of the date of this order under section 385.713 of the Commission's regulations.[7] This letter order does not constitute final agency action with respect to the contested audit findings and recommendations noted above.

9. This letter order is without prejudice to the Commission's right to require hereafter any adjustments it may consider proper from additional information that may come to its attention. In addition, any instance of non-compliance not addressed herein or that may occur in the future may also be subject to investigation and appropriate remedies.

10. I appreciate the courtesies extended to the Division of Audits. If you have any questions, please contact Mr. Bryan K. Craig, Director and Chief Accountant, Division of Audits, at (202) 502-8741.

Sincerely,

Norman C. Bay

Norman C. Bay
Director
Office of Enforcement

Enclosure

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[5] *Id.*

[6] 18 C.F.R. § 375.311 (2011).

[7] 18 C.F.R. § 385.713 (2011).

Federal Energy Regulatory Commission

Performance Audit of the North American Electric Reliability Corporation for Budget Formulation, Administration, and Execution

Docket No. FA11-21-000
May 4, 2012

Office of Enforcement
Division of Audits

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I. Executive Summary

A. Overview

The Division of Audits (DA) within the Office of Enforcement has completed an audit of the North American Electric Reliability Corporation (NERC). The audit was commenced to evaluate NERC's financial performance with respect to its budget formulation, administration, and execution. This economy and efficiency audit focused on the costs and resources used to achieve program objectives. The audit covered the period from August 23, 2006 to March 14, 2012.

Based on audit staff's review of NERC's budget formulation, administration, and execution, as well as its responsibilities for carrying out its program obligations, audit staff identified several areas where performance enhancements are needed to improve the transparency of the budget process, accountability over time-reporting and cost controls, accounting systems, and development of certain processes and procedures to facilitate effective, efficient operations. While audit staff is encouraged by the steps NERC has taken during this audit to improve several areas of its operations, audit staff still has concerns with how NERC is carrying out its budget and program responsibilities. Audit staff is concerned that the NERC philosophy of considering everything it does as activities authorized by and funded under Federal Power Act (FPA) section 215 may not have provided the appropriate incentives for NERC to build more transparency into its budget process or to implement robust time reporting, cost controls, and certain processes and procedures in a timely manner. These areas of concern are summarized in section D below and in full in Part IV.

B. NERC as the ERO

In Order No. 672, issued in February 2006, the Commission established the criteria that an applicant must satisfy to qualify as the single Electric Reliability Organization (ERO) for the United States under section 215 of the FPA.[1] In this order, the Commission clearly articulated that the ERO would be certified "as the organization that will propose and enforce Reliability Standards for the Bulk-Power System (BPS) in the United States, subject to Commission approval." In addition, FPA section 215(g) requires that the ERO conduct periodic assessments of the reliability and adequacy of the BPS in North America. According to FPA section 215(c)(2)(D), the ERO's rules must "provide for reasonable notice and opportunity for public comment, due process,

[1] *Rules Concerning Certification of the Electric Reliability Organization; Procedures for the Establishment, Approval and Enforcement of Electric Reliability Standards*, Order No. 672, 114 FERC ¶ 61,104 (2006), *order on reh'g*, Order No. 672-A, 114 FERC ¶ 61,328 (2006), *modified*, 123 FERC ¶ 61,046 (2007).

openness, and balance of interests in developing reliability standards and otherwise exercising its duties."

On April 4, 2006, NERC was the only party that requested certification.[2] By order issued on July 26, 2006, the Commission certified NERC as the ERO and ordered it to make a compliance filing.[3] The Commission recognized that there would be a period of transition at NERC to move from its historical role to that of the ERO:

> The Commission understands the need for an orderly transition from the current approach of voluntary reliability standards under NERC and the regional reliability councils to the mandatory regime under the Commission's ultimate oversight through the ERO and Regional Entities.[4]

Over the next few years, NERC continued to submit additional compliance filings under Docket No. RR06-1-000 related to specific structural, procedural, governance and delegation matters necessary to conduct the orderly transition and refine the way that NERC would function as the ERO and interact with the Regional Entities. The Commission issued a series of orders, under the same docket, accepting these filings subject to Commission-directed conditions.

Order No. 672 lays out the mission for the newly created ERO: the establishment and approval of electric Reliability Standards, the enforcement of electric Reliability Standards, and the monitoring of the reliability and adequacy of the Bulk-Power System. These three enumerated activities are clearly defined as within the scope of activities for which the entity certified as the ERO should receive appropriate funding under section 215. Other activities falling within (1) Situational Awareness and Infrastructure Security Program and (2) Reliability Assessment and Performance Analysis Program received initial Commission approval as ongoing activities that NERC as the ERO may be the best party to perform in the absence of any other entity assuming the responsibility of these activities.[5] However, the criteria by which to determine whether these activities, or any other activities falling under the scope of these programs, were never developed by NERC nor established by the Commission. The manner in which these initial activities

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[2] North American Electric Reliability Council and North American Electric Reliability Corporation, Application, Docket No. RR06-1-000, (Apr. 4, 2006) (requesting certification as the Electric Reliability Organization).

[3] *North American Electric Reliability Corporation*, 116 FERC ¶ 61,062, *order on reh'g and compliance*, 117 FERC ¶ 61,126 (2006), *aff'd sub nom. Alcoa, Inc. v. FERC*, 564 F.3d 1342 (D.C. Cir. 2009).

[4] Order No. 672, 114 FERC ¶ 61,104 at P 142.

[5] *North American Electric Reliability Corporation*, 116 FERC ¶ 61,062 at P 188 (2006).

would continue on a going-forward basis, or new reliability-related activities in these programs could be added, was subject to subsequent Commission review and approval. However, the Commission clearly expressed its opinion that an entity selected to be the ERO might have an expanded scope of activities that it could perform, but not receive funding to perform under section 215:

> We find that section 215 of the FPA provides for federal authorization of funding *limited to* the development of Reliability Standards and their enforcement, and monitoring the reliability of the Bulk-Power System. However, the ERO or a Regional Entity is not precluded from pursuing other activities, funded from other sources.[6] [emphasis added]

Therefore, when NERC was selected as the ERO, the Commission made provision for NERC, as an organization, to continue, or even expand, its historic role in whatever reliability activities it felt were appropriate. However, there were two caveats: these activities should not impede the duties of the ERO to develop and implement mandatory reliability standards, and funding for such voluntary activities not within the scope of section 215 would come from sources other than section 215 authorized funds.[7]

C. Statutory and Non-Statutory Philosophy

In its application to be certified as the ERO, NERC discussed how its ongoing programs of gathering performance data, assessing reliability, and other reliability-focused activities created a dynamic process by which NERC's historical mission and the mission of the ERO were coterminous. These ongoing programs were grouped into six broad functional categories:

- Standards Development and Maintenance
- Compliance Registration, Certification, and Enforcement
- Reliability Assessment and Performance Analysis
- Reliability Readiness Audits
- Situation Awareness and Infrastructure Protection
- Training and Education

NERC's application indicated its belief that all activities NERC carried out in these broad program areas were eligible to be funded pursuant to FPA section 215, i.e.,

[6] Order No. 672, 114 FERC ¶ 61,104 at P 202.

[7] *North American Electric Reliability Corporation*, 116 FERC ¶ 61,062 at P 173 (2006), *order on reh'g*, 118 FERC ¶ 61,111 (2007), *order on compliance filing*, 118 FERC ¶ 61,257 (2007), *order on reh'g*, 119 FERC ¶ 61,257 (2007), *order on reh'g*, 120 FERC ¶ 61,260 (2007).

"statutory activities." Based upon its review of the filings made with the Commission, audit staff believes that NERC defended the statutory nature of all its on-going activities on the basis that these programs were necessary to allow NERC, as the ERO, to assess the need for Reliability Standards, and the way that such standards could best be developed and enforced to achieve the goals of section 215. NERC made this assertion despite the fact that activities NERC undertook before being certified as the ERO were not limited to the development and enforcement of mandatory reliability standards and the monitoring of grid reliability. NERC historically did not confine its activities to the development of reliability solutions that always, or even primarily, involved mandatorily enforceable reliability standards.

During the course of the audit fieldwork, in its discussions with NERC senior officials and staff, audit staff found that NERC continued to operate under the assumption that all of its projects, initiatives, and tools were directly related to section 215, and that NERC did not believe itself compelled to provide a nexus by which any specific activity related to the three explicit functions in section 215. Rather NERC, in its practices, adopted a policy of undertaking some activities based on the loosely defined relationship of the activity to a perceived reliability concern. No criteria as to whether they were mandatorily enforceable via Commission-approved standards, or clearly defined and approved as a monitoring activity were developed or deemed necessary.

Audit staff is concerned that NERC as the ERO has continued, and at times expanded, its historic mission of seeking voluntary reliability activities, rather than the specific mandatory objectives of the ERO as authorized in section 215. Through discussions with NERC senior officials and staff, audit staff found that NERC has operated under the assumption that its projects, initiatives, and tools are directly related to section 215. This has resulted in some projects, initiatives, and tools being undertaken and funded under section 215 that do not have either clear written criteria upon which to justify funding under section 215 or clearly discernible linkages to the development and enforcement of mandatory reliability standards or the monitoring of BPS reliability and adequacy.

While the Commission provided instruction on how to identify activities as non-statutory and how NERC could seek funding apart from section 215, NERC has instead adopted a policy of including all activities into one or more of the six broad program areas identified in its certification application and treating them as statutory. Also, NERC did not develop time-keeping and expense reporting that could track statutory and non-statutory activities, and instead rolled all activities into budget categories to be reported as statutory. By not tracking time by project, and not assigning projects to specific statutory activities, it is difficult for NERC, as well as audit staff and other entities responsible for oversight of NERC's activities, to determine how budgetary funds were used on specific statutory programs. Consequently, NERC's accountability for statutory and non-statutory activities has suffered.

D. Summary of Audit Findings

Audit staff's findings and recommendations for enhanced performance are summarized below. A detailed discussion of these findings is included in Part IV of this report. Audit staff found 11 areas in which enhanced performance of NERC's budgeting process could be achieved:

NERC Budget Process – NERC's budget process did not provide sufficient transparency to allow the Commission, the Board of Trustees (BOT), and stakeholders to efficiently and effectively evaluate annual budget requests and subsequent requests to change approved budgets. This situation was due to a lack of procedures and controls to: (1) address the use of section 215 funds for unbudgeted activities as well as the redirection of unused budgeted funds from approved statutory activities to unbudgeted activities; (2) advise the Commission, BOT, and stakeholders of significant deviations from requested budgeted targets; and (3) develop budget filings with granularity to project-specific levels. As a result, NERC funded unbudgeted activities and significantly deviated from its budgeted activities without approval from the Commission or the BOT.

NERC Oversight of the Regional Entities' Budgets – NERC's process of reviewing Regional Entity budgets was inadequate and lacked appropriate qualitative procedures to efficiently and effectively assess Regional Entities' annual budgets. Greater qualitative oversight in this area may improve the efficiency and effectiveness of the process.

Time Reporting and Accounting Systems – NERC's method for reporting and tracking employee time and expenses failed to track time and attendance on a project-specific basis, and properly classify expenses in its accounting system at a level that provided sufficient transparency to permit effective budget oversight. These deficiencies were due to NERC's lack of adequate procedures for reporting and tracking employee time and insufficient functionality implemented in its accounting system. These shortcomings resulted in inefficient and ineffective budget oversight, time and expense tracking, and control over cost.

Employee Compensation – NERC used studies to determine employee compensation levels that did not have adequate support to justify the reasonableness of compensation NERC paid its officers and staff. Audit staff is concerned that NERC has not systematically assessed its organizational staffing needs to determine the core competencies and skill sets required of employees. This weakness occurred in part because NERC did not contract for an adequate compensation. As a result, NERC incurred considerable personnel costs funded by end-users under section 215.

Standard for Determining the Reasonableness of Expenses – NERC did not have a clear standard of reasonableness by which to judge expenses it or a staff member incurs. Also, NERC's expense review and approval process was decentralized and inefficient. These problems are exacerbated by NERC's lack of sufficient policies, procedures, and controls over: (1) expenses incurred by its employees; (2) employee recruitment expenses; and (3) employee retention expenses. As a result of not having a clear and well-documented standard of reasonableness, NERC did not have adequate cost controls to prevent end-users from paying for excessive expenses.

Employee Entertainment – NERC did not have adequate policies and procedures governing employee entertainment expenses. These policies and procedures were deficient as follows: (1) NERC did not have formal guidance for determining if entertainment expenses were reasonable and reimbursable; (2) NERC paid approximately $74,000 and $109,000, respectively for office holiday parties in December 2010 and December 2011 (Holiday Galas) that were neither fully nor transparently budgeted for; and (3) NERC did not properly account for employee entertainment expenses, including those of the Holiday Galas. As a result of these inadequacies, the BOT, Commission, and stakeholders did not have the necessary information to comment on, or the BOT and the Commission to approve these expenses, and consequently NERC used budgeted funds for expenses not represented in NERC's budget.

Board of Trustees Compensation and Expenses – NERC did not support its shift to a flat-fee methodology of compensating its Board of Trustees (BOT) with a time study based on actual time spent by the BOT on BOT activities or a representative study of the actual time spent on these activities. Also, NERC incurred various BOT member-related expenses outside the official BOT meetings. As a result, audit staff believes NERC's shift to a flat-fee compensation methodology was not adequately supported and the expenses incurred outside the official BOT meetings may have been improperly funded by end-users under section 215.

Retirement Plans – NERC contributed 10 percent of the salary for each employee participating in the retirement plan, which is above energy sector norm. This 10 percent contribution was in addition to an up to 4.5 percent matching contribution for employees participating in NERC's 401(k) plan. Also, NERC included bonuses as well as base salary in its determination of its retirement contribution obligations for employees. In addition, NERC paid excess amounts above the allowable Internal Revenue Service (IRS) limit for retirement contributions to certain employees as additional compensation when it should have maintained these amounts in a tax-deferred account.

NERC Critical Infrastructure Protection Program – NERC inadequately staffed for the needs of its critical infrastructure protection (CIP) program. NERC's senior management focused on a limited scope of activities that did not adequately address the compliance monitoring and enforcement program (CMEP) needs of the ERO in the CIP program. This lack of attention to compliance-related activities led to insufficient staffing for this section 215 responsibility.

NERC Activities – NERC did not have written criteria to determine whether activities should be funded under the Federal Power Act (FPA) section 215. Audit staff is concerned that NERC's failure to develop written criteria to guide its decisions of what constitutes a statutory activity is directly related to its philosophy that all activities that promote the reliability of the Bulk-Power System (BPS) are statutory. As a result, it was difficult for audit staff to determine the scope and extent of permissible activities that should be funded under section 215 and NERC's method of prioritizing such activities to ensure the appropriate focus of activities undertaken as the ERO.

NERC as the Electric Sector Information Sharing and Analysis Center – NERC's dual role as the Electric Sector-Information Sharing and Analysis Center (ES-ISAC) and as the ERO raises significant challenges. NERC has continued functioning in both roles, resulting in internal confusion and confusion among the Commission and stakeholders.

E. Summary of Recommendations

This section summarizes audit staff's recommendations to remedy the audit findings and enhance performance of NERC's budget process. Audit staff will conduct a post-audit site visit when NERC reports that it has completed all of the recommendations to ensure that all of the corrective actions taken as a result of implementing the recommendations were properly completed. Detailed recommendations are included in section IV of this report. Audit staff recommends that NERC:

1. Establish more robust procedures and controls over NERC's use of working capital reserves;

2. Develop a transparent process that permits the Commission, the BOT and stakeholders opportunity to review the expenditure of funds approved for specific statutory activities to be redirected to unbudgeted activities, and develop and obtain Board approval of enhanced guidelines governing such expenditures including criteria for determining when Board and Commission approval is required;

3. Request budgetary funds for activities initiated between budget cycles that were not included in the annual budget filing in a manner similar to section 1108 of the NERC Rules of Procedure (ROP);

4. Increase the granularity of the NERC budget filings by: (1) breaking out significant cost categories in its expenses; (2) identifying proposed budgeted expenditures, at a minimum, on a project specific basis; and (3) separating working capital reserves needed for operations from working capital reserves needed for contingencies and identifying those contingencies;

5. Increase the granularity of the NERC true-up filings in line with the budget filings;

6. Increase the level of NERC review of proposed Regional Entity business plans and budgets, including qualitative and quantitative analyses, with a specific focus on increasing the amount of review provided by NERC's statutory program departments to the business plans and budgets of their counterpart Regional Entity functions;

7. Establish policies and procedures for using information gained and lessons learned from NERC's oversight of Regional Entity operations in the review process for Regional Entity business plans and budgets;

8. Provide budget changes and recommendations to the Regional Entities during the early stages of the Regional Entity budget processes so there is sufficient time to incorporate NERC's recommendations prior to final review and approval of such business plans and budgets by the Board;

9. Implement a time reporting system with the functionality to track employees' time based on the amount of time spent on specific projects or activities and on statutory or non-statutory reliability activities;

10. Develop and implement more comprehensive policies and procedures governing employee time reporting and tracking;

11. Provide training to NERC employees on the proper use of the new time reporting system;

12. Develop project and business activity codes to allow better project management, including the tracking of operating expenses to project-specific levels;

13. To the extent consistent with good business practices, NERC should expeditiously implement functionality in the expense reporting software to allow the tracking of expenses on a project and activity basis;

14. Improve automated controls in its accounting system, such as flags and alerts, to ensure proper accounting classifications, efficiency, and oversight for reporting and analyzing expenses;

15. Establish a comprehensive, single-sourced accounting manual consisting of comprehensive accounting policies, procedures, controls, guidance, and other materials to ensure costs are properly classified, reviewed, approved, and presented accurately in NERC's accounting system, financial statements, and budget filings;

16. Continue to conduct on a routine and periodic basis a thorough review of its entire organization to determine the particular skills and competencies that are required to perform the necessary tasks of each organizational position;

17. Continue to perform routine and periodic updates to employee compensation studies, using comparability data that targets the required skill sets and competencies needed to carry out NERC's mission as the ERO;

18. Use total compensation and update policies to reflect the use of total compensation as the relevant guideline in assessing salaries, retirement benefits, bonuses and other forms of compensation;

19. Enhance formal policies, procedures, and guidance governing expenses incurred by employees to include the following: (1) developing a well-documented reasonableness standard for employee and Trustee meal, hotel, and other travel expenses, including guidance on what constitutes a reasonable cost; (2) guidance on what constitutes a reasonable cost; (3) monetary caps for meals; (4) detailed steps for reviewing and approving expenses; and (4) other necessary procedures to provide clear guidance to employees;

20. In the enhancements under recommendation 19, NERC should evaluate the effectiveness of dividing its process for approving expenses into two steps, leaving managers responsible for approving the purpose and rationale for incurring expenses and designating accounting staff to be responsible for evaluating the reasonableness of expenses;

21. Devise formalized recruitment and hiring policies, procedures, and strategies that address, among other things, controls over the total compensation packages, salary, retention bonuses, benefits, and other accommodations offered to prospective employees. The policies and procedures should also address the qualifications and experience of prospective employees;

22. Explicitly budget for employee entertainment expenses by including line items of sufficient granularity in the budget filings;

23. Use miscellaneous expense accounts to track entertainment expenses separately from business-related expenses in its accounting system;

24. Ensure entertainment expenses are clearly and transparently presented to the BOT, Commission, and stakeholders in the budget before these costs are incurred;

25. Consider returning to the performance-based method of compensating BOT members until NERC gains the necessary experience to support a change to a flat-fee compensation model;

26. Establish a method for tracking BOT time and participation on BOT activities to be able to properly evaluate and quantify the performance of each trustee;

27. Implement the planned BOT tracking software to assist in measuring BOT participation and reducing undue administrative burden;

28. Conduct an analysis of BOT participation and effort based on a time study using actual time spent during BOT activities, or a representative study of the actual time spent and implement a compensation methodology that pays BOT members reasonably for performance of their duties;

29. Estimate and include in its annual budgets an amount of funding to cover BOT expenses that it deems appropriate and seek approval for such funding;

30. Track the expenses actually incurred on BOT-related activities to the budgeted amounts for such expenses;

31. Develop appropriate policies for the giving of gifts, funded from NERC's own resources or paid by any NERC officer or employee to a Trustee;

32. Determine its retirement obligations using relevant comparability and other data that reflects current market conditions;

33. Work with the BOT to craft a total remuneration policy based on principles of total compensation, electric power industry practices, and other relevant factors. This policy should include procedures to justify that all retirement plan contribution levels are appropriate and reasonable;

34. Develop an alternative mechanism for addressing retirement contributions in excess of the IRS cap that maintains the payment as a retirement benefit and not as additional compensation to the employee;

35. Conduct an assessment of existing CIP-related staffing levels to ensure that NERC staff work aligns with section 215 activities and that there are adequate resources to accomplish CIP work;

36. Devote greater resources to carry out its duties under the CMEP as to the CIP-002 through CIP-009 standards and provide effective oversight of CIP CMEP activities by the Regional Entities;

37. Establish written criteria for determining whether a reliability activity should be funded under section 215 through coordination and discussion with Commission staff and stakeholders. Submit to audit staff the criteria established from this collaborative process;

38. Identify all ERO activities funded under section 215, detailing, at a minimum: the purpose of the activity, a description, and the justification for using section 215 funding. Submit all documentation to audit staff for these reliability activities;

39. Work with Commission staff to define NERC's role as the ES-ISAC, to evaluate NERC's role as the ES-ISAC in connection with NERC's other roles as the ERO, and to clearly lay out the Commission's role in overseeing the ES-ISAC;

40. Evaluate the impact on compliance-related activities of "walling off" certain staff from these activities, and modify NERC's current proposal for redefining the operation of the ES-ISAC to include clear guidance on how the "walled-off" sub-division will interact with the ERO;

41. Clarify the flow of information between the ES-ISAC and the Federal Energy Regulatory Commission (FERC) staff for situational awareness and compliance purposes; and

42. Determine whether the funding of the ES-ISAC, in whole or in part, should be treated as non-statutory and, if so, how to manage such funding.

F. Compliance and Implementation of Recommendations

Audit staff further recommends that NERC:

- Submit for audit staff's review its plans for implementing this report's recommendations. NERC should provide these plans to audit staff within 30 days of the issuance of the final audit report in this docket.

- Submit quarterly reports to DA describing the company's progress in completing each corrective action recommended in the final audit report. NERC should make these nonpublic quarterly filings no later than 30 days after the end of each calendar quarter, beginning with the first quarter after the final audit report is issued, and continuing until NERC completes all recommended corrective action.

- Submit copies of any written policies and procedures developed in response to recommendations in the final audit report. These copies should be submitted for audit staff review in the first nonpublic quarterly filing subsequent to NERC completion of documents containing such policies and procedures.

- Select an independent third party, with DA staff approval, to review NERC's budget formulation, administration and execution processes. The third-party auditor shall submit a report contemporaneously directly to DA staff and to NERC. If DA staff so requests, NERC will contract for a second independent audit for the following year.

II. Background

A. NERC Budget

NERC Budget Process

During the audit period, NERC filed six annual budgets with the Commission beginning with the first year of ERO operations in 2007. As the ERO, NERC filed its business plan and budget each year within 130 days in advance of the ERO fiscal year.[8] The Commission, after public hearing notice and opportunity for hearing, has accepted each budget no later than 60 days before each ERO fiscal year begins.

When NERC submits its annual budget to the Commission, the filing includes the NERC and Regional Entity budgets. The Commission's regulations require the ERO and the Regional Entities to include in the annual budget filing a general list of statutory and non-statutory activities and supporting materials, including the ERO and each Regional Entity's business plan and organization chart, an explanation of the proposed collection of all dues, fees, and charges, and the proposed expenditure of funds collected. Audit staff observed that although NERC as the ERO does not believe any activities it performs are non-statutory, several of the REs do include activities they perform as non-statutory and fund them from non-section 215 sources. These activities are not subject to Commission oversight under section 215. Below is a summary of NERC's budget filings that the Commission accepted along with conditions on the acceptance of NERC's business plan and budget.

NERC and the Regional Entities' 2007 Budgets

On August 23, 2006, NERC filed its and the Regional Entities' 2007 business plans and budgets with the Commission. NERC then made a supplemental filing on October 6, 2006 to update information the Regional Entities provided in the original budget filing. The Commission issued an order conditionally accepting the 2007 business plans and budgets on October 24, 2006. The Commission conditioned its acceptance of the budget filing on NERC's development of a system of accounts comparable to the Commission's Uniform System of Accounts. The Commission required NERC to develop its proposed system of accounts and record-keeping requirements, include it as part of its 2008 budget filing, and inform the Commission as to whether NERC's system of accounts complied with generally accepted accounting principles. Also, the Commission required NERC in its 2008 budget filing to identify its general statutory activity and the sub-activities NERC's 2008 budget and business plan covered. Moreover, the Commission directed NERC to provide further consistency and

[8] The ERO fiscal year begins on January 1 each year.

standardization in the formatting of its budget and those of the Regional Entities, and to identify the criteria used for categorizing statutory activities so proposed budgets are consistent across funded activities. Lastly, the Commission directed NERC to add detail to its 2008 budget on: (1) its compliance enforcement activities, including comparisons to its 2007 accomplishments; (2) the estimated number of staff it will provide to assist the Regional Entities; (3) the estimated number of ERO staff on each audit team; and (4) the percentage of reliability standard compliance audits in which the ERO will participate, and how the ERO will select which audits to monitor.

NERC and the Regional Entities' 2008 Budgets

On August 24, 2007, NERC filed its and the Regional Entities' 2008 business plans and budgets and corrected them on August 31, 2007. The Commission issued an order conditionally accepting the 2008 business plans and budgets on October 18, 2007. The Commission directed NERC and the Regional Entities to correct or explain their business plans and budgets to eliminate inconsistencies. The Commission further directed NERC to explain why the differences between the Regional Entities' business plans and budgets were reasonable and acceptable, and directed NERC to provide additional consistency when making budgeting comparisons between the Regional Entities for the broad NERC functional categories for future budget filings. Also, the Commission directed NERC to inform the Commission in a compliance filing about the extent to which current funding, identified as statutory, was used to fund non-statutory activities, and document that any statutory funds used for non-statutory purposes have been or will be reimbursed. In addition, the Commission directed NERC to continue its efforts to improve and refine its performance metrics and to include additional metrics in its 2009 business plan and budget filing. NERC also was directed to revise its records retention schedule so that all records on its proposed records retention schedule that had a retention period of less than five years, except routine vendor correspondence and employment applications, were retained for the longer of five years or until a final Commission order was issued regarding NERC's performance assessment, due in 2009.

NERC and the Regional Entities' 2009 Budgets

On August 22, 2008, NERC filed its and the Regional Entities' 2009 business plans and budgets and corrected them on August 31, 2008. The Commission issued an order conditionally accepting the 2009 business plans and budgets on October 16, 2008. The Commission directed NERC to submit a compliance filing to explain whether the current funding and staffing levels for each of its statutory activities and programs was sufficient and, if not, to propose an increase in funding so that the ERO could adequately perform the activity or program. The Commission further directed NERC to explain why no interest income was expected on monies received but not yet expended. The Commission directed NERC to provide additional information explaining the proposed salary increases in its budget and to improve upon its analysis of metrics used to evaluate the Regional Entities in future budget filings. In addition, the Commission directed NERC to include as part of the 2010 business plans and budgets a definition of the term "indirect costs" that shall be applied consistently by NERC and each Regional Entity, and to provide additional information in a compliance filing to justify indirect cost increases in the 2009 budget.

NERC and Regional Entities' 2010 Budget

On August 24, 2009, NERC filed its and the Regional Entities' 2010 business plans and budgets, and made a supplemental filing on September 15, 2009. In addition, NERC amended the filing on September 18, 2009. The Commission issued an order conditionally accepting the 2010 business plans and budgets on October 15, 2009. The Commission directed NERC to submit a compliance filing explaining the details of NERC's requests for working capital funds and the applicable restrictions or conditions placed on NERC's revolving line of credit. Further, the Commission stated that it expected NERC to maintain independent expertise with which to make relevant judgments, including advice to the BOT regarding proposed Reliability Standards developed by NERC's stakeholder process. In addition, the Commission directed NERC and the Regional Entities to maintain an accurate record of depreciation expense. Also, the Commission directed NERC to provide additional information about particular projects and their associated resources, including Situational Awareness for the Commission, NERC, and the Regional Entities (SAFNR), the processing of Technical Feasibility Exceptions (TFEs) to particular Critical Infrastructure Protection (CIP) standards, the review of Risk-Based Assessment Methodologies (RBAMs) to determine the criticality of entity assets used to perform reliability functions, the review of events that adversely impact the BPS and the processes for conducting Compliance Violation Investigations (CVIs).

NERC and the Regional Entities' 2011 Budgets

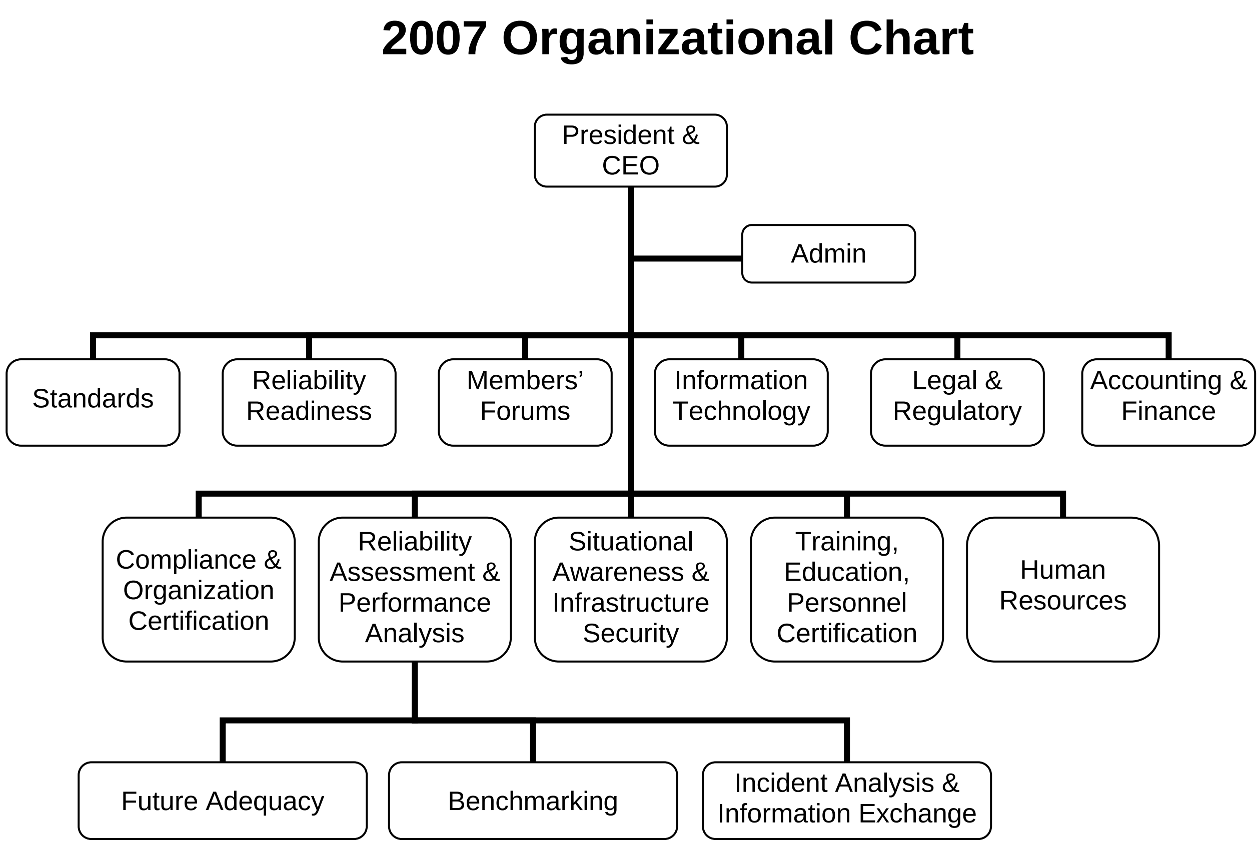
On August 24, 2010, NERC filed its and the Regional Entities' 2011 business plans and budgets. On October 21, 2010, the Commission issued an order conditionally accepting the 2011 business plans and budgets and requiring NERC to make a compliance filing within 60 days. The Commission directed NERC to provide additional information on its structural reorganization, including a mapping of the duties of each department to statutory program areas to ensure that the statutory functions were fully addressed after the reorganization was complete. Also, the Commission directed NERC to include in its future business plan and budget filings NERC's progress in processing violations, including background on NERC's caseload and caseload management. In addition, the Commission directed NERC to further develop the performance metrics used to analyze the Regional Entities' operations in future business plan and budget filings, including an analysis of the current fiscal year in addition to the "Metrics for Budget Submission" for the next budget year.

NERC and the Regional Entities' 2012 Budgets

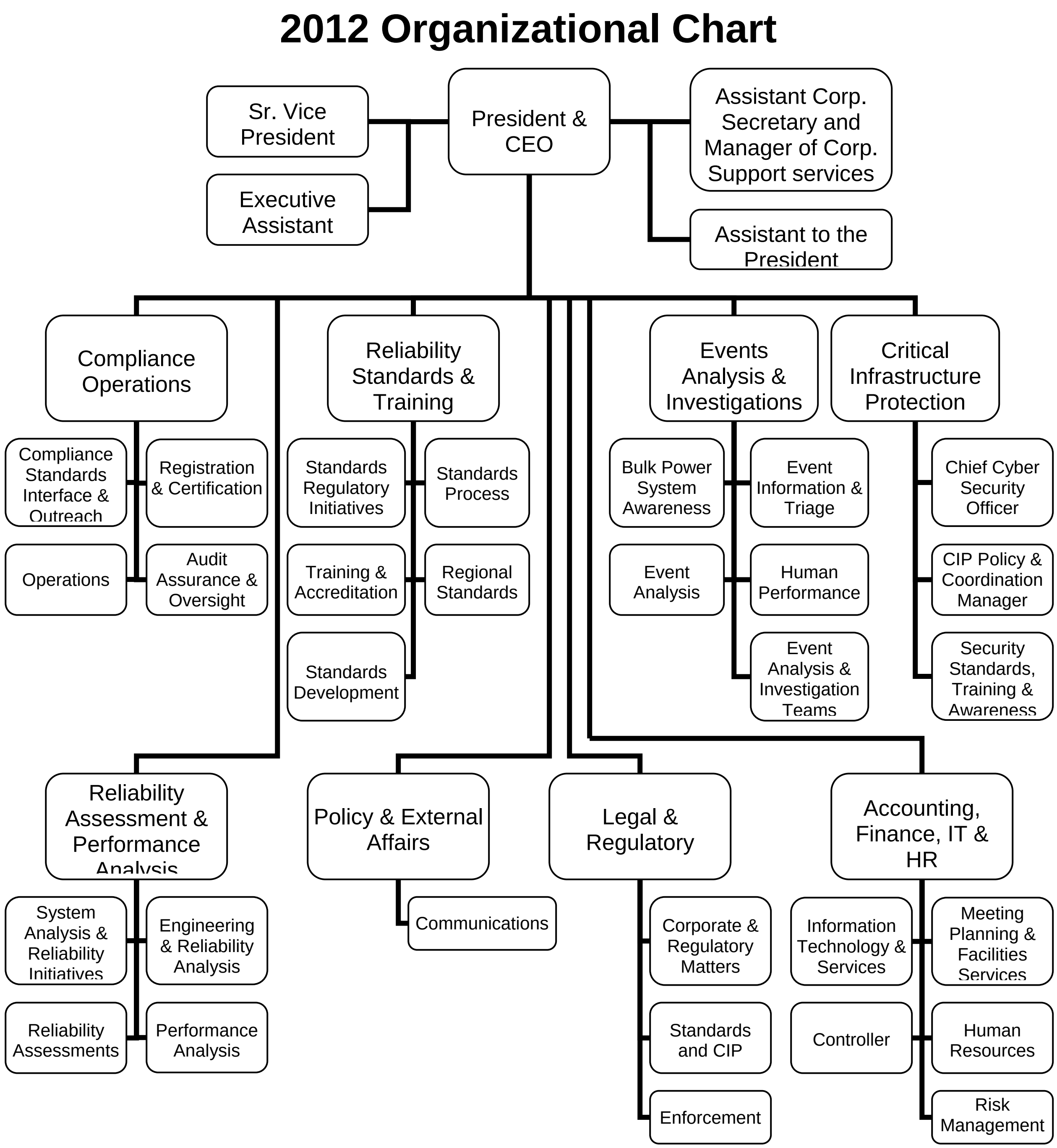
On August 24, 2011, NERC filed its and the Regional Entities' 2012 business plans and budgets. The Commission issued an order accepting the 2012 business plans and budgets on October 20, 2011 without condition.

B. NERC Organizational Structure and Staffing

NERC's organizational structure has undergone a great deal of transformation since its application to be certified as the ERO. The level of staffing has grown substantially during the audit period, from about 70 staff members in 2006 to over 175 in 2012. This staffing increase reflects the expanded role that NERC as the ERO plays in the development and enforcement of mandatory reliability standards as well as increases in its performance of, as well as the scope of, the activities undertaken in its process programs and administrative functions. Below is NERC's organizational chart for its first year as the ERO in 2007:



NERC's organizational charts have continued to generally reflect the broad functional categories initially approved by the Commission when it certified the ERO (i.e., operating divisions within NERC). As such, they do not clearly reflect the relationships that exist in the performance of particular tasks. NERC operates in a matrix (i.e., cross-functional) environment with staff participating in specific programs that sometimes span operating divisions, making it difficult to discern lines of responsibility and authority. Below is NERC's organizational chart effective February 2012:



As depicted in the 2012 organizational chart, various department titles on the organizational charts do not always accurately reflect the responsibilities of NERC staff. For example, some Directors have no NERC staff, but direct programs which are staffed by industry volunteers. Also, audit staff had difficulty understanding NERC's organizational chart due to the changes in the scope of activities performed over time, and the nomenclature used to describe the nature of the activity. Based on audit staff's review of NERC's organizational chart, audit staff believes it would be difficult for those outside of NERC to understand how it operates without obtaining additional explanation and information. It was necessary to conduct extensive interviews over several site visits with NERC senior management and the heads of the NERC divisions in order to gain a sufficient working knowledge of the manner in which NERC operates as the ERO.

III. Introduction

A. Objectives

The objective of this financial performance audit was to evaluate NERC's budget formulation, administration, and execution. This economy and efficiency audit focused on the costs and resources used to achieve program objectives. The audit covered the period from August 23, 2006 to March 14, 2012.

B. Scope and Methodology

Audit staff first identified the criteria to evaluate NERC's performance with respect to its budget formation, administration, and execution. Audit staff gathered and reviewed information through a series of data requests, interviews, teleconferences, and site visits. To address audit objectives, audit staff performed the following audit procedures and audit steps to evaluate NERC's performance:

- *Reviewed Public Information* – To familiarize itself with NERC and its operations as the ERO, audit staff reviewed publicly available materials, NERC's web site, the Commission's e-Library for budget and related filings, Commission orders and stakeholder comments, local newspapers, and trade and academic press to identify significant developments and occurrences that arose during the audit period.

- *Sought Interoffice Support* – Audit staff met with Commission staff within the Office of Electric Reliability's Division of Logistics and Security to discuss the Commission's review of NERC's annual budget and related filings.

- *Conducted Site Visits* – Audit staff conducted site visits to NERC facilities to gain a thorough understanding of NERC's processes, procedures, and operations. During the site visits, audit staff conducted extensive interviews, learned about NERC's operations, evaluated policies and controls, and sampled accounting records and supporting documentation. Audit staff interviewed the majority of NERC's executive management team, including the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), as well as support personnel in the accounting, legal, and government affairs departments. Specific topics covered included:

    - The goals and objectives of the ERO;
    - NERC's functional organization and operations;
    - Budget development, administration, and execution;

  - NERC's system of accounts and accounting policies, procedures, and controls; and
  - Staffing and organizational responsibilities.

- *Conducted Interviews and Teleconferences* – Audit staff conducted interviews with over 25 NERC employees and held numerous teleconferences with company staff to support audit staff's fieldwork. In addition, audit staff conducted interviews of various former NERC employees and members of NERC's Board of Trustees (BOT).

- *Issued Data Requests* – Audit staff requested information relating to NERC's corporate structure, internal policies and procedures, employee compensation, accounting for expenses, budget development, and other key documents. Audit staff used this data as its underlying support for testing and evaluating NERC's performance.

To facilitate the evaluation of the economy and efficiency of NERC's operations, audit staff conducted extensive field testing and analysis of NERC's costs and resources. During the course of fieldwork, audit staff conducted the following activities relating to the major subject areas of the audit:

Objectives of the ERO and NERC's Functional Organization

- Reviewed NERC's goals and business objectives as the ERO, and discussed how NERC aligns its current activities to achieve the objectives;

- Examined how NERC aligns its resources to achieve the goals and objectives of the ERO;

- Assessed the coordination between NERC, the Regional Entities, the Commission, and stakeholders to achieve the goals and objectives of the ERO; and

- Interviewed the CEO and other executive management about the process for setting and tracking the ERO's efforts to achieve business objectives.

Budget Development, Administration, and Execution

- Examined the processes used to develop the NERC and the Regional Entities' annual budgets, including how the programs and objectives of the ERO feed into the budget development process, as well as how the budgets of the Regional Entities are aligned with NERC's;

- Reviewed NERC's process for compiling and submitting the annual budget and true-up filings for Commission approval;

- Discussed NERC's BOT involvement in the budget development and approval process;

- Interviewed multiple BOT members about their involvement in the budget development and approval process;

- Examined the controls in place to ensure adherence to the NERC budget, as well as the controls for overseeing the development, administration, and execution of the Regional Entity budgets;

- Interviewed the CEO and other executive management about their roles in developing and executing the annual budget; and

- Discussed how NERC budgets for particular programs and initiatives, as well as for day-to-day operations, contingencies, and other activities.

NERC's System of Accounts and Accounting for Expenses

- Examined the accounting system in place at NERC, including the associated policies, procedures, and controls;

- Evaluated the adequacy of the currently enabled functionality of the accounting system;

- Sampled travel and operating expenses and reviewed the supporting documentation;

- Interviewed the CFO and accounting staff about specific accounting treatments and activities, including NERC's headquarters relocation, working capital, line of credit, capital expenditures and depreciation, and interest income;

- Reviewed and discussed the lobbying activities and expenses of the legal, government affairs, and executive management staff;

- Discussed the role and responsibilities of the BOT Finance and Audit Committee (FAC); and

- Interviewed the chairperson of the FAC.

NERC Staffing and Organizational Responsibilities

- Discussed the alignment of NERC's staffing and resources to the responsibilities of the ERO;

- Examined the qualifications of NERC staff, including support personnel, executive management, and operational staff, as well as the qualifications of contractors;

- Examined the compensation of NERC staff, including benefits, bonuses, and other forms of incentive compensation;

- Evaluated the controls in place with respect to employee compensation;

- Reviewed the compensation studies and supporting documentation relied upon by NERC to determine employee base salary, bonuses, and other incentive compensation;

- Interviewed NERC Human Resources staff to discuss the NERC hiring process, including NERC's approach to succession planning for key staff and positions, employee qualifications, and employee retention and turnover;

- Discussed NERC's oversight of the Regional Entities' staff and contractors responsible for performing compliance monitoring and enforcement program (CMEP) activities;

- Discussed NERC's headquarters relocation, its effect on staffing, and the efforts taken by NERC to retain key employees;

- Discussed the compensation of NERC's BOT;

- Discussed the role and responsibilities of the BOT Corporate Governance and Human Resources Committee (CGHRC) in relation to employee and BOT compensation;

- Interviewed the chairperson of the CGHRC;

- Reviewed the employee performance evaluation process and discussed how it ties to the bonus allocation process; and

- Reviewed employment contracts in place with current and former employees.

IV. Findings and Recommendations

1. NERC Budget Process

NERC's budget process did not provide sufficient transparency to allow the Commission, the BOT, and stakeholders to efficiently and effectively evaluate annual budget requests and subsequent requests to change approved budgets. This situation was due to a lack of procedures and controls to:

- Address the use of section 215 funds for unbudgeted activities as well as the redirection of unused budgeted funds from approved statutory activities to unbudgeted activities;

- Advise the Commission, BOT, and stakeholders of significant deviations from requested budgeted targets; and

- Develop budget filings with granularity to project-specific levels.

As a result, NERC funded unbudgeted activities and significantly deviated from its budgeted activities without approval from the Commission or the BOT.

Pertinent Guidance

Section 215(c)(2)(D) states the Commission may certify an entity as an ERO if, among other things, the Commission determines that the ERO "has established rules that allocate equitably reasonable dues, fees, and other charges among end-users for all activities under this section."

18 C.F.R. § 39.4 sets out the requirements for funding an ERO. Specifically, section 39.4(b) states:

> The Electric Reliability Organization shall file with the Commission its proposed entire annual budget for statutory and any non-statutory activities, including the entire annual budget for statutory and any non-statutory activities of each Regional Entity, with supporting materials, including the ERO's and each Regional Entity's complete business plan and organization chart, explaining the proposed collection of all dues, fees and charges and the proposed expenditure of funds collected in sufficient detail to justify the requested funding collection and budget expenditures 130 days in advance of the beginning of each Electric Reliability Organization fiscal year. The annual Electric Reliability Organization budget shall include line item

> budgets for the activities of each Regional Entity that are delegated or assigned to each Regional Entity pursuant to § 39.8.[9]

18 C.F.R. § 39.4(d) further states:

> On a demonstration of unforeseen and extraordinary circumstances requiring additional funds prior to the next Electric Reliability Organization fiscal year, the Electric Reliability Organization may file with the Commission for authorization to collect a special assessment. Such filing shall include supporting materials explaining the proposed collection in sufficient detail to justify the requested funding, including any departure from the approved funding formula or method. After notice and an opportunity for hearing, the Commission will approve, disapprove, remand or modify such request.

In the Commission's order conditionally approving NERC's 2007 budget request, the Commission stated:

> We agree with [Edison Electric Institute]'s comments regarding consistency and direct NERC to provide further consistency and standardization in the formatting of its budget and the Regional Entities' budgets for 2008. Consistency and standardization of the formatting will provide greater transparency, which, in turn, will facilitate our evaluation of whether the ERO's and Regional Entities' budgets enable them to meet Order No. 672's goal of "provid[ing] for an appropriate level of uniformity in Reliability Standard development and enforcement policies."[10]

The Rules of Procedure (ROP) of the North American Electric Reliability Corporation state the following:

> 1103. NERC Budget Development – (3) the NERC annual budget submittal to Applicable Governmental Authorities shall include description and explanation of NERC's proposed ERO program activities for the year; budget component justification based on statutory or other authorities; explanation of how each budgeted activity lends itself to the accomplishment of the statutory or other authorities; sufficiency of resources provided for in the budget to carry out the ERO program responsibilities; explanation of the calculations and budget estimates; identification and explanation of changes in budget components from the

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[9] 18 C.F.R. § 39.4(b) (2011).

[10] *North American Electric Reliability Corporation*, 117 FERC ¶ 61,091 at P 84 (2007).

previous year's budget; information on staffing and organization charts; and such other information as is required by FERC and other Applicable Governmental Authorities having authority to approve the proposed budget.

Background

NERC has a budget development and review process that allows the active participation of its BOT, the Commission, and stakeholders. The process is iterative and permits the BOT, the Commission, and stakeholders to offer input. While audit staff recognizes the current budget development and review process is consistent with NERC's Rules of Procedure, we believe that there are several areas where increased transparency could improve budget formulation, administration, and execution to achieve improved performance as the ERO. Below audit staff discusses three areas where NERC can improve budget transparency.

Controls on Funding Unbudgeted Activities

Audit staff has concerns that NERC does not have sufficient procedures or controls to ensure: (1) section 215 funds are not used to pay for reliability activities not budgeted or approved, and (2) unused budgeted funds from statutory activities are not redirected to unbudgeted activities. NERC officials indicated during the audit that approved budgeted funds are at times seen as a cap on total spending rather than as funds designated for accomplishing a specifically approved, statutory reliability activity. Such practices erode the transparency of the budget, and cause the input and direction provided by the BOT, the Commission, and stakeholders through the budget review and approval process to be devalued or lost.

Audit staff believes that the manner in which NERC funded its recent office and data center relocations and the Washington, DC, expansion demonstrates NERC's ability to redirect a significant amount of unused funding without providing sufficient notice or transparency to the BOT, the Commission, and stakeholders. Audit staff analysis of working capital disclosed that NERC's working capital reserves increased by millions over the projected working capital reserves for 2011. The significant increase in working capital reserves were generated primarily from unused funds. NERC used these monies included in its working capital reserves to pay for the relocations and expansion.

In 2011 NERC relocated its corporate headquarters from Princeton, NJ to Atlanta, GA, expanded its office space in the Washington, DC area, and accelerated the relocation of its data center. NERC accomplished these three parts of the relocation during 2011, though its final 2011 budget expressed only an intention to *begin* the process of relocating its corporate headquarters to a location suitable to effectively conduct its role as the ERO. In the 2011 budget filing, NERC stated the budgeted expenses for 2011 related to the relocation totaled $1,175,000, including $200,000 in moving expenses,

$750,000 in unspecified relocation expenses, and $225,000 in startup costs for the data center relocation.[11] In that filing, NERC also stated that it expected to incur further relocation expenses gradually in 2012 and 2013, and that it would end the relocation no later than May 2013.[12] NERC did not include an estimate of the total costs of the relocation in its 2011 budget submission.[13] However, NERC incurred total expenses of $6,375,000 for the relocation in 2011, completing the entire headquarters relocation and data center relocation efforts and the majority of the Washington, DC, office expansion during that year. Audit staff's analysis of NERC accounting records revealed that approximately $1,474,000 in 2010 and $2,921,000 in 2011 was approved in the budgets for those years for specific activities, was not used for those activities, and was placed into working capital. Additionally, $869,000 in 2010 and $588,000 in 2011 was collected above the budgeted amounts for Testing Fees, Workshop Fees, and funding sources other than Assessments; these amounts also served to bolster working capital available. Since NERC had no guidelines limiting the use of working capital, audit staff believes that NERC elected to use them for its relocation.

Audit staff believes that working capital should be used to cover short-term operating cash flow concerns due to timing differences between when expenses are paid and when funding is received. In interviews, NERC officers stated that working capital reserves are seen more as contingency funding, used for unexpected expenditures (e.g., an unanticipated event investigation) and for projects that were not finalized at the time of the budget filing but came to fruition during the operating year. Audit staff believes that a distinction needs to be made between reserves needed for continuing operations (working capital reserves) and reserves needed for contingencies (contingency reserves). Audit staff also believes that NERC should use the Commission-approved process set forth in section 39.4(d) of the Commission's regulations for requesting additional funding for projects that are initiated or completed outside of the budget cycle. This process exists not merely to provide NERC funding for an activity, but also to give the BOT, the Commission, and stakeholders a chance to evaluate the activity and the Commission and the BOT opportunity to approve the activity.

Significant Deviations from Budgets

Audit staff identified some significant deviations between the budget formulation and execution phases of NERC's budget process that resulted in divergence from budgeted expenditures. Audit staff believes NERC operates as if the approved budget sets a cap under which NERC may redirect its budgeted resources without disclosure to

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[11] North American Electric Reliability Corporation, Request, Docket No. RR10-13-000, Transmittal Letter at 34, Attachment 2 at 21 (filed Aug. 24, 2010) (submitting its 2011 business plan and budget, for approval).

[12] *Id*. P 50.

[13] *Id.*

the BOT, the Commission, and stakeholders prior to expending such funds. Rather than retain these funds to offset future assessments or seek approval to use these funds, NERC expended the funds as it saw fit, either on projects that were not approved through the budget process or on approved projects that were budgeted at levels significantly below what NERC actually expended on them.

For a variety of reasons during the operating years, NERC has been unable to expend funds according to the proposed expenditures it presented in its budget. Some of these reasons include: (1) an inability to use approved fulltime equivalent (FTE) funding because NERC is unable to attract suitable candidates in a timely fashion; (2) unanticipated resignation of staff members; and (3) fewer industry participants than projected when formulating the budget. Moreover, NERC must reprioritize its planned activities to address unanticipated events that occur during the operating year after budget approval. While audit staff recognizes these possible disconnects between budget formulation and execution, we believe NERC should develop more robust procedures to allow the BOT, the Commission, and stakeholders to see, and the BOT and the Commission to approve where appropriate, how unused funds are redirected during the operating year.

Increased Granularity of the Budget

NERC's budget filings are broken out into the functional categories that were approved by the Commission when NERC was certified as the ERO, and as amended in subsequent Commission orders. While this breakdown may be useful to examine cost trends over time, NERC's operational structure has notably evolved since it first became the ERO. NERC currently engages in reliability activities that span multiple functional areas, because an employee in one functional area may work on projects led by multiple other functional areas (i.e., a matrix environment). As a result, it is difficult to understand the amount and level of NERC's funding expended on general functional areas, much less on specific activities. Audit staff believes that budget reporting at a more granular level would allow for a greater understanding and appreciation by the BOT, the Commission, and stakeholders of the reliability activities NERC is undertaking and the costs associated with them. For example, other sections of this audit report indicate specific areas that audit staff has identified as warranting a more detailed level of reporting than is currently provided in the budget process.[14]

An example of an area that audit staff believes needs more granularity in budget filings is the manner in which the total cost of BOT oversight responsibilities is reported.

[14] For example, Finding 5 recommends that BOT expenses not be recorded as general business expenses, Finding 7 deals with employee expenses that need to be separately reported and Finding 10 concludes that employee entertainment should be presented as a discrete line item in the budget.

While NERC separately reports Board of Trustee members' compensation, this is only a portion of the actual costs of providing BOT oversight to the ERO. Reporting the costs associated with holding periodic board meetings (e.g., hotel conference facility charges), the costs of the various BOT committee meetings that are convened, BOT travel expenses for attending BOT and Regional Entity board meetings, and other BOT-related costs as elements of total BOT expenses would allow greater attention to be focused on this important element of the NERC budget. This level of granularity would provide greater opportunity to the BOT, the Commission, and stakeholders to review and comment on costs directly incurred by the ERO with an effort to increase efficiency and effectiveness.

Audit staff also found that NERC was directed to file true-ups to provide the Commission and stakeholders with information that will help in analyzing the following year's budget.[15] Reviewing these true-up filings, audit staff discovered that following actual expenditures in the budget true-up filings was difficult because of the lack of granularity in reporting expenditures, the redirection of funds, and the funding of unbudgeted programs. This difficulty diminishes the usefulness of true-up filings for informing the following year's budgets. In line with improved transparency and granularity in the budget approval process, audit staff believes the annual budget true-up filings should be reported with a degree of granularity that is similar to the initial budget request. True-up filings should clearly distinguish which projects came in under budget, which projects had funds redirected to other programs and the effect of those redirections, and which unbudgeted projects were funded.

To increase granularity, audit staff believes NERC should consider project-specific reporting within the budget. Presentation at this level might better permit the BOT, the Commission, and stakeholders the opportunity to review, comment on, and provide guidance on specific projects to ensure that reliability activities undertaken are statutory in nature and are being funded at appropriate levels. This change would also assist NERC with identifying appropriate reliability activities to focus on as the ERO.

Recommendations:

We recommend that NERC:

1. Establish more robust procedures and controls over NERC's use of working capital reserves;

2. Develop a transparent process that permits the Commission, the BOT and stakeholders opportunity to review the expenditure of funds approved for specific statutory activities to be redirected to unbudgeted activities, and

[15] *North American Electric Reliability Corporation*, 121 FERC ¶ 61,057 at P 23 (2007).

develop and obtain Board approval of enhanced guidelines governing such expenditures, including criteria for determining when Board and Commission approval is required;

3. Request budgetary funds for activities initiated between budget cycles that were not included in the annual budget filing in a manner similar to section 1108 of the NERC Rules of Procedure (ROP);

4. Increase the granularity of the NERC budget filings by: (1) breaking out significant cost categories in its expenses; (2) identifying proposed budgeted expenditures, at a minimum, on a project specific basis; and (3) separating working capital reserves needed for operations from working capital reserves needed for contingencies and identifying those contingencies; and

5. Increase the granularity of the NERC true-up filings in line with the budget filings.

2. NERC Oversight of the Regional Entities' Budgets

NERC's process of reviewing Regional Entities' budgets was inadequate and lacked appropriate qualitative procedures to efficiently and effectively assess Regional Entities' annual budgets. Greater qualitative oversight in this area may improve the efficiency and effectiveness of the process.

Pertinent Guidance

The Federal Power Act (FPA), as amended by the Energy Policy Act of 2005, added section 215 on Electric Reliability. Section 215(e)(4) states "The Commission shall issue regulations authorizing the ERO to enter into an agreement to delegate authority to a regional entity for the purpose of proposing reliability standards to the ERO and enforcing reliability standards under paragraph (1) ... "

As a result of the addition of section 215(e)(4) to the FPA, the Commission enacted regulations related to the delegation of authority from the ERO to the Regional Entity. Specifically 18 C.F.R. § 39.8 states:

> The Electric Reliability Organization may enter into an agreement to delegate authority to a Regional Entity for the purpose of proposing Reliability Standards to the Electric Reliability Organization and enforcing Reliability Standards under § 39.7.

In addition, the Commission reiterated in Order No. 672 that the ERO may delegate its enforcement activities to the Regional Entities.[16]

Further, Order No. 672 at P 227 states, in part:

> The ERO must have oversight to ensure that Regional Entities are adequately funded to accomplish their delegated functions. To implement this, we are including the following text at the end of subsection 39.4(b):
>
> > The annual Electric Reliability Organization budget shall include line item budgets for the activities of each Regional Entity that are delegated or assigned to each Regional Entity pursuant to section 39.8 of the Commission's regulations.
>
> Accordingly, the ERO must exercise budgeting oversight over the Regional Entities.

[16] Order No. 672, 114 FERC ¶ 61,104 at P 23.

On April 4, 2006, NERC filed its Rules of Procedure with the Commission.[17] The Rules of Procedure include a section on Submittal of Regional Entity Budgets to NERC (section 1104). In the filing, NERC's section 1104.2 stated NERC will presume each regional entity's budget is reasonable if their governing body has approved the budget for submission to NERC. However, a Commission order addressed the issue of the reasonable budget of the regional entity:

> NERC has not provided sufficient rationale for the provision that would establish a presumption of reasonableness by the ERO of a Regional Entity's budget if the Regional Entity's governing body has approved its budget. We believe that this proposed provision could hinder the ERO's ability to conduct a meaningful review of the proposed Regional Entity budgets as contemplated by Order No. 672 and is inconsistent with the overarching goal of establishing a strong ERO. Accordingly, we direct NERC to remove this provision from the *pro forma* delegation agreement…We agree with the California Commission that the budget should provide for performance and funding of reliability functions that are essential for maintaining overall reliability, that the way to accomplish this is by having the ERO review the budget and, where necessary, suggest or make changes and not presume the budget and thus the activities to be reasonable.[18]

On October 24, 2006 FERC issued an order conditionally accepting NERC's 2007 business plan and budget. In the order, the Commission stated the following:

> We direct NERC and the Regional Entities to examine the various activities proposed by each Regional Entity to be performed under each statutory function, and to determine what activities need to be performed consistently across the Regional Entities. They should develop their budgets for 2008 to reflect the best practices found from this examination.[19]

[17] North American Electric Reliability Council and North American Electric Reliability Corporation, Application, Docket No. RR06-1-000, (filed Apr. 4, 2006) (requesting certification as the Electric Reliability Organization).

[18] *North American Electric Reliability Corporation*, 116 FERC ¶ 61,062 (2006), *order on reh'g*, 118 FERC ¶ 61,111 at P 203 (2007), *order on compliance filing*, 118 FERC ¶ 61,257 (2007), *order on reh'g*, 119 FERC ¶ 61,257 (2007), *order on reh'g*, 120 FERC ¶ 61,260 (2007).

[19] *North American Electric Reliability Corporation*, 117 FERC ¶ 61,091 (2006).

Background

NERC is responsible for ensuring that funds collected under section 215, including those funds allocated to the Regional Entities, are being used efficiently and effectively. To date, NERC's review of the Regional Entities' budgets primarily consisted of ensuring that across the regions: (1) similar costs are reported in a uniform manner; (2) staffing (FTEs) and funding are consistently distributed between major program components; (3) variances between regions appear reasonable; and (4) stakeholder comments received from the budget review process are incorporated. Audit staff noted that NERC's method of review is in accordance with its Rules of Procedure, and that in recent budget cycles NERC has improved consistency by coordinating with Regional Entities to develop a common set of assumptions. However, with maturation of the ERO audit staff believes, as discussed in greater detail below, that NERC should conduct more focused reviews to oversee Regional Entities adequately, and to ensure their budgets are sufficient to accomplish duties delegated under section 215 in an effective and efficient manner.

Based upon interviews and audit staff's review of emails and supporting documentation, audit staff determined that NERC conducted a fairly high-level review that generally lacked qualitative assessments of the underlying data available to it. Audit staff identified several areas in which it believes an expanded NERC role is necessary for effective and efficient oversight. These areas include: evaluating the skills and compositions of audit teams and proactively evaluating resources for new or expanded Regional Entity roles.

With respect to the first area identified above, audit staff noted the skills and compositions of the CIP audit teams varied significantly among the eight Regional Entities. Audit staff sees this as an issue NERC should have addressed as part of its responsibility to oversee the Regional Entity budgets. However, NERC's review of Regional Entities' budgets for CIP compliance audits focused only on the funding and numbers of FTEs without addressing the skills and composition of audit teams, despite the abundance of Regional Entity data and information available to it. In interviews, audit staff learned that the only member from the CID who participated in the Regional Entity budget review process was the Director of the Division. Audit staff believes the experiences CID gained through its oversight of Regional Entity audits, as well as valuable lessons learned, should have been incorporated into the Regional Entity budget review process. Sharing of this information as part of a review that includes more focus on the quality of CIP audits among Regional Entities would improve NERC's oversight of the Regional Entity budgets and promote consistency among Regional Entity execution of their delegated duties.

Audit staff believes NERC must use the budget process effectively to perform its oversight duties of new or expanded roles of Regional Entities. By proactively addressing these roles through the budgeting process, audit staff believes NERC and the Regional Entities would achieve improved consistency and performance. Audit staff notes that NERC made several after-the-fact efforts to address the CIP audit team inconsistencies discussed above, but these efforts had limited effectiveness. Qualitative and proactive oversight of the Regional Entity budgets would have been a more efficient approach to establishing CIP audit teams that yielded consistent results.

However, in order for NERC to accomplish this it will be necessary for NERC to get involved in the Regional Entity process at an earlier stage of the budget development process. Under the existing procedure, after an initial meeting to discuss common assumptions, the Regional Entity budgets largely are developed in discrete processes running in parallel tracks with NERC's own budget process. It is only after the Regional Entities have nearly completed their budget processes that the two tracks converge. Greater efforts need to be made to involve NERC in providing oversight to the Regional Entity budget development process at an early stage.

Recommendations

We recommend that NERC:

6. Increase the level of NERC review of proposed Regional Entity business plans and budgets, including qualitative and quantitative analyses, with a specific focus on increasing the amount of review provided by NERC's statutory program departments to the business plans and budgets of their counterpart Regional Entity functions;

7. Establish policies and procedures for using information gained and lessons learned from NERC's oversight of Regional Entity operations in the review process for Regional Entity business plans and budgets; and

8. Provide budget changes and recommendations to the Regional Entities during the early stages of the Regional Entity budget processes so there is sufficient time to incorporate NERC's recommendations prior to final review and approval of such business plans and budgets by the Board.

3. Time Reporting and Accounting System

NERC's method for reporting and tracking employee time and expenses failed to track time and attendance on a project-specific basis, and properly classify expenses in its accounting system at a level that provided sufficient transparency to permit effective budget oversight. These deficiencies were due to NERC's lack of adequate procedures for reporting and tracking employee time and insufficient functionality implemented in its accounting system. These shortcomings resulted in inefficient and ineffective budget oversight, time and expense tracking, and control over cost.

Pertinent Guidance

The Federal Power Act (FPA), as amended by the Energy Policy Act of 2005, added section 215 on Electric Reliability. Section 215(c)(2) states the Commission may certify an entity as an ERO if, among other things, the Commission determines that the ERO " ... has established rules that allocate equitably reasonable dues, fees, and other charges among end users for all activities under this section."

18 C.F.R. § 39.4 sets out the requirements for funding an ERO. Specifically, section 39.4(b) addresses ERO annual budget requirements.[20]

In a response filed on April 1, 2008 to the Commission's 2008 ERO budget order, NERC stated the following:

> [P]roper charg[es] of personnel expenses incurred by employees whose activities involve more than one functional category is typically supported by a daily or other periodic time reporting system in which the employee is required to report the number of hours or percentage of his/her time spent during the reporting period on activities in each Functional Category.[21]

Background

Since the date on which NERC was certified as the ERO through December 31, 2011, NERC's method for tracking employee time and expenses was inadequate to permit effective budgetary and cost controls. Specifically, NERC failed to track the time spent by staff on specific ERO projects, and the manner in which NERC recorded expenses in its books and records did not permit NERC to effectively and efficiently match expenditures to specific projects.

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[20] *See supra* text accompanying note 9.

[21] North American Electric Reliability Corporation, Filing, Docket No. RR07-16-003 at 7 (filed Apr. 1, 2008) (responding to the Commission's 2008 ERO Budget Order).

Tracking of Employee Time

Audit staff's review of NERC's policies and procedures for reporting and tracking employee time revealed several major concerns. Specifically, the time tracking system in place at the commencement of the audit was primarily used to track employee attendance, with entries denoting duty hours and leave hours by operating division. The term "duty hours" refers to NERC's practice of allowing employees exempt from overtime pay to record eight-hour days rather than the actual number of hours worked on any specific activity. NERC had no mechanism requiring employees to report their time on a project-specific basis, either within their divisions or on projects led by another division.

Audit staff noted that in an April 1, 2008 response to the Commission's 2008 ERO budget order, NERC indicated the existence and use of a time reporting system in which employees were "required to report the number of hours or percentage of his/her time spent during the reporting period on activities in each Functional Category,"

The "Functional Categories" NERC referenced were originally equivalent to the operating divisions existing when the order was issued. Thus, audit staff understood that in this filing NERC committed to maintain a reliable contemporaneous record of the time spent by each staff member on each Commission-approved function. Tracking of hours to this level of detail would facilitate more accurate and effective budget formulation and oversight.

Audit staff determined that NERC did not follow the time-reporting practice that it described to the Commission in its 2008 response. Instead, NERC employees typically reported all their duty hours to their administratively assigned operating division without identifying the projects they worked on or the time spent on each project. These operating divisions have shifted over time, as NERC's organizational structure and operations changed since NERC became the ERO; NERC evolved into a "matrix" organization in which projects often spanned operating divisions. The reporting of employees' time only to their operating divisions without linking to specific projects or activities did not provide an effective means of tracking the actual work performed by NERC employees. Failure to track actual efforts by project inhibits effective and efficient budget formulation and project management, making it difficult to specify the effort expended on a given activity or project. For example, when filing quarterly congressional lobbying disclosures, NERC undertook a cumbersome and inefficient process to determine the time employees spent on lobbying activities: NERC employees examined their calendars, extracting the information to a stand-alone spreadsheet, and submitting it to NERC's Legal department for review and analysis. The Legal department then determined the final number of hours devoted to lobbying activities.

The failure to report time and expenses by specific reliability activities affected all facets of NERC's operations. This failure hampered NERC's ability to:

- Evaluate the effectiveness and efficiency in achieving statutory goals;
- Submit a budget with sufficient detail to show NERC's statutory projects and activities;
- Assist the development of core competencies required for the hiring process;
- Track the actual effort being expended on specific projects;
- Track and evaluate individual employee performance;
- Analyze and report on differences between incurred costs and budgeted amounts; and
- Facilitate the development of meaningful position descriptions reflecting actual work performed.

NERC's CEO acknowledged to audit staff the limitations of the time reporting system, and indicated that it was contrary to his intentions when he assumed his position in 2010. The CEO stated that he intended to implement time-reporting at a more granular level as he had done elsewhere with success. However, this effort was not one of NERC's highest priorities at the time, and the CFO indicated that implementing this change was too complex given other activities already under way at NERC. During interviews on the issue, audit staff found no documentation evaluating, suggesting, or recommending such a change. NERC's justification for the delay in requiring project-specific reporting of time was that NERC was still a growing, learning organization and "there was just so much [it] could do at once." Audit staff believes that it is imperative that NERC establish a robust time reporting system to establish records of its employees' activities, thereby allowing NERC to ensure its employees spend the appropriate amount of time on statutory reliability activities. The CEO and CFO acknowledged that, in retrospect, adopting a better time-tracking system should have received a higher priority.

During the audit, NERC management indicated its intention to procure and implement a new time-tracking system addressing the issues identified by audit staff. NERC contracted with a third party that implemented software on January 1, 2012, allowing NERC to effectively and efficiently track employee time and the time spent on specific activities. NERC provided program training to employees on December 14, 2011, with additional training and optimization sessions held in January 2012. During its January 2012 site visit, audit staff learned that NERC had successfully implemented the software and would continue enhancing the time-reporting detail. NERC managers expressed support for the enhanced ability to manage employees and projects, and seemed eager to improve the system by suggesting additional reporting codes. NERC reported that its senior management is developing a coding scheme to allow enterprise-wide consistent reporting on a project-specific basis.

NERC Accounting System

Audit staff found deficiencies in NERC's implementation of its accounting and expense reporting software. These deficiencies became apparent during the audit as NERC expended an excessive amount of time and effort to respond to certain basic requests for data. For example, NERC was unable to readily produce records of all expenses incurred for any given event, such as a BOT meeting, or travel for a specific audit. These requests required NERC to conduct an analysis of individual expense reports to aggregate the necessary data, as NERC had no software functionality in place to efficiently aggregate the costs of a given event. Audit staff believes that NERC must improve its accounting software by using: (1) project-specific and business activity codes when recording expenses, and (2) improved automated flags to alert internal users, as well as reviewers, of possible data entry problems and violations of NERC's policies and procedures.

NERC informed audit staff that despite existing capabilities in this software, project and business activity codes had not been systematically implemented. Audit staff discovered that NERC had limited policies and procedures for entering and reviewing expenses in the system. Audit staff also noted that NERC had limited accounting controls in place, such as automated flags and alerts, to assist users and reviewers and to ensure proper expense reporting and accounting. The lack of consistent project and business activity code use often resulted in various expense components of a single business activity being disconnected, making it difficult to track the activity in the system. For a given business trip, each participating employee would report expenses to his or her operating division with no systematic link in the accounting system between the expense reports or the business trip. When analyzing individual employees' expenses, audit staff noted that expenses incurred for a single trip at times fell into different expense reports, further disaggregating NERC's total expenses for any one business trip.

During interviews with NERC officials, it became apparent to audit staff that NERC management had discussed, but ultimately deferred, utilizing project and business activity codes. NERC management explained the deferral by stating there were other, more pressing changes that needed to be made. However, audit staff found no documentation evaluating such changes. Having better functionality in the accounting system will also provide NERC a more effective management tool to facilitate budget implementation, a point that NERC appears to have embraced during the audit process. Audit staff concluded that enhancing software functionality and developing policies and procedures to use activity codes for specific projects and activities should have been implemented sooner, and would have allowed for greater budget transparency, accountability, and cost control.

Recommendations

We recommend that NERC:

9. Implement a time reporting system with the functionality to track employees' time based on the amount of time spent on specific projects or activities and on statutory or non-statutory reliability activities;

10. Develop and implement more comprehensive policies and procedures governing employee time reporting and tracking;

11. Provide training to NERC employees on the proper use of the new time reporting system;

12. Develop project and business activity codes to allow better project management, including the tracking of operating expenses to project-specific levels;

13. To the extent consistent with good business practices, NERC should expeditiously implement functionality in the expense reporting software to allow the tracking of expenses on a project and activity basis;

14. Improve automated controls in its accounting system, such as flags and alerts, to ensure proper accounting classifications, efficiency, and oversight for reporting and analyzing expenses; and

15. Establish a comprehensive, single-source accounting manual consisting of comprehensive accounting policies, procedures, controls, guidance, and other materials to ensure costs are properly classified, reviewed, approved, and presented accurately in NERC's accounting system, financial statements, and budget filings.

4. Employee Compensation

NERC used studies to determine employee compensation levels that did not have adequate support to justify the reasonableness of compensation NERC paid its officers and staff. Audit staff is concerned that NERC has not systematically assessed its organizational staffing needs to determine the core competencies and skill sets required of employees. This weakness occurred in part because NERC did not contract for an adequate compensation study. As a result, NERC incurred considerable personnel costs funded by end-users under section 215.

Pertinent Guidance

The Federal Power Act (FPA), as amended by the Energy Policy Act of 2005, added section 215 on Electric Reliability. Section 215(c)(2) states the Commission may certify an entity as an ERO if, among other things, the Commission determines that the ERO " ... has established rules that allocate equitably reasonable dues, fees, and other charges among end users for all activities under this section."

18 C.F.R. § 39.4 sets out the requirements for funding an ERO. Specifically, section 39.4(b) addresses ERO annual budget requirements.[22]

Background

Since becoming the ERO, NERC grew from an organization with approximately 70 employees in 2006 to over 175 budgeted employees in 2012. Examination of NERC's budgets showed that employee compensation (i.e., salaries, payroll taxes, employee benefits, and retirement) dramatically increased during this growth period. Employee compensation is the largest cost category in the NERC budget, amounting to $30.1 million in 2012, representing 61.4 percent of the budget.[23]

In the summer of 2011, NERC hired a new director for its Human Resources department. Upon commencement of the audit and discussions with audit staff, the new director began a comprehensive assessment of NERC's organizational structure and staffing needs to ensure that it can effectively carry out its duties and responsibilities as the ERO. Though these efforts remain ongoing, recent actions taken by NERC include: retaining specialized skills in key administrative areas (e.g., event planning and Human

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[22] *See supra* text accompanying note 9.

[23] North American Electric Reliability Corporation, Request, Docket No. RR11-7-000, Attachment 2 at 25 (filed Aug. 24, 2011)(submitting the 2012 business plans and budgets of NERC and Regional Entities for acceptance and Proposed Assessments to Fund Budgets for approval).

Resources), systematically re-evaluating NERC staffing needs, and determining strategies to attract and retain the staffing to perform the necessary functions as the ERO.

In November 2008, the BOT established and approved a process for determining compensation levels for the CEO, executives, and employees (Compensation Policy).[24] This document outlines the process guiding the BOT's consideration of employee compensation levels. The essential element of this process is the need for reliable "comparability data" by which to measure remuneration.

During the audit period, NERC contracted four independent firms to conduct eight compensation studies. NERC meant the compensation studies to provide guidance on compensation levels and benefits for the CEO, executives, and employees. Given the nature of NERC's role as the ERO, audit staff believes that detailed compensation studies should take NERC's functional and operational responsibilities into consideration to determine the most applicable comparability data. However, NERC appropriated a relatively low level of funding to the first six compensation studies it commissioned, resulting in insufficient analyses and inadequate "comparability data." While audit staff does not believe that more funding would necessarily produce higher quality studies, audit staff believes the lack of sufficient funding is an indicator of the relative importance that NERC attributed to the studies. Audit staff is concerned that the low level of funding coupled with NERC's lack of attention and control over the assumptions used in the studies led to the inclusion of companies in the compensation studies that did not operationally correlate to NERC. These studies provided limited relevance and usefulness as "comparability data" and lacked the substance needed to provide reasonable compensation comparators for NERC staff and BOT to make appropriate compensation decisions. As one NERC executive characterized these efforts: "You get what you pay for." The following table describes the compensation studies NERC undertook to establish a basis for CEO, executive, and employee compensation levels:

[24] Process for Determining Annual Compensation of Independent Trustees, Chief Executive Officer, Other Officers, and Key Employees, November 13, 2008 (http://www.nerc.com/files/Process%20for%20Determining%20Annual%20Compensation.pdf).

NERC Compensation Studies

No.	Study Name	Date Conducted	Price Paid
1	Executive Compensation	February, 2007	$7,985.60
2	Staff Compensation	July, 2007	$13,500.00
3	CEO Compensation	July, 2009	Unknown
4	Executive and Staff Compensation	January, 2011	$50,692.49
5	Executive Benefits	April, 2011	$15,000.00
6	Total Remuneration	July, 2011	$15,282.40
7	Total Remuneration - Executives	December, 2011	$50,000.00
8	Total Remuneration - Staff	January, 2012	$95,000.00

Note: NERC made several attempts but could not provide the cost incurred for the July 2009 CEO Compensation Study to audit staff.

The table above reflects eight compensation studies for which NERC contracted with independent compensation firms. Prior to the studies conducted from late 2011 to 2012, the studies focused in a piecemeal fashion on base compensation, total remuneration, benefits, and annual incentives. Audit staff found that these earlier studies did not provide appropriate or adequate comparability data for CEO, executive, or employee compensation. Audit staff believes that these studies contained both inaccurate comparators and suffered from inappropriate methodologies. To highlight the issues with the earlier compensation studies, audit staff discusses in detail below the January 2011 Executive and Staff Compensation Study (Study 4 in the table above), which relied on 2010 data.

2011 Executive and Staff Compensation Study

The compensation firm's 2010 comparators included a broad range of companies pulled from its database for the general energy industry. Audit staff's review of this list found fault with at least 27 of the 98 companies because they fall outside the electric sector by including; natural gas pipelines, exploration and production firms, and nuclear operation companies. Audit staff questioned the comparability of these companies to NERC; the analysis provided sparse supporting data and indicated a general lack of familiarity with NERC's role in the electric industry as the ERO. In addition, audit staff noted the list of comparators included six companies twice, and the study made little or no adjustments to comparator data based on cost of living differentials (determined by the geographic location of the comparators), total entity budgets, or the scope of the comparators' activities.

Audit staff determined that the compensation study provided inappropriate compensation data and was not sufficient to provide the comparability data required by NERC's Compensation Policy. When asked about the comparables, NERC staff stated that it too had raised concerns with the appropriateness of many of the comparative companies included in the study and asked the study's author to change the composition of the companies. However, the author of the study commenced a contracted follow up Total Remuneration Study (Study 6 in the table above) using the same comparables, and would not accommodate NERC's request based on the contracted funding amount. At this point, NERC staff stated that it halted funding for this study, did not request a finalized report, and effectively "threw out" the study. NERC then contracted with a different firm for Total Remuneration Studies (Studies #7 and #8 in the table above).

Despite the admitted flaws in the study, NERC used the "data points" (total direct compensation and total cash compensation of comparable positions) from the 2011 Executive and Staff Compensation Study as reference points when determining percent increases to annual base salaries. Audit staff questioned why NERC would use such "data points" given the faults with the analysis and comparators. NERC staff represented that the data points provided a good reference and could help inform their decisions. However, audit staff noted that although the study generally found NERC's employee compensation to be high relative to industry, NERC in fact increased overall compensation levels of employees and appeared to only reference data points from the study that justified the increase.

Audit staff agrees with NERC's Compensation Policy that it is important to have sound, comparable data to determine compensation levels. Use of such data should protect end-users from funding unreasonable compensation costs, but NERC failed to implement the policy effectively. Audit staff is troubled by NERC's use of flawed compensation data to influence its compensation levels. NERC presented the January 2011 compensation data to the BOT during its February 2011 meeting in which the BOT discussed and approved compensation levels and 2010 employee bonuses. Audit staff's review indicates that the materials given to the BOT made no mention of NERC "throwing out" the study. Rather, NERC officials represented to the BOT that, although the study results were uneven, NERC used the compensation study. NERC staff made no mention of its dissatisfaction with the methods used by the compensation firm.

More Recent Compensation Studies

NERC contracted with the Mercer Group, Inc., an Atlanta-based management consultant, to conduct compensation studies of executive direct total compensation (base salary, short-term incentive opportunity (e.g., bonuses), and total compensation and bonuses for NERC staff. The studies' results were released to the NERC Board in February 2012, and NERC submitted study materials to audit staff in March 2012.

The Mercer study used metrics drawn from comparisons between NERC and: (1) Mercer's primary comparator group of not-for-profit entities; (2) published survey data; and (3) Mercer's proprietary database of general industry and utilities. Also, Mercer used general industry comparators from its proprietary database with revenues ranging between $100 million and $400 million, and utility comparators from its proprietary database with annual revenues of less than $3 billion (discounted 20 percent allegedly to align with the $100 million to $400 million range comparators).

One of the assumptions used for the selection of this group was the assumption that NERC's budget was $200 million. However, the 2012 NERC budget is only $53 million. The difference between the actual budget over which NERC executives fully exercises authority (i.e., $53 million) and the $200 million Mercer used, is accounted for by the budgets of the eight Regional Entities, which for 2012 totaled $151 million. The 2012 WECC budget alone, due to its operation of WECC Reliability Coordination and significant grant funding, was more than $14 million larger than the 2012 NERC budget. The role of NERC executives in the development and implementation of the Regional Entities budgets is minimal, as discussed in section IV of this report, Finding 2 – NERC Oversight of Regional Entities' Budgets. Consequently, audit staff believes NERC executives exercise authority over a more modest $53 million budget. For this reason, the use of a significantly higher budget range (i.e., two to eight times greater than NERC's actual budget) in selecting the appropriate comparables might be subject to further refinement by Mercer in future studies.

In addition, Mercer did not use the same comparator group to evaluate executive retirement and supplemental benefits that it did for the direct compensation analysis. This disconnect may impact the effectiveness in evaluating the total overall compensation element, which was the one of the original goals of the studies. Instead, Mercer used an unspecified "published survey" database composed of 17 for-profit utilities with annual revenues of less than $1 billion each and 73 nonprofit companies with median operating budgets of $200 million each. The nonprofit comparators were used solely for comparing retirement benefits. This makes the results difficult to compare, either on a stand-alone basis for retirement contributions or when combined with NERC's direct compensations for its executives.

For the study of total compensation and rewards for NERC staff, the Mercer report found that total cash compensation was in line with or above market levels. While audit staff has not received and evaluated all of the study's supporting materials, including the list of comparators used, audit staff notes that at the time the audit began NERC had only just begun to a systematically analyze staffing positions within NERC and rewrite employee job descriptions. Audit staff believes these elements are important in determining total staff compensation, as they are used to determine the necessary skills each position requires and ensures the descriptions reflect the necessary skills and competencies.

Audit staff makes no determination regarding the appropriateness of the compensation currently paid to NERC's officers, senior management, or staff. NERC has make significant advances in supporting compensation by means of the new Mercer study and audit staff believes that this support could be further strengthened by improving the comparability data, refining its internal evaluation of the skills and competencies needed in the staff positions and carefully considering the total compensation paid to staff, management and executives.

Recommendations

We recommend that NERC:

16. Continue to conduct on a routine and periodic basis a thorough review of its entire organization to determine the particular skills and competencies that are required to perform the necessary tasks of each organizational position;

17. Continue to perform routine and periodic updates to employee compensation studies, using comparability data that targets the required skill sets and competencies needed to carry out NERC's mission as the ERO; and

18. Use total compensation and update policies to reflect the use of total compensation as the relevant guideline in assessing salaries, retirement benefits, bonuses and other forms of compensation.

5. Standard for Determining the Reasonableness of Expenses

NERC did not have a clear standard of reasonableness by which to judge expenses it or a staff member incurs. Also, NERC's expense review and approval process was decentralized and inefficient. These problems are exacerbated by NERC's lack of sufficient policies, procedures, and controls over: (1) expenses incurred by its employees; (2) employee recruitment expenses; and (3) employee retention expenses. As a result of not having a clear and well-documented standard of reasonableness, NERC did not have adequate cost controls to prevent end-users from paying for excessive expenses.

Pertinent Guidance

The Federal Power Act (FPA), as amended by the Energy Policy Act of 2005, added section 215 on Electric Reliability. Section 215(c)(2) states the Commission may certify an entity as an ERO if, among other things, the Commission determines that the ERO " ... has established rules that allocate equitably reasonable dues, fees, and other charges among end users for all activities under this section."

18 C.F.R. § 39.4 sets out the requirements for funding an ERO. Specifically, section 39.4(b) addresses ERO annual budget requirements.[25]

Background

NERC is a non-profit corporation that, as the ERO, has been authorized to receive public funding under section 215 to carry out its statutory functions. As such, NERC has an obligation to ensure that its use of such funds is appropriate. To date, NERC has not set auditable standards for reasonableness of expenses, preferring instead to use the personal discretion of its management. The lack of clearly articulated standards has led NERC to incur and pay for expenses that, in the opinion of audit staff, NERC has not adequately justified. To ensure an adequate level of protection to those end-users who fund the ERO activities, audit staff believes that NERC should develop an appropriate standard by which to assess reasonableness. Audit staff discusses below three areas in which NERC lacks adequate policies, procedures, and controls to ensure costs are reasonable: (1) expenses incurred by NERC employees; (2) employee recruitment expenses; and (3) employee retention expenses.

Expenses Incurred by NERC Employees

During its review of NERC's accounting software and records, audit staff selected a sample of accounting records and reviewed the supporting documentation. Audit staff's sample identified various instances of noncompliance with NERC's policies and

[25] *See supra* text accompanying note 9.

procedures, including missing documentation, misclassified expenses, and unusually expensive meals and hotels. These instances revealed inadequacies in the current practices and the need for improvement in NERC's existing cost controls over expense reporting, tracking, and accounting.

Audit staff evaluated NERC's policies and procedures governing employee travel and related expenses, and determined that the policies themselves were limited in detail and did not include monetary caps for certain expenses, such as meals. Instead, the policies reference an undefined standard of "reasonableness," thus relying solely on the judgment of individual employees and their supervisors. In addition, guidance given to employees on incurring expenses and to managers for reviewing and approving expenses was not formalized or sufficient to ensure that costs are reasonable.

Meal Expenses

Audit staff's examination of meal expenses from meetings attended by NERC and Regional Entity staff and others found that NERC paid for meals that were beyond what NERC considers reasonable.[26] For the sample period February 2011 through December 2011, audit staff analyzed documentation supporting meal expenses that were incurred at NERC meetings and in connection with travel, and observed that the cost of meals range up to $126 per attendee with numerous meals ranging above the $50 threshold trigger point. During interviews, audit staff was informed that NERC sometimes rewarded its staff by paying for high-priced meals. NERC approved these employee entertainment expenses as routine business expenses, which audit staff believes was inappropriate. When this topic was discussed with the CEO, he was not aware of this matter and agreed that such costs should not have been incurred. Therefore, it is clear the existing policies, procedures, and controls in place were inadequate to prevent these costs from being included for recovery as approved business expenses. Due to this lack of formalized guidance, other senior management allowed the practice to occur and only "spoke to" employees incurring excessive costs without requiring assumption of personal responsibility for the excess cost. These admonishments were not documented, and audit staff questions their effectiveness. In further discussions about the matter, the CEO stated that employee rewards for performance should be made in more transparent categories, such as salaries or bonuses. Audit staff believes that the development of

[26] Although NERC's policies reference the term "reasonable" without defining it, based upon interviews and expense reporting practices a cost of $50 is considered a trigger beyond which a meal expense is expected to have more than one attendee. This understanding is based upon: (1) NERC's expense accounting software prompts the user to input a list of attendees for any meal expense entered into the system that exceeds $50 incurred, and (2) an email dated November 2010 from the CFO to senior NERC managers indicating that he would expect "staff would consider $50 to $60 per person to be a high-end dinner."

formalized guidance for the entertainment and reward of employees is necessary to ensure costs are appropriate and transparent.

<u>Hotel Expenses</u>

Employees have been told to choose the cheapest hotel available that meets their needs; however, there is very limited guidance on how employees should identify the most economic option. The lack of adequate policies and procedures led to inconsistencies across departments, as both employees and managers varied in how they implemented the informal guidance. Audit staff found instances that appeared to involve high-cost charges but, due to lack of accounting records tracking the particular circumstances that might have impacted the employees' decisions, no reliable conclusion could be reached during the audit.

Audit staff believes it is very important for NERC to have a well-documented standard of reasonableness to achieve effective cost controls and provide guidance to its staff as to cost guidelines and limits, and the types of employee costs that are reimbursable from NERC.

<u>Review of Employee Expenses</u>

Audit staff noted that individual managers currently have primary responsibility for reviewing, tracking, and approving their employees' expenses. Audit staff interviewed several department managers and determined that this structure has led to significant inconsistencies in the level of review and scrutiny of employee expenses. Audit staff also noted that department managers expend a considerable amount of time reviewing employee expenses. Audit staff believes that NERC's current method of reviewing employee expenses is not effective or efficient, and does not represent the best use of management time. Shifting responsibility from the department managers to the accounting staff would result in a more efficient use of NERC resources and ensure consistency through all departments at NERC. Having clearly articulated written polices to inform and train the accounting staff in the performance of this duty would be necessary. Violations to existing policies could then be resolved in accordance with appropriate written procedures that would only involve the managers minimally in cases of serious or persistent violations.

Employee Recruitment

NERC had no documented recruitment strategy and only limited policies and procedures governing its recruitment of employees. Human Resources and other NERC staff lacked adequate guidance to effectively control costs. During the audit period, NERC committed significant accommodation incentives to hire prospective employees without conducting a review to determine the reasonableness of such commitments and without the supporting documentation. In interviews, NERC management stated it did not have the appropriate human resources leadership in place to develop a formal recruitment strategy and robust administrative policies and procedures to govern this administrative function. Without these governing documents, NERC could not determine whether such incentives were reasonable and in the best interest of the end-user.

In discussions with NERC staff, audit staff learned that all NERC employee contracts were “at will,” meaning NERC or the employee may terminate employment at any time, without cause. Rather than formal employment contracts, NERC detailed employment terms in offer letters or Memorandums of Understanding (MOUs). When audit staff inquired about the use of “at-will” contracts, NERC executives stated that NERC used this approach prior to certification as the ERO, and that these arrangements provided flexibility in the recruitment process. However, audit staff reviewed various offer letters and MOUs and noted significant accommodations offered to candidates. In discussions with NERC staff and its review of accounting records, audit staff was concerned by the lack of accountability for these costs exercised by NERC. Since these costs are not required to be linked with any assurance that the candidate’s services will be retained for any specific period of time such costs may not result in value being provided to the ERO. Therefore, maintaining NERC’s accountability in incurring these costs to achieve a specific outcome (i.e. the recruitment and retention of the candidate) has not been done by NERC to date.

Audit staff is concerned that this approach continues to be practiced in NERC’s operations as the ERO. Audit staff identified an example of this approach occurring in 2010 when NERC offered an executive-level position to a candidate with a recruitment package including standard benefits, incentives, base compensation, and reimbursement for a one-time relocation. Shortly thereafter, in order to accommodate the candidate’s requests, NERC modified the offer to: (1) increase annual base salary by 10 percent; (2) allow the candidate to work from home for 90 days but reimburse for all travel and hotel accommodations; (3) agree to reimburse expenses for the shipment of one vehicle; (4) agree to reimburse for two house-hunting trips; and (5) offer a one-time signing bonus of $15,000. The candidate accepted the position at NERC under an “at-will” arrangement. Despite the additional accommodations, NERC did not require the employee to remain at NERC for a given period of time without having to reimburse NERC for the cost of these accommodations. In this instance, the employee accepted an alternative employment offer and left NERC less than two years later. Furthermore, the cost incurred by NERC to accommodate the employee’s travel and hotel expenses, vehicle shipment, and house-hunting trips were recorded as normal business expenses rather than as employee recruitment expenses. Audit staff is concerned by the lack of transparency this presents, as it inflates the cost of normal business and under-reports the cost of recruitment, hiring, and total remuneration to the employee. Therefore, audit staff believes that these costs could be best controlled by evaluating the effectiveness of the cost of the recruitment process in securing value to the ERO.

In discussion of NERC's recruitment process, NERC staff asserted that they struggled to compete with Independent System Operators (ISOs), Regional Transmission Organizations (RTOs), and large utilities that could offer profit sharing and stock options. NERC believed it must use special incentives and accommodations to develop comparable compensation packages with which to recruit and hire qualified employees. Since NERC had no formalized recruitment strategy or robust administrative policies and procedures, it treated each candidate on a case-by-case basis. Audit staff believes this practice led to the following deficiencies in NERC's recruitment and hiring practices: unnecessary hiring and recruitment expenses, inflation of expenses, inconsistencies and inefficiencies in recruitment practices, and a lack of transparency in the recruitment and hiring process.

Employee Retention

In conjunction with its headquarters relocation in 2011, NERC gave certain support staff retention bonuses to incentivize them to remain at NERC through the relocation. The bonuses ranged from $4,000 to as much as $25,000, and were in addition to a general relocation policy that NERC designed and offered to all employees. This relocation policy offered employees the option to choose a one-time cash payment or reimbursement for certain expenses related to moving, including house-hunting trips and shipment of personal goods. In general, the policy provided sufficient incentives for employees to relocate to their new duty station, designated by management as either Atlanta, GA, or Washington, DC. Audit staff noted that stakeholders and the Commission were denied their chance to comment on this policy because it was not in place during the routine budget process, but rather the BOT approved the policy during the operating year. Although audit staff recognized the need to incentivize employees critical to its operations and for whom replacement costs would be a significant burden, it is concerned about the reasonableness and transparency given that the retention bonuses and relocation policy were not vetted through the routine budget process.

In addition to the two accommodations described above, NERC provided relocation packages to accommodate three executive-level employees. Although each accommodation varied slightly, NERC negotiated for these employees to retain Princeton as their duty station beyond the period outlined in the relocation policy, which resulted in NERC paying for travel to and lodging in Atlanta for each of these executives up through January 1, 2012. Audit staff's review of supporting documentation revealed a lack of transparency in these arrangements, as two executives had no documentation, and the third executive's arrangement was documented by email approximately two months into it. Furthermore, NERC recorded these costs in its books and records as regular business expenses, and audit staff found no evidence that these arrangements had been reviewed or approved by either the BOT or vetted through the routine budget process. For these reasons, audit staff is concerned about the reasonableness, transparency, and accounting of these employee retention expenses.

Audit staff is not asserting that NERC should not be able to exercise appropriate managerial discretion in these matters. However, audit staff believes that such costs should be reported in a manner that identifies these costs for what they are, and not treat them as routine business expenses, thereby inflating NERC's customary business overheads. Accounting for such costs in a more transparent manner will increase confidence in NERC and better enable NERC as an enterprise to understand and manage its costs. It will also allow those who review NERC's operations to exercise more effective oversight.

Recommendations

We recommend that NERC:

19. Enhance formal policies, procedures, and guidance governing expenses incurred by employees to include the following: (1) developing a well-documented reasonableness standard for employee and Trustee meal, hotel and other travel expenses, including guidance on what constitutes a reasonable cost; (2) detailed steps for reviewing and approving expenses; and (3) other necessary procedures to provide clear guidance to employees;

20. In the enhancements under recommendation 19, NERC should evaluate the effectiveness of dividing its process for approving expenses into two steps, leaving managers responsible for approving the purpose and rationale for incurring expenses and designating accounting staff to be responsible for evaluating the reasonableness of expenses;

21. Devise formalized recruitment and hiring policies, procedures, and strategies that address, among other things, controls over the total compensation packages, salary, retention bonuses, benefits, and other accommodations offered to prospective employees. The policies and procedures should also address the qualifications and experience of prospective employees.

6. Employee Entertainment

NERC did not have adequate policies and procedures governing employee entertainment expenses. These policies and procedures were deficient as follows:

- NERC did not have formal guidance for determining if entertainment expenses were reasonable and reimbursable;
- NERC paid approximately $74,000 and $109,000, respectively for office holiday parties in December 2010 and December 2011 (Holiday Galas) that were neither fully nor transparently budgeted for; and
- NERC did not properly account for employee entertainment expenses, including those of the Holiday Galas.

As a result of these inadequacies, the BOT, Commission, and stakeholders did not have the necessary information to comment on, or the BOT and the Commission to approve these expenses, and consequently NERC used budgeted funds for expenses not represented in NERC's budget.

Pertinent Guidance

Section 215(c)(2) states the Commission may certify an entity as an ERO if, among other things, the Commission determines that the ERO " ... has established rules that allocate equitably reasonable dues, fees, and other charges among end users for all activities under this section."

18 C.F.R. § 39.4 sets out the requirements for funding an ERO. Specifically, section 39.4(b) addresses annual budget requirements.[27]

Compliance Filing Regarding Organization and Structure of the Accounting and Record Keeping Systems of the North American Electric Reliability Corporation filed 12/22/2006 under docket number RR06-3-002 specifies the following accounts:

> 62000 - Travel - This account shall include charges for expenses for employees, trustees, and contractors to travel to meetings and workshops in support of functional
>
> 71000 - Telephone - This account shall include charges for telephone services (land lines and cellular)

[27] *See supra* text accompanying note 9.

71100 - Internet Expense - This account shall include charges for fees paid for internet connectivity (communications) and/or service (outsourcing of website).

71200 - Office supplies - This account shall include charges for office supplies.

99000 - Miscellaneous Expense - This account shall include miscellaneous expenses not readily categorized to other expense accounts.

Background

Based on a review of NERC accounting records, audit staff identified three areas of concern related to the use and accounting of NERC funds for unbudgeted employee entertainment expenses: an office holiday party, employee meal expenses, and how these expenses were classified.

NERC Holiday Galas

NERC incurred considerable expense for employee holiday parties held in December 2010 (2010 Gala) and December 2011 (2011 Gala) (collectively referred to as the Holiday Galas[28]). Audit staff's analysis divided the Holiday Galas' costs into four main categories: travel costs to and from the Holiday Galas, lodging while at the Holiday Galas, the expenses of the Holiday Galas themselves, and other expenses, as reflected in the following table:

[28] The term "Gala" used in the finding is a term that NERC itself used internally in its company communications and in other supporting evidence produced by NERC to audit staff to describe the end-of-year parties that NERC provided for its employees.

Expenses Incurred in Connection with the Holiday Galas

Expense Type		**2010**	**2011**
Travel	Airfare	$11,547	$25,105
	Train	5,167	59
	Reimbursement (car mileage, gas, parking, tolls)	4,362	2,842
	Other	1,208	2,877
	Travel Total	$22,284	$30,883
Lodging	Staff Rooms - group rate at hotel	$11,259	$19,665
	Staff Rooms - billed separately not at group rate	4,027	9,874
	Lodging Total	$15,286	$29,539
Gala Expenses	Holiday Gala Gifts	$5,871	$0
	Food and Beverage - Gala	21,982	38,796
	Gala Entertainment	1,575	925
	Office Supplies	446	0
	Gala Expenses Total	$29,875	$39,721
Other	Food and Beverage - Meetings	$1,043	$2,425
	Food and Beverage - Non meeting, non Gala	3,132	6,223
	Car Rental	2,727	172
	Miscellaneous	402	511
	Other Expenses Total	$7,304	$9,332
Total Expenses		**$74,748**	**$109,474**

Due to the way NERC accounted for these expenses, NERC was unable to readily identify the total cost of the Holiday Galas, which raised concerns about the way costs were recorded in NERC's books and records. For the 2010 Gala, audit staff determined that NERC properly recorded in its books and records $35,127 of the Holiday Gala expenses in Account No. 99000, Miscellaneous Operating Expenses under the General and Administrative function. However, NERC recorded the other costs related to the Holiday Gala, which included the travel, a portion of the lodging costs, gifts, and equipment, as approved business-related expenses in various operating expense accounts.[29] Audit staff believes these company-wide entertainment costs should be

[29] Travel Expenses: Travel – Account No. 62000; Office Costs: Telephone – Account No. 71000, Internet Expense – Account No. 71100; and Office Supplies – Account No. 71200

recorded in Account No. 99000, Miscellaneous Operating Expenses. Additionally, NERC incorrectly recorded employee breakfast and award costs as travel expenses.

NERC staff stated that some of the Holiday Galas costs were recorded as routine business expenses because they were primarily incurred in connection with meetings held the day of the Holiday Galas instead of for the Holiday Galas themselves. Audit staff reviewed these meetings and determined them to be training not requiring in-person attendance that was not previously planned for that day. In interviews, NERC stated it "used the opportunity" of the Holiday Galas to conduct these voluntary group training sessions, and incurred additional expense by hosting a continental breakfast and a luncheon to "encourage attendance." Audit staff questions the validity of incurring expenses for such ancillary training, and believes the primary reason for incurring all the above costs was the Holiday Galas.

NERC's 2010 budget true-up filing stated that it was $65,954 over the $4,000 budget for Miscellaneous Operating Expenses under the General and Administrative function, and referenced a "provision for uncollected accounts receivable related to unpaid assessments and GADS Services" as the cause for the variance.[30] NERC accounting records showed these items totaled $31,000. NERC failed to mention the $35,000 of Holiday Gala expenses, which appear to have accounted for an even larger portion of the variance. Additionally, NERC's 2012 budget filing proposed to increase the budget for this account from $4,000 to $26,000 to account for "recent experience" without mention of funding for its annual holiday party. Audit staff is concerned by the lack of transparency in NERC's budget and true-up filing for these expenses.

During the course of this audit, audit staff shared with NERC concerns with the costs incurred for the 2010 Holiday Gala and the lack of transparency of these costs as reflected in the NERC budget. However, despite the fact that audit staff shared its concerns about the appropriateness and accounting associated with the 2010 Holiday Gala, NERC held a similar party in 2011. NERC again scheduled company-wide training to take advantage of the travel and related costs incurred for employees to gather at the Atlanta headquarters. For example, NERC sent nearly its entire Critical Infrastructure Division staff of 15 to a meeting usually attended by two staff members. The holiday party was in the midst of the training sessions that were held the day before, the morning of, and the day after.

Audit staff believes that for most public utilities regulated by the Commission, employee entertainment expenses as described in the above table are not generally recoverable from ratepayers but recorded as "below-the-line" expenses recovered from

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[30] North American Electric Reliability Corporation, Report, Docket No. RR11-4-000, (filed May 31, 2011) (comparing budgeted to actual costs for 2010 for NERC and the Regional Entities).

stockholders. However, NERC is a non-profit corporation subject to a cost recovery funding mechanism, and to protect ratepayers it is imperative that NERC not incur costs that have not been explicitly approved. For these reasons, audit staff believes employee entertainment costs must be transparently presented so the BOT, the Commission, and interested parties can review and comment on the appropriateness of budgeting for such costs, and to allow the BOT and the Commission the opportunity to approve whether such expenses should be incurred and paid under section 215.

Recommendations:

We recommend that NERC:

22. Explicitly budget for employee entertainment expenses by including line items of sufficient granularity in the budget filings;

23. Use miscellaneous expense accounts to track entertainment expenses separately from business-related expenses in its accounting system;

24. Ensure entertainment expenses are clearly and transparently presented to the BOT, Commission, and stakeholders in the budget before these costs are incurred.

7. Board of Trustees Compensation and Expenses

NERC did not support its shift to a flat-fee methodology of compensating its Board of Trustees (BOT) with a time study based on actual time spent by the BOT on BOT activities or a representative study of the actual time spent on these activities. Also, NERC incurred various BOT member-related expenses outside the official BOT meetings. As a result, audit staff believes NERC's shift to a flat-fee compensation methodology was not adequately supported, and the expenses incurred outside the official BOT meetings may have been improperly funded by end-users under section 215.

Pertinent Guidance

Section 215(c)(2) states the Commission may certify an entity as an ERO if, among other things, the Commission determines that the ERO " ... has established rules that allocate equitably reasonable dues, fees, and other charges among end users for all activities under this section."

18 C.F.R. § 39.4 sets out the requirements for funding an ERO. Specifically, section 39.4(b) addresses ERO annual budget requirements.[31]

Background

Board of Trustee Compensation

NERC compensated its BOT based upon a participation-based methodology from the inception of the ERO until January 2011. Beginning January 2011, NERC switched to a flat-fee methodology of compensating its BOT. NERC did not provide adequate support for the change in BOT compensation. In response to data requests and during onsite interviews, NERC staff stated that the BOT initiated the move to alter compensation and implied that the change was not under NERC's control. NERC staff further indicated that it supported the change due to the administrative burden to NERC of providing compensation based upon meeting attendance. Audit staff believes this burden was self-imposed by NERC's inadequate policies and procedures for tracking BOT time and meeting participation. The study supporting the change in compensation methods consisted of a four-page report and two presentations to the BOT. The study was intended to deal with both the appropriate level of compensation and the manner in which compensation should be provided. However, as discussed below, the study's report failed to accomplish either objective.

[31] *See supra* text accompanying note 9.

Level of Compensation

In November 2008, NERC's BOT established and approved a process for determining compensation levels, including levels for its BOT (Compensation Policy).[32] The Compensation Policy outlined the process guiding the BOT's consideration of compensation at each level. Two elements of the trustee compensation process are the need for the BOT's Corporate Governance and Human Resources Committee (CGHRC) to: evaluate the amount of work and level of responsibility the BOT is being asked to undertake, and examine comparability data of representative organizations as part of that review.

NERC commissioned an independent consulting firm in the spring of 2010 to conduct an Executive Compensation study based on data from other entities that it believed to be comparable with NERC. However, audit staff's review of the data supporting the compensation study revealed that it did not address the first objective of the trustee compensation process and failed to meet the second. The data supporting the study were sparse and did not adequately address NERC's role in the electric industry, the complexity of the various entities' operations and structures, those entities' total budgets, and the degree of involvement (including actual hours worked or meetings attended) of those entities' trustees. Rather, the study's author included a list of comparators consisting of ISOs, RTOs, and Regional Entities to which surveys were sent. Only eight entities submitted data in response to the survey, with one of the responders not providing compensation levels. The author relied on those eight responses and did not use publicly available data sources, such as IRS Form 990 annual filings that contain data on trustee compensation, to support the analysis. The author instead used another survey's results from utility boards to determine the baseline compensation recommendation.

While the audit staff is not making a determination of the appropriateness of the level of compensation to the BOT members, audit staff believes that when all of these factors are considered, the adequacy of the analysis supporting the compensation of NERC's BOT does not appear adequate. The change in method did result in a significant increased in the customary total and per-trustee compensation levels for the BOT. This increase is depicted in the following table:[33]

[32] Process for Determining Annual Compensation of Independent Trustees, Chief Executive Officer, Other Officers, and Key Employees, November 13, 2008 (http://www.nerc.com/files/Process%20for%20Determining%20Annual%20Compensation.pdf).

[33] The 2008, 2009, and 2010 data is based on NERC's IRS 990 filings. The 2011 data is based on the new BOT flat fee structure in place for that year.

Average Compensation per Trustee

	2008	2009	2010	2011
Total BOT Fees	$685,225	$834,476	$819,050	$980,000
Number of Independent Trustees on the Board	10	10	11	11
Average per Member fee	**$68,523**	**$83,448**	**$74,459**	**$89,091**

However, an increase in the level of compensation in itself does not indicate that the methodology is inappropriate. What is lacking is the support to demonstrate that the increase is justified.

<u>Manner of Compensation</u>

Audit staff's review of the study materials revealed that the conclusion to move to a flat-fee retainer was unsupported. Audit staff's first concern is highlighted in the study's Conclusions and Recommendation section, which begins: "[the author] has long supported the introduction of 'flat-fee,' retainer only approach, to board compensation." Audit staff views this statement not as a conclusion supported by the data, but as a preference of the study's author rather than an independent assessment. The data supporting the study contradicted the author's recommendation of a flat-fee retainer because 70 percent of all BOTs identified in the study were compensated in a manner *other* than flat-fee retainers. Furthermore, though the analysis surveyed Regional Transmission Organizations (RTOs), Independent System Operators (ISOs), and Regional Entities to determine the level of compensation, it is unclear why the author did not use the same or a similar sample to analyze the manner of compensation. The author instead relied on statistics from outside surveys of unspecified boards. The study stated that none of the author's survey participants had adopted the advocated compensation and indicated that only one of the sampled ISOs had considered moving in that direction.

The study stated that the proposed change would reflect a policy change from paying for actual time spent on NERC activities to paying for achieving the accountabilities of the role of the BOT. The study also stated the proposed change would "reinforce the appropriate role of the Board without encouraging (consciously or unconsciously) unnecessary meetings." While NERC and audit staff agreed that these goals may be desirable, audit staff found no evidence that unnecessary meetings had occurred or that the new methodology had any systems to prevent such meetings from occurring. Audit staff's discussions with NERC revealed that NERC had no initiatives to hold the BOT accountable for carrying out their duties, no independent analyses of the time and effort spent by the BOT, and no objective standards for evaluating how well the BOT fulfills its responsibilities.

Discussion with Compensation Firm

To gain further understanding of the study's approach and methodology, audit staff discussed the study and its results with the study's authors. Audit staff discovered that the study's authors did not investigate NERC's claims that the current method of compensating the BOT imposed an administrative burden upon NERC prior to reaching their recommendation to shift to a flat-fee methodology. In addition, audit staff determined that the authors: (1) did not review the actual time and meeting participation spent by NERC's BOT to support its determination, and (2) based their conclusions upon problems that existed at other boards, such as unnecessary meetings, without any evidence that these problems existed at NERC. Without evaluating such matters, audit staff questions the adequacy of the authors' support for its recommendation to switch to a flat-fee methodology.

BOT Expenses

Audit staff sampled four months of BOT meetings by examining NERC's accounting records and found that NERC staff commonly hosted the BOT at banquet-type dinner events that were separate and apart from the meals offered during scheduled BOT and BOT committee meetings. Most of the costs involved with these events consisted of meal expenses (i.e., food and beverages) that ranged up to $146 per-person, which resulted in meal expenses well in excess of the "reasonable" level NERC provided as guidance to its employees.[34] Also, these events included not only the BOT and NERC staff, but also spouses or invited guests of attendees. Despite the presence of spouses and other invited guests at these functions, NERC claimed that official business was conducted at these events. Audit staff believes that, while business may well be discussed at these gatherings and that such gatherings may be within the discretion of NERC, funding for these activities must be clearly budgeted and approved if it is to be paid from section 215 funds.

Audit staff notes that NERC did not record these meeting costs in any one particular account; rather NERC recorded the costs in various accounts as routine business expenses. To properly account for these costs in its books and records, NERC should have classified these costs in Account No. 99000, Miscellaneous Operating Expenses, instead of using several expense accounts to account for these costs. This accounting would also provide more transparency for these types of costs.

[34] Audit staff notes that the term "reasonable" is not explicitly defined by NERC. However, the CFO stated that a cost of approximately $50 to $60 per person was the upper bound for a reasonable dinner meal, and NERC's expense reporting system triggers a prompt for a user to enter "additional attendees" if the meal cost entered is greater than $50.

In addition to the accounting practices and budgeting processes, discussed above, audit staff believes that some expenses incurred on behalf of the BOT raise possible conflict of interest concerns. It is customary to have policies and procedures regarding the giving of gifts by a subordinate to a superior, particularly if the superior is in a position to reward the subordinate. NERC has no policies or procedures in place to govern incurring such expenses, even though the BOT approves the level of remuneration of NERC officers (directly) and senior staff (indirectly). Although NERC has focused its attention on policies and procedures related to accepting such gifts from stakeholders, it has not addressed this area of concern internal to the ERO structure.

Audit staff believes that providing meals costing two to three times what NERC considers a reasonable meal expense may have the appearance of gifting. Had the BOT members incurred meals costing this much and submitted them as routine expenses, it would have triggered the accounting mechanisms of NERC's expense tracking system, to which BOT members are subject and should presumably have been called into question as reasonable. Therefore, for the BOT members to accept meals at these levels of expense from the very persons whose remuneration is approved by them has an appearance of impropriety and conflict of interest. While audit staff appreciates that these costs comprise only a small portion of NERC's budget, audit staff is concerned that the independence and integrity of the BOT members be carefully preserved.

Recommendations

We recommend that NERC:

25. Consider returning to the performance-based method of compensating BOT members until NERC gains the necessary experience to support a change to a flat-fee compensation model;

26. Establish a method for tracking BOT time and participation on BOT activities to be able to properly evaluate and quantify the performance of each trustee;
27. Implement the planned BOT tracking software to assist in measuring BOT participation and reducing undue administrative burden;

28. Conduct an analysis of BOT participation and effort based on a time study using actual time spent during BOT activities, or a representative study of the actual time spent and implement a compensation methodology that pays BOT members reasonably for performance of their duties;

29. Estimate and include in its annual budgets an amount of funding to cover BOT expenses that it deems appropriate and seek approval for such funding;

30. Track the expenses actually incurred on the BOT to the budgeted amounts for such expenses; and

31. Develop appropriate policies for the giving of gifts, funded from NERC's own resources or paid by any NERC officer or employee to a Trustee.

8. Retirement Plans

NERC contributed 10 percent of the salary for each employee participating in the retirement plan, which is above energy sector norm. This 10 percent contribution was in addition to an up to 4.5 percent matching contribution for employees participating in NERC's 401(k) plan. Also, NERC included bonuses as well as base salary in its determination of its retirement contribution obligations for employees. In addition, NERC paid excess amounts above the allowable IRS limit for retirement contributions to certain employees as additional compensation when it should have maintained these amounts in a tax-deferred account.

Pertinent Guidance

The Federal Power Act (FPA), as amended by the Energy Policy Act of 2005, added section 215 on Electric Reliability. Section 215(c)(2) states the Commission may certify an entity as an ERO if, among other things, the Commission determines that the ERO " ... has established rules that allocate equitably reasonable dues, fees, and other charges among end users for all activities under this section."

18 C.F.R. § 39.4 sets out the requirements for funding an ERO. Specifically, section 39.4(b) states, in part:

> The Electric Reliability Organization shall file with the Commission its proposed entire annual budget… explaining the proposed collection of all dues, fees and charges and the proposed expenditure of funds collected in sufficient detail to justify the requested funding collection and budget expenditures.

Background

Audit staff is concerned with certain aspects of NERC's defined contribution retirement plan. NERC has a defined contribution retirement plan in place for all employees, which in various NERC materials is termed as a profit-sharing plan, under which NERC contributes a guaranteed 10 percent of salary plus bonus for each employee. In addition, NERC has a program to match voluntary employee contributions to its 401(k) plan according to a set formula, not to exceed a capped percentage of 4.5 percent of combined salary and bonuses.

A guaranteed contribution of 10 percent of salary plus bonus is significantly higher than usually encountered in the energy sector. An indication of this is found in a benefits study of 56 companies in the energy sector commissioned by NERC and released in early 2011. The study shows that only 18 percent of the sample companies offer a profit-sharing plan, and of these, only 17 percent have a percentage greater than 7 percent. This places NERC in the top 3 percent of energy sector companies. This study also categorizes the NERC retirement plan as "very generous." It shows that the 10 percent rate upon which NERC guarantees retirement fund contributions is twice the average level of the entities included in the study. Moreover, the study indicates that the inclusion of bonuses in addition to base salary is also contrary to prevailing industry practices (only 28 percent of capital accumulation plans allow for bonuses to be included in the compensation on which employer contributions are based). Since bonuses are received at some level by most NERC employees, and are received at significant levels by officers and senior managers, inclusion of bonuses has a significant impact upon NERC's obligation to budget and pay for such contributions. While the study does indicate that in other areas of benefits NERC is below average, in this category NERC is significantly higher than the other entities surveyed.

In interviews, NERC senior management defended the practice, explaining that the 10 percent guaranteed contribution is NERC's alternative to a profit-sharing element. NERC cannot offer profit-sharing elements, such as stock options, as NERC is a non-profit entity and does not have profits to share with its employees or anyone else. NERC has fully budgeted for its retirement plan contribution obligations as a cost included in its annual budget that is funded by end-users. NERC senior management justified the additional compensation from a "total compensation" perspective, stating that it was a necessary element to stay competitive in the marketplace for skilled professionals. However, former employees interviewed by audit staff did not state inadequate compensation as a primary factor for their departure.

In discussions with audit staff regarding this compensation element, the NERC CEO agreed that guaranteeing a 10 percent contribution lacked the appearance of the performance-based compensation of more traditional profit sharing programs that NERC is attempting to emulate. The CEO also indicated that NERC would consider a different approach going forward, such as guaranteeing a smaller percentage and subjecting the remainder to annual review and approval by the BOT. This approach is in line with the benefits study that NERC commissioned, which recommends the guaranteed retirement contribution component be lowered from 10 percent to 5 percent so that this amount, when coupled with the 4.5 percent matching 401(k) contribution, would equal up to "9.5 percent of pay, which is more in line with typical market practices."[35] Audit staff noted that any changes in compensation, including changes to the guaranteed portion of the contribution, would not appear to violate any contractual entitlements to current employees, as all NERC officers and staff serve on the basis of "at will" arrangements.

[35] The term "pay" used in the study is ambiguous in this context. The study report does not address whether bonuses should or should not be included when making retirement contributions. The study itself indicates that a majority of capital accumulation plans do not count bonuses as compensation for determining contributions.

Audit staff discovered that NERC's retirement contributions at this level for certain officers and senior management exceeded the Internal Revenue Service (IRS) maximum allowable contribution, which was $49,000 for 2009 through 2011. When scheduled payments exceed the IRS cap, the current practice is for NERC to pay the difference as a direct payment to the employee in the form of supplemental income. This practice defeats the purpose of tax-deferred benefits of retirement contributions, and is in effect additional compensation and not a retirement benefit.

Audit staff believes that the current guaranteed 10 percent retirement fund contribution plus the 4.5 percent matching contribution, with both contributions based upon salary and bonuses is very generous and does not reflect current market conditions. First, audit staff believes retirement contributions should only be based upon compensation to which an employee is entitled. The NERC CEO and the senior management stated during interviews that bonuses are not an entitlement for any employee or officer of NERC, thus exclusion of bonuses from the calculation of retirement contributions is appropriate and reasonable. Second, audit staff believes that NERC's guaranteed retirement obligation of 10 percent is not in line with current industry market conditions.

Recommendations:

We recommend that NERC:

32. Determine its retirement obligations using relevant comparability and other data that reflects current market conditions;

33. Work with the BOT to craft total remuneration policy based on principles of total compensation, electric power industry practices, and other relevant factors. This policy should include procedures to justify that all retirement plan contribution levels are appropriate and reasonable; and

34. Develop an alternative mechanism for addressing retirement contributions in excess of the IRS cap that maintains the payment as a retirement benefit and not as additional compensation to the employee.

9. NERC Critical Infrastructure Protection Program

NERC inadequately staffed for the needs of its critical infrastructure protection (CIP) program. NERC's senior management focused on a limited scope of activities that did not adequately address the CMEP needs of the ERO in the CIP program. This lack of attention to compliance-related activities led to insufficient staffing for this section 215 responsibility.

Pertinent Guidance

The Rules of Procedure (ROP) of the North American Electric Reliability Corporation state the following:

> 402.1. NERC Monitoring Program – NERC shall have a program to monitor the compliance enforcement program of each regional entity that has been delegated authority. The objective of this monitoring program shall be to ensure that the regional entity carries out its compliance enforcement program in accordance with these rules and the terms of the delegation agreement, and to ensure consistency and fairness of the regional entity's compliance enforcement program. Oversight and monitoring by NERC shall be accomplished through an annual compliance enforcement program review, program audits, and regular evaluations of regional entity compliance enforcement program performance.

Background

As a program element under section 215, CIP has undergone significant changes since NERC was certified as the ERO. At the time NERC filed its 2007 Business Plan and Budget, the CIP program focused primarily on NERC's role as the US Department of Energy (DOE)-approved Information Sharing and Analysis Center for the electric sector (ES-ISAC). In its business plan and budget filing for 2007, NERC treated its role as the ES-ISAC as a situational awareness element under section 215, one of its purposes being to identify the need for mandatory standards to be developed in the CIP area.[36] The CIP standards were approved by the Commission in January 2008[37] and the first CIP standards became auditably compliant for high-priority "Table 1" entities (i.e., Reliability

[36] North American Electric Reliability Corporation, Request, Docket No. RR06-03-000, (filed Aug. 23, 2006) (submitting the 2007 business plans and budgets of NERC and Regional Entities for acceptance and Proposed Assessments to Fund Budgets for approval.

[37] *Mandatory Reliability Standards for Critical Infrastructure Protection*, Order No. 706, 122 FERC ¶ 61,040 (2008).

Coordinators, Balancing Authorities, and Transmission Operators) in July 2010. By late 2011, as the audit commenced, the ERO was tasked with ensuring compliance with the full slate of currently approved CIP standards for an expanded list of registered entities. The roll-out of these new Reliability Standards resulted in a significant increase in reported possible violations, both in self-reports by registered entities but also more importantly in the initial audits conducted by Regional Entity staff. Audit staff believes as NERC's responsibilities grew in this area, it failed to adequately budget and allocate resources to CIP. NERC should have established strong oversight of compliance with these emerging standards, ensuring consistency and commitment to establishment of a high-level of security for the BPS. Instead, NERC focused its attention and limited budgeted resources on what it perceived were higher-priority demands in other program areas (e.g., dealing with Commission directives in the operating and planning standards) and in expanding the functionality of NERC's ES-ISAC.

Prior to the commencement of the audit, NERC had not committed adequate resources for compliance activities in the CIP program. The organizational chart provided at the start of the audit in September 2011 showed 15 FTEs in the Critical Infrastructure Division (CID), composed of the following:

- A Division Director and his Executive Assistant (Two FTEs)
- Risk Management and Technology [dedicated to ES-ISAC] (Five FTEs)
- Policy and Coordination (Two FTEs)
- Standards, Training, and Awareness:
    - Branch Manager (One FTE)
    - CIP Compliance (Two FTEs)
    - Standards Development (One FTE)
    - Event Analysis (One FTE)
    - Resource Adequacy/Risk Specialist (One FTE)

As indicated by this organizational chart, NERC only had only two CIP staff dedicated to compliance activities. This low level of staffing at NERC for compliance activities did not allow for adequate oversight of the enforcement of CIP standards across the entire BPS. Moreover, NERC's staffing levels did not address the need for contingencies, succession planning, and other continuity of functions to be maintained.

Despite NERC's growing responsibilities in the CIP area, audit staff noted NERC's commitment and staffing levels for its CIP compliance program remained low throughout the audit period. In fact, NERC tasked only the two CIP Compliance FTEs (i.e., two auditors) with providing oversight to all eight Regional Entity CIP audit programs. It was not until the current Commission staff audit commenced that NERC began the preliminary stages of increasing its staffing and resources in this area. In addition to their Regional Entity audit oversight responsibilities, NERC's two auditors were also assigned to support NERC's duties as the Compliance Enforcement Authority

(CEA), which oversees compliance with the CIP Reliability Standards for those Regional Entities registered to perform critical reliability functions (e.g., SPP, WECC, FRCC, and Texas Regional Entity). Furthermore, the two NERC auditors performed the following other duties: oversight of the Regional Entity program to implement Technical Feasibility Exemptions to CIP standards, routine meetings and calls to ensure consistency between regions and answer questions from FERC staff, communications with Commission staff on cyber-related incidents, participation in pilot programs to involve auditors in standards development, attendance at ERO auditor training workshops, and educational efforts at Regional Entity workshops. This was a significant amount of responsibility for two auditors, and given the difficulties encountered in implementing new reliability standards in this important area, audit staff believes the commitment of such a limited number of resources did not allow for a robust CIP compliance program to effectively and efficiently carry out NERC's CIP compliance-related activities.

The first Regional Entity audit of a registered entity for compliance with the CIP standards was conducted in the spring of 2010. However, due to inadequate staffing and commitment in this area, NERC's CIP compliance staff was unable to attend and provide CIP oversight on the audit. NERC thereafter scheduled its two CIP auditors to attend only compliance audits at which Commission auditors were also present, and would never send both auditors to any one audit. This scheduling policy made effective oversight of the Regional Entities' CIP compliance audits by NERC difficult, as Regional Entity CIP teams often split into multiple groups in order to conduct their compliance audits efficiently. Further, being limited to only two auditors prevented NERC from meeting even its limited compliance audit oversight commitments. Illnesses, other commitments, emergency absences, and other situations arose preventing NERC's CIP auditors from attending the oversight audits. The most recent example of this occurred in September 2011 when NERC CIP auditors attended a NERC auditor training workshop rather than perform their oversight obligations.

Audit staff noted in NERC's response to data requests that during 2010 and 2011 the NERC CIP auditors attended about half the number of compliance audits that FERC staff observed. Rather than taking the lead on providing oversight of the Regional Entity audits, NERC relied upon FERC's efforts to fulfill its oversight role.[38] Audit staff believes that during the audit period NERC's commitment to CIP auditing activities was weak primarily due to inadequate staffing levels and increased attention to other areas (e.g., ES-ISAC). As evidenced by interviews conducted by audit staff, significant attention, resources, and funding were devoted to expanding the NERC ES-ISAC capabilities under the tenure of the recently departed Director of NERC's Critical

[38] Audit staff notes that the compliance audits of non-CIP (i.e., Order No. 693) standards had a much better initial track record in the early years, but dipped in 2011. However, audit staff noted a major staffing effort and recommitment to this important compliance area planned for 2012.

Infrastructure Division (CID), while attention to CIP compliance activities at the senior management level was minimal. CID leadership demonstrated limited knowledge of the state of compliance-related activities for CIP program elements at either the NERC or Regional Entity level. Senior management review of the Regional Entity CIP compliance programs was limited to a high-level budget check that lacked any substantive elements that might enable NERC to assist the Regional Entities in achieving improved performance in CIP compliance.

Despite the shortfalls in the NERC CIP program, NERC senior management did not express any concern about the staffing levels for this program area in discussions with audit staff until late in the Commission staff audit process. For example, when audit staff inquired how NERC selected the Regional Entity CIP compliance audits for which to provide oversight, NERC's senior management indicated that NERC had followed FERC's lead. However, NERC's senior management did not demonstrate that NERC had developed its own independent criteria to determine whether the risks in the Regional Entity CIP compliance auditing program were being addressed by the NERC oversight process. Audit staff's review of the NERC CIP compliance program disclosed that NERC had not conducted any analysis to determine whether NERC or the Regional Entities had the appropriate resources to properly execute the CIP compliance program or whether NERC had developed a systematic process, plan, and schedule for conducting Regional Entity compliance audit oversight activities. Further confusion in the direction of NERC's CIP compliance program was revealed during the audit period, when the recently hired Director of NERC's CID left NERC in the midst of the Commission staff audit and significant organizational changes in the CID took place.

Since the Commission staff audit began, NERC has indicated that in 2012 it will make an effort to reallocate resources into critical CIP compliance activities. NERC indicated its plan to hire an additional CIP auditor as well as a compliance manager, but the position descriptions and defined responsibilities for these proposed positions had not been completed and provided to audit staff when fieldwork concluded. Despite these changes, audit staff believes that NERC still does not appear to have conducted a rigorous assessment of the commitment that should be made in the CIP compliance activities. For example, CID management indicated that upwards of 21 CIP compliance audits were being planned for 2012, even if a third auditor were not hired. NERC's draft audit procedure guidelines outline the intensive efforts necessary to plan, prepare, and implement effective NERC oversight for a Regional Entity compliance audit. Audit staff believes that an adequate program of CIP oversight cannot be conducted by a staff of two auditors for that many audits, especially given their other assigned duties. NERC's failure to expand its compliance staff in a timely manner for CIP compliance activities contrasts markedly with efforts made on compliance to the operating and planning standards (i.e., Order No. 693). In this area, audit staff observed a significant growth in staffing for audits and other compliance-related activities.

Recommendations

We recommend that NERC:

35. Conduct an assessment of existing CIP-related staffing levels to ensure that NERC staff work aligns with section 215 activities, and that there are adequate resources to accomplish CIP work; and

36. Devote greater resources to carry out its duties under the CMEP as to the CIP-002 through CIP-009 standards and provide effective oversight of CIP CMEP activities by the Regional Entities.

10. NERC Activities

NERC did not have written criteria to determine whether activities should be funded under the Federal Power Act (FPA) section 215. Audit staff is concerned that NERC's failure to develop written criteria to guide its decisions of what constitutes a statutory activity is directly related to its philosophy that all activities that promote the reliability of the Bulk-Power System (BPS) are statutory. As a result, it was difficult for audit staff to determine the scope and extent of permissible activities that should be funded under section 215 and NERC's method of prioritizing such activities to ensure the appropriate focus of activities undertaken as the ERO.

Pertinent Guidance

The FPA, as amended by the Energy Policy Act of 2005, added section 215 on Electric Reliability. Section 215(a)(2) defines an ERO as the organization certified by the Commission, under section 215(c), for the purpose of establishing and enforcing reliability standards for the bulk-power system, subject to Commission review. In addition, section 215(a)(3) of the FPA defines the term "reliability standard." Under the FPA, the term reliability standard means:

> [A] requirement, approved by the Commission under this section, to provide for reliable operation of the bulk-power system. The term includes requirements for the operation of existing bulk-power system facilities, including cybersecurity protection, and the design of planned additions or modifications to such facilities to the extent necessary to provide for reliable operation of the bulk-power system, but the term does not include any requirement to enlarge such facilities or to construct new transmission capacity or generation capacity.

Further, FPA section 215(g) requires that the ERO conduct periodic assessments of the reliability and adequacy of the bulk-power system in North America.

According to FPA section 215(c)(2)(D), the ERO's rules must "provide for reasonable notice and opportunity for public comment, due process, openness, and balance of interests in developing reliability standards and otherwise exercising its duties."

18 C.F.R. § 39.1 defines the Electric Reliability Organization as follows:

> [T]he organization certified by the Commission under § 39.3 the purpose of which is to establish and enforce Reliability Standards for the Bulk-Power System, subject to Commission review.

Commission Order No. 672 developed the rules for certification of the ERO. In Order No. 672 the Commission stated in part:

> On August 8, 2005, EPAct was enacted as law. New Section 215 of the FPA provides for a system of mandatory enforceable Reliability Standards. Under the new electric power reliability system enacted by the Congress, the United States will no longer rely on voluntary compliance by participants in the electric industry . . . [39]
>
> Section 215 of the FPA generally provides for Commission authorization of funding for statutory functions, such as the development of Reliability Standards and their enforcement, and monitoring the reliability of the Bulk-Power System. The Final Rule clarifies, however, that while the ERO or a Regional Entity is not necessarily precluded from pursuing other activities, it may not use Commission-authorized funding for such activities.[40]

In an order issued July 20, 2006, certifying NERC as the ERO, the Commission stated in part:

> We agree with National Grid that NERC's funding proposal at a very high level seems appropriate, but lacks details. Consistent with Order No. 672, we direct NERC to submit in its compliance filing a list of budget principles for approval. These principles should include budget execution as well as budget formulation matters, including: (1) budget component justification based on statutory or other authorities; (2) how the budgeted activity lends itself to the accomplishment of the statutory or other authorities; (3) methods of calculating budget estimates; (4) who prioritizes competing needs; (5) affordability, sustainability, and efficiency and effectiveness of expenditures; (6) implementation to meet

[39] *Rules Concerning Certification of the Electric Reliability Organization; and Procedures for the Establishment, Approval, and Enforcement of Electric Reliability Standards*, Order No. 672, 114 FERC ¶ 61,104 at P 20 (2006), *order on reh'g*, Order No. 672-A, 114 FERC ¶ 61,328 (2006), *modified*, 123 FERC ¶ 61,046 (2007).

[40] *Id.* P 34.

> international standards; (7) transparency; and (8) accountability and execution in accordance with operating plan, performance measures, and shifting priorities. Moreover, we expect NERC to submit its first detailed budget in the coming months that should answer many of these questions.[41]

In an order issued October 24, 2006, conditionally approving the NERC business plan and budget for 2007, but leaving open the definitive determination that all activities were statutory, the Commission stated in part:

> We find that NERC's proposed activities reasonably fall within the types of activities the Commission considers to be covered by FPA Section 215, i.e., the development and enforcement of reliability standards, and are entitled to receive funding under Section 215 of the FPA. As explained in the *ERO Certification Order*, anything required of the ERO or a Regional Entity by the statute, Order No. 672 pursuant to the statute, or any subsequent Commission order pursuant to Section 215 of the FPA is a statutory activity. NERC, in its budget filing and subsequent response, has provided an explanation for each of its program areas that relates to a function for which the ERO is responsible pursuant to section 215 of the FPA, Order No. 672 or the *ERO Certification Order*. Accordingly, we find acceptable NERC's designation of specific program activities as "statutory[.]"[42]

> In the same order, the Commission stated in part:

> In the *ERO Certification Order*, the Commission directed NERC to submit a list of budget principles in its compliance filing for Commission approval. These principles should include among other things, how the budgeted activity lends itself to the accomplishment of the statutory or other authorities. We believe that the 2007 NERC business plan and budget provide sufficient information for the Commission to determine that the proposed designated activities are statutory because they are within the scope of the reliability functions required of the ERO and the Regional Entities under section 215. However, we acknowledge commenters' concerns that NERC should provide greater detail and justification for the criteria it uses to designate statutory activities.

[41] *North American Electric Reliability Corporation*, 116 FERC ¶ 61,062 at P 202 (2006).

[42] *North American Electric Reliability Corporation*, 117 FERC ¶ 61,091 at P 28 (2006) (*citing North American Electric Reliability Corporation*, 116 FERC ¶ 61,062 at P 185 (2006)).

> Accordingly, we require that, when NERC files its 2008 budget and business plan, it identify the general statutory activity, and which sub-activities, are covered by the 2008 budget and business plan.[43]

NERC's compliance filing in response to the Commission's conditional approval of the business plan and budget for 2007 stated in part:

> NERC will insert a new Section 1103.3 to its Rules of Procedure, as follows:
>
> The NERC annual budget submittal to governmental authorities shall provide for the following principles: (1) budget component justification based on statutory or other authorities; (2) how the budgeted activity lends itself to the accomplishment of the statutory or other authorities; (3) methods of calculating budget estimates; (4) who prioritizes competing needs; (5) how the budget meets the objectives of affordability, sustainability, and efficiency and effectiveness of expenditures; (6) implementation to meet international standards; (7) transparency; and (8) accountability and execution in accordance with operating plan, performance measures, and shifting priorities.[44]

NERC's business plan and budget for 2008 stated in part:

> The principal activities of the ERO as specified in Section 215 of the FPA and in the Commission's regulations promulgated thereunder are development of reliability standards for the bulk power system (§ 215(d) of the FPA; 18 C.F.R. § 39.5); enforcement of compliance with reliability standards, including imposition of penalties and sanctions for violations (§ 215(e) of the FPA; 18 C.F.R. § 39.7); and conducting periodic assessments of the reliability and adequacy of the bulk power system in North America (§ 215(g) of the FPA; 18 C.F.R. § 39.11). In addition, the ERO may delegate functions to regional entities pursuant to delegation agreements approved by the Commission (§ 215(c)(4) of the FPA; 18 C.F.R. § 39.8).
>
> NERC has organized and presented its business plan and budget based on six specific program areas. Each of these program areas carries out or supports implementation of one or more of the statutory activities.

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[43] *Id.* P 30.

[44] North American Electric Reliability Council and the North American Electric Reliability Corporation, Filing, Docket No. RR06-1-003, at 5 (filed Oct. 18, 2006) (addressing non-governance issues).

> Specifically: (1) the Reliability Standards Program implements the statutory activity of development of reliability standards. (2) The Compliance Enforcement and Organization Registration and Certification Program implements the statutory activity of enforcement of compliance with reliability standards, including imposition of penalties and sanctions for violations of standards. (3) The Reliability Readiness Evaluation and Improvements Program supports the statutory activity of enforcing and achieving compliance with reliability standards and the statutory activity of conducting assessments of the reliability of the bulk power system. This program also provides information and feedback that supports the statutory activity of development of reliability standards. (4) The Training, Education and Operator Certification Program supports the statutory activity of enforcing and achieving compliance with reliability standards, and also provides information and feedback that supports the statutory activity of development of reliability standards. (5) The Reliability Assessment and Performance Analysis Program implements the statutory activity of conducting periodic assessments of the reliability and adequacy of the bulk power system in North America. This program also provides information and feedback that supports the statutory activities of development of reliability standards and achieving compliance with reliability standards. (6) The Situation Awareness and Infrastructure Security Program supports the statutory activity of enforcing and achieving compliance with reliability standards, and also provides information and feedback that supports the statutory activities of development of reliability standards and conducting assessments of the reliability and adequacy of the bulk power system.[45]

In an order issued July 16, 2009 accepting in part a NERC compliance filing on the 2009 NERC business plan and budget, the Commission stated:

> The Commission accepts the ERO's proposal to terminate funding of the Reliability Readiness Program. As described above, documents provided in response to the Commission's data request indicate that the ERO engaged in a thorough vetting, both internally and with stakeholders, on the decision to eliminate the Reliability Readiness Program. The ERO's documentation provides in detail how, over time, the Reliability Readiness Program had become redundant of other ERO and Regional Entity activities. Further, the ERO's response to the data request

[45] North American Electric Reliability Corporation, Request, Docket No. RR07-16-000, at 45-46 (filed Aug. 24, 2007) (submitting its 2008 business plan and budget for acceptance).

indicates that the ERO considered alternative solutions before concluding that the best option was to eliminate funding for the program.[46]

18 C.F.R. § 39.4 sets out the requirements for funding an ERO. Specifically, section 39.4(b) addresses ERO annual budget requirements.[47]

Background

Audit staff interviewed NERC senior management, staff, and various Board of Trustee (BOT) members to understand the criteria NERC used to determine whether its activities should be funded under FPA section 215. Audit staff believes such criteria are necessary because section 215 allows funding for: (1) development of mandatory standards; (2) enforcement of those standards; and (3) monitoring the BPS.[48] Through these discussions, audit staff discovered that NERC has not developed any policies, procedures, processes, or practices (i.e., criteria) to guide its staff on the types of activities permissible under section 215. These discussions also revealed that NERC adopted a philosophy that the development of criteria was unnecessary because all NERC activities promote reliability, and therefore should be funded under section 215. Audit staff notes that the Regional Entities have undertaken efforts to determine activities performed that are non-statutory in nature and have transparently reflected these activities in their budget submissions to the Commission. Audit staff is concerned that the scope of some activities NERC undertook was not specifically required by the Commission in Order No. 672 or any subsequent order. Also, audit staff questions whether some of these activities exceeded the functions of the ERO explicitly defined in section 215.

Before becoming the ERO, NERC engaged in numerous reliability activities and developed solutions to address reliability matters impacting the Bulk-Power System (BPS). These solutions were voluntary, as NERC did not have authority to require entities to adopt the solutions. When NERC became the ERO, its primary responsibilities under section 215 became: (1) reliability standards development and refinement; (2) Compliance Monitoring and Enforcement (CMEP); and (3) monitoring the reliability and adequacy of the BPS. In its application to be certified as the ERO, NERC tied its six

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[46] *North American Electric Reliability Corporation*, 128 FERC ¶ 61,025 at P 28.

[47] *See supra* text accompanying note 9.

[48] In the Commission order certifying NERC as the ERO, the Commission interpreted the monitoring activities to include the periodic BPS reliability assessment activities that were ongoing at NERC prior to being approved as the ERO. While these activities were approved during NERC's transition as the ERO, NERC has continued to be responsible for such existing assessments and has assumed even greater assessment responsibilities in other areas. The degree to which such assessment and monitoring activities currently ongoing should be deemed statutory is therefore also an element that audit staff believes should be revisited.

historic functional areas to its new primary responsibilities as the ERO under section 215. The application categorized NERC's ongoing programs as follows:

- Standards Development and Maintenance;
- Compliance Registration, Certification, and Enforcement;
- Reliability Assessment and Performance Analysis;
- Reliability Readiness Audits;
- Situation Awareness and Infrastructure Protection; and
- Training and Education.

When the Commission reviewed NERC's application to become the ERO, and certified NERC as the ERO, it approved the ongoing programs but stated that "the funding proposal at a high level seems appropriate but lacks details" and directed NERC to "submit in its compliance filing a list of budget principles . . . including: (1) budget component justification based on statutory or other authorities; (2) how the budgeted activity lends itself to the accomplishment of the statutory or other authorities . . . "[49] NERC's compliance filing stated that each budget filing would provide for each principle.[50] When reviewing the 2007 business plan and budget, the Commission stated that, "The 2007 budget provides sufficient information for the Commission to determine that the proposed designated activities are statutory," but in order to "provide greater detail and justification for the criteria [NERC] uses to designate statutory activities," the Commission required NERC to "identify the general statutory activity, and which sub-activities, are covered by the budget and business plan in the 2008 business plan and budget filing."[51] NERC vaguely addressed this requirement by stating that each of its program areas "carries out or supports implementation of one or more of the statutory activities."[52] Although many of the ongoing activities NERC performed were consistent with this Commission determination that additional details were required in order to clarify there status as statutory activities, audit staff has concerns that the manner in which NERC addressed the Commission's requirement for greater detail was insufficient to allow NERC itself, or the Commission audit staff, to verify that specific NERC programs and activities should be funded as section 215.

The Commission order certifying NERC as the ERO outlined the process NERC would follow to pursue reliability-related activities other than those specified in section 215. The Commission also recognized that the ERO is not precluded from pursuing these

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[49] *See supra* note 41.

[50] *See supra* note 44.

[51] *North American Electric Reliability Corporation*, 117 FERC ¶ 61,091 at P 30 (2006).

[52] *See supra* note 45.

activities as long as the funding comes from non-section 215 sources,[53] and as long as the non-statutory activities are included in its business plan and budget. If NERC had followed this process, it would "provide the Commission with necessary information about any non-statutory activities, the source of their funding, and whether the pursuit of such activities presents a conflict of interest for the ERO."[54] However, to date, NERC has not used the Commission's process for seeking approval of non-statutory activities.

Since becoming the ERO, NERC has embarked on new or expanded programs it believes maintain and improve the reliability and security of the BPS. Audit staff questions whether some of these programs fall outside the explicit scope of the ERO under section 215, which is the development and enforcement of mandatory reliability standards and monitoring of the BPS[55], but are more consistent with how NERC historically pursued its mission prior to its certification as ERO (i.e., the pursuit of reliability and security through voluntary programs). Audit staff understands that NERC has the authority to perform any activities that do not conflict with its role as the ERO; however, it must designate them as non-statutory and fund them separately and apart from the permitted section 215 activities. Several of the Regional Entities have adopted this approach and continue to pursue their historic missions as well as undertaking their responsibilities and duties under section 215.

NERC, however, did not establish written criteria to determine whether its activities are statutory and instead deemed all activities as statutory. As previously mentioned, audit staff found the NERC justifications to be unsuitable to serve as a set of criteria by which to determine the appropriateness of funding under section 215. Nevertheless, under this broad interpretation, NERC used its resources on new or expanded projects without the need to determine whether the activity was statutory. Given the lack of transparency, the budget process provided the Commission, the BOT and stakeholders only limited opportunity to question the statutory nature of projects NERC engages in or plans to commence. However, NERC embarked on projects not previously vetted through the budget process, providing the Commission, BOT, and stakeholders no such opportunity.

Audit staff sampled NERC's current activities and requested NERC to provide evidence that it had developed documentation to demonstrate that the activity was within the scope of activities that would permit funding under section 215. After reviewing this material audit staff did not find a clear linkage to section 215 activities in the materials examined. While there were certainly elements related to grid reliability and security, NERC had not developed project specifications that laid out the statutory goals to be

[53] Order No. 672, 114 FERC ¶ 61,104 at P 202.

[54] *Id.* P 198.

[55] The Commission issued Order No. 672 specifically to amend its regulations to incorporate this mandatory regime.

accomplished by the project with sufficient clarity. Therefore NERC had no clear written criteria adequate to satisfy the concerns of the audit staff. This was of particular concern for projects that were undertaken within a budget cycle and had not therefore been subject to review as part of the budget approval process for statutory applicability prior to being undertaken by NERC.

While each of the sampled programs promoted reliability and has reliability or security aspects (to a greater or lesser extent), audit staff believes that these alone are not appropriate criteria upon which to assess their statutory nature. NERC needs to establish and operate under formal criteria that ensure all of its program activities that are funded pursuant to FPA section 215 are statutory. This is of particular concern to audit staff when NERC embarks on new projects within an operating year that were not budgeted and approved through the budget process, NERC needs clear guidance to ensure that the funds expended are for statutory purposes.

Recommendations

We recommend that NERC:

37. Establish written criteria for determining whether a reliability activity should be funded under section 215 through coordination and discussion with Commission staff and stakeholders. Submit to audit staff the criteria established from this collaborative process; and

38. Identify all ERO activities funded under section 215, detailing at a minimum: the purpose of the activity, a description, and the justification for using section 215 funding. Submit all documentation to audit staff for these reliability activities.

11. NERC as the Electric Sector - Information Sharing and Analysis Center

NERC's dual role as the Electric Sector-Information Sharing and Analysis Center (ES-ISAC) and as the ERO raises significant challenges. NERC has continued functioning in both roles, resulting in internal confusion and confusion among the Commission and stakeholders.

Pertinent Guidance

The Commission's Order No. 672 states, in part:

> Section 215 of the FPA generally provides for Commission authorization of funding for statutory functions, such as the development of Reliability Standards and their enforcement, and monitoring the reliability of the Bulk-Power System. The Final Rule clarifies, however, that while the ERO or a Regional Entity is not necessarily precluded from pursuing other activities, it may not use Commission-authorized funding for such activities.[56]

Commission Order No. 672 Certifying NERC as the ERO states, in part:

> The Commission finds that NERC has met the requirements of Order No. 672 and we hereby certify NERC as the ERO for the United States.[57]

NERC Rules of Procedure include a section on the Electric Sector Information Sharing and Analysis Center (Section 1003.1). Subsection 1003.1.1 states:

> NERC shall serve as the electricity sector's sector coordinator and operate its Information Sharing and Analysis Center to gather information and communicate security-related threats and incidents within the sector, with United States and Canadian government agencies, and with other Critical Infrastructure sectors.[58]

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[56] Order No. 672, 114 FERC ¶ 61,104 at P 34.

[57] *North American Electric Reliability Corporation*, 116 FERC ¶ 61,062 at P 3 (2006).

[58] North American Electric Reliability Council and North American Electric Reliability Corporation, Application, Docket No. RR06-1-000, (filed Apr. 4, 2006). (requesting certification as the Electric Reliability Organization).

Background

Data gathering related to security threats is a relatively recent development. Its genesis can be traced to Presidential Decision Directive 63 (PDD63), issued by President Clinton in 1998. It also proposed the creation of Information Sharing and Analysis Centers (ISACs). Each critical infrastructure industry has established an ISAC to communicate with its members, its government partners, and other ISACs about threat indications, vulnerabilities, and protective strategies. ISACs work together to better understand cross-industry dependencies and to account for them in emergency response planning. The ES-ISAC shares critical information with industry participants regarding infrastructure protection. The Department of Energy (DOE) designated NERC as the entity responsible for the ES-ISAC.

The role and responsibility of the ES-ISAC has been further refined and developed by subsequent legislation, which gave the Department of Homeland Security (DHS) the lead responsibility for the protection of critical facilities, and the Homeland Security Presidential Directive (HSPD-7). Under the DHS structure, the DOE is the sector specific agency with responsibility for the energy sector, and NERC continues its important role as the ES-ISAC.

Under the ISAC program, NERC, as the ES-ISAC, receives physical security, cyber security, and operational security event and incident reporting from the electricity sector and Bulk-Power System entities. This reporting requirement is reflected in the current CIP standards under CIP-008 security incident reporting. Requirement 1.3. reads: "The Responsible Entity must ensure that all reportable Cyber Security Incidents are reported to the ES-ISAC either directly or through an intermediary." The required reports are filed DOE OE-417 reports, and are subject to the applicable rules and regulations of the DOE reporting system.

In addition to these required reporting forms, NERC has indicated a desire to encourage additional voluntary reporting of incidents that do not rise to the level that would require mandatory reporting. NERC recognizes that there are lower-level threats and incidents that routinely occur that are not currently required to be captured by the ISAC regime. Formal reporting of such threats or incidents through the ISAC portals is encouraged either by means of a NERC voluntary form or by filing a report free-form or by use of the entity's own reporting form. Recently, NERC has conducted an extensive redesign of the ISAC portals to focus on its ability to receive registered entities' willingness to provide a greater response rate for reporting the lower-level information.

Audit staff acknowledges that ES-ISAC activities have significantly expanded and undergone a change in focus since NERC became the ERO, and thus understands that the interaction between NERC as the ERO and NERC as the ES-ISAC had not been fully evaluated. However, audit staff believes NERC's operation as the ES-ISAC may need to undergo additional significant changes to improve its effectiveness. Audit staff noted that, until very late in the Commission's staff audit of NERC, the NERC employees performing ES-ISAC duties were not clearly designated as such in NERC's organization charts and other publicly available materials. The CID structural organization did not make such a distinction clear, but instead used position titles and descriptions that implied involvement in compliance-related activities. In addition, staff members from other NERC divisions, including Compliance and Enforcement, played a role in ES-ISAC operations. This confusion resulted from the emerging role of NERC as the ES-ISAC.

Audit staff noted that at the conclusion of its audit fieldwork, NERC proposed a significant organizational change to its CID to its BOT. This proposal was reflected in a policy statement presented to, and approved by, NERC's BOT at its February 2012 meeting. The proposal would define the operation of the ES-ISAC as a "non-compliance obligated function" to, in effect, "wall off" certain staff within its CID from compliance-related activities. In interviews, NERC staff stated the primary motivation for the change was to increase industry participants' use of ES-ISAC and encourage information sharing. NERC believed industry's use of the site would increase if ES-ISAC staff were perceived and accepted by industry participants as "non-compliance obligated." In particular, NERC believed the industry would more readily report to the ES-ISAC site non-mandatory high-frequency/low-risk incidents. While NERC said it might at some unspecified date in the future be able to use these incident reports to identify activity patterns that pose security threats to the electric grid, this provided a very weak linkage to the standards development function of the ERO.

Audit staff has several concerns about NERC's proposal. First, NERC stated it intended to allocate all ES-ISAC tasks to a CID subdivision; however, it was unclear to audit staff how the expertise of the ES-ISAC subdivision would be used to support CIP compliance-related activities, if at all. Audit staff noted that NERC's proposal might restrict four highly trained staff members from providing their expertise to any compliance-related activities. Replacing staff with this expertise level would be both costly and time consuming, and it is unclear how their loss would affect NERC's ability to fulfill its statutory compliance responsibilities. Audit staff believes that NERC needs to determine if sharing the ES-ISAC staff's expertise, while preserving an actual and perceptual separation from compliance activities, can be resolved effectively and efficiently.

Additionally, audit staff noted that the Commission's approval of NERC's ES-ISAC role for funding under section 215 was, at least in part, based on NERC's 2007 Business Plan and Budget. In that budget filing, NERC stated the ES-ISAC was a statutory, compliance-related program to the extent that "performance of the function included in this program will assist NERC in identifying areas for which new or revised reliability standards may be required."[59] NERC's proposal sought to maintain a link between the ES-ISAC and compliance-related activities by flowing "sanitized trends" in security-related matters to assist in the development of reliability standards. This process would involve removing all identifiable information from collected data in order to maintain anonymity prior to conducting trend analysis. Audit staff believes this could present issues regarding the Commission's oversight responsibilities for NERC's performance in this process.

NERC staff takes no position on whether the ES-ISAC is statutory or non-statutory in nature. Audit staff's concerns is that NERC's proposal must adequately address, at a minimum, the Commission's mandate to oversee all programs funded under section 215, and sufficiently show how the ES-ISAC continues to fall within the rubric of NERC's statutory activities and the Commission's oversight responsibilities. Audit staff believes that such a determination might be able to be reached by means of implementing its recommendations through the budget review process or my some other means that NERC may elect to include in its implementation plan. While not being in any manner prescriptive in its recommendations, audit staff believes that the satisfaction of these concerns is important to NERC's effective and efficient performance of its budgeted activities as the ERO.

Recommendations

We recommend that NERC:

39. Work with Commission staff to define NERC's role as the ES-ISAC, to evaluate NERC's role as the ES-ISAC in connection with NERC's other roles as the ERO, and to clearly lay out the Commission's role in overseeing the ES-ISAC;

40. Evaluate the impact on compliance-related activities of "walling off" certain staff from these activities, and modify NERC's current proposal for redefining the operation of the ES-ISAC to include clear guidance on how the "walled-off" sub-division will interact with the ERO;

41. Clarify the flow of information between the ES-ISAC and the FERC staff for situational awareness and compliance purposes; and

42. Determine whether the funding of the ES-ISAC, in whole or in part, should be treated as non-statutory and, if so, how to manage such funding.

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[59] North American Electric Reliability Corporation, Request, Docket No. RR06-3-000, Attachment 2 at 25 (filed Aug. 23, 2006)(submitting the 2007 business plans and budgets of NERC and Regional Entities for acceptance and Proposed Assessments to Fund Budgets for approval).

Appendix A

NERC’s Response to the Draft Audit Report

Appendix B

Audit Staff Comments to
NERC Response to Draft Audit Report

NORTH AMERICAN ELECTRIC RELIABILITY CORPORATION'S

RESPONSE TO

DRAFT AUDIT REPORT DATED MARCH 23, 2012

Docket No. FA11-21-000

APRIL 23, 2012

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NORTH AMERICAN ELECTRIC RELIABILITY CORPORATION'S RESPONSE TO DRAFT AUDIT REPORT Docket No. FA11-21-000

The North American Electric Reliability Corp. ("NERC) hereby submits this response to the draft Audit Report ("Draft Report") issued by the Division of Audits ("DA" or "Audit Staff"), Office of Enforcement, on March 23, 2012. In addition, attached are (i) a blackline of the Draft Report suggesting changes to it, and (ii) a modified list of recommendations to which NERC can agree.

I. Introduction

The Commission and NERC share complementary, and critically important, roles in maintaining the reliability of the Bulk Power System in the United States. The Commission and NERC have worked cooperatively and productively in these roles over the past several years to address many difficult challenges, including streamlining and strengthening the enforcement of reliability standards, strengthening a broad range of important reliability standards, and enhancing the Nation's ability to prevent a cyber attack. NERC appreciates the Commission's leadership in these areas and its support for NERC as the Electric Reliability Organization ("ERO"). *N. Am. Elec. Reliability Corp.*, 132 FERC ¶ 61,217 at P 55-56, 126, 160, 191 (2010) (finding, based on the Commission's review of NERC's Three-Year ERO Performance Assessment Report, that NERC's implementation of its statutory responsibilities as ERO had been successful, including its budgets and operations).

NERC is committed to continually improving its operations and performance as the ERO. In that regard, the Board of Trustees and NERC's senior management take very seriously the criticisms set forth in the Draft Report. Although we do not agree with many of the criticisms—particularly because they fail to provide an accurate description of NERC's processes and controls—the Board nonetheless shares the Commission's objective, and many of the Draft Report's recommendations, that NERC continually improve its operations, including financial and accounting controls, to ensure a high level of performance.

In this regard, the Board wishes to emphasize that in early 2011 under the leadership of the Finance and Audit Committee of the Board of Trustees, NERC's management initiated steps to develop an enhanced risk management and internal control framework. In August 2011, the Board of Trustees approved the formation of a Risk Management and Internal Controls Subcommittee (RMICS) comprised of all of the members of the Finance and Audit Committee, the chair of the Compliance and Certification Committee and the president of the Regional Entity Management Group. A recommended form of RMICS charter will be presented by the NERC Finance and Audit Committee to the NERC Board of Trustees for approval at its May 2012 meeting. The RMICS has also developed a work plan for 2012 which will be posted as part of the May 2012 Finance and Audit Committee agenda materials.

Consistent with this commitment to continual improvement in processes and controls, NERC can agree to support 34 out of 42 of Audit Staff's recommendations, with modifications, including recommendations addressing the following matters:

- Continue to make improvements in the transparency that inform the Commission, the Board of Trustees and stakeholders concerning the expenditure of funds approved for specific budgeted statutory activities on unbudgeted activities;

- Continue to increase the granularity of the NERC budget filings by breaking out budgeted expenses into more detailed cost categories;
- Increase the level of NERC review of proposed Regional Entity business plans and budgets, integrating both qualitative and quantitative analyses;
- Establish policies and procedures for using information gained and lessons learned from NERC's oversight of Regional Entity operations in the review process for Regional Entity business plans and budgets;
- Complete the implementation of the time reporting system with the functionality to track employees' time based on the amount of time spent on functional activities or key specific projects;
- Develop and implement more comprehensive policies and procedures governing employee time reporting and tracking;
- Improve automated controls in its accounting system, such as flags and alerts;
- Establish a comprehensive, single-source accounting manual consisting of comprehensive accounting policies, procedures, controls, guidance, and other materials to ensure costs are properly classified, reviewed, approved, and presented accurately in NERC's accounting system, financial statements, and budget filings;
- Continue to conduct on a routine and periodic basis a thorough review of its entire organization to determine the particular skills and competencies that are required to perform the necessary tasks of each organizational position;
- Continue to perform routine and periodic updates to employee compensation studies, using comparability data that target the required skill sets and competencies needed to carry out NERC's mission as the ERO;
- Enhance formal policies, procedures, and guidance governing expenses incurred including developing well-documented reasonableness standards for employee and trustee meal, hotel and other travel expenses, including guidance on what constitutes a reasonable cost;
- Devise formalized recruitment and hiring policies, procedures, and strategies that address, among other things, controls over the total compensation packages, salary, retention bonuses, and benefits;
- Continue to conduct periodic updates and review of the Board compensation model and compensation levels;
- Track expenses actually incurred for Board activities to the budgeted amounts for such expenses;
- Conduct an assessment of CIP-related staffing levels to ensure that there are adequate resources to accomplish CIP work;
- Establish written criteria for determining whether an activity is a statutory activity and should be funded under Section 215;
- Provide additional information in NERC's 2013 Business Plan and Budget regarding NERC's role as the ES-ISAC and provide opportunities for stakeholder input regarding NERC's role as the ES-ISAC during the 2013 business plan and budget process.

The Board of Trustees is hopeful that its ongoing commitment to continual improvement in operations and procedures, coupled with its support of these recommendations, can provide the basis for a continuing strong working relationship with the Commission and facilitate a successful resolution of this audit. NERC is also willing to engage a third party consultant to conduct an independent review of NERC's implementation of the agreed-upon audit recommendations regarding budget formulation, administration and execution and submit a report to NERC and to the Commission regarding the results of that review. The timing of this engagement, including the timing of delivery of the consultant's report, will be set forth in NERC's plan for implementing the recommendations.

Consistent with the NERC's ongoing commitment to improving its processes and operations, the Board and NERC's management believes that it is important to respond in detail to the criticisms contained in the Draft Report. Although NERC's operations and processes are not perfect, we do take strong objection to the incomplete, factually incorrect and often harsh criticisms set forth in the Draft Report. We summarize our major concerns with these findings below.

Objectivity and Balance. A central problem with the Draft Report is related to the nature of an "economy and efficiency" audit. Most audits concern *compliance* with Commission regulations or orders. 18 C.F.R. § 41.1(a) (audit report under FPA Part II focuses on "findings that the audited person has not complied with a requirement of the Commission"); *Revised Policy Statement on Enforcement*, 123 FERC ¶ 61,156 at P 14 (2008) ("[t]he Divisions of Audits within the Office of Enforcement helps ensure compliance with the Commission's statutes, regulations, and orders by conducting a wide array of audits of jurisdictional entities."). By focusing on compliance, the Audit Staff ordinarily has *specific criteria*—the Commission's regulations and orders—against which to judge the conduct or practices being audited. Indeed, specific criteria are essential to any government audit. Government Accountability Office ("GAO"), *Government Auditing Standards*, GAO-12-331G (Dec. 2011) ("GAGAS 2011") Section §6.37 (a government audit must "identify . . . the laws, regulations, contracts, grant agreements, standards, specific requirements, measures, expected performance, defined business practices, and benchmarks against which performance is compared or evaluated").

In this case, however, the purpose of the audit was not to measure compliance with Commission rules and regulations (and, indeed, the Draft Report finds no instances of noncompliance), leaving Audit Staff with no objective, Commission-approved criteria by which to critique NERC's processes. It is therefore understandable that numerous differences would emerge over how NERC should be managed. NERC values the insights of the Audit Staff and, as indicated in this response as well as during the course of the audit, is willing to support many of their recommendations. However, it is important to understand that those insights are simply the opinions of the members of the Audit Staff because they had no objective criteria to apply

Two examples should suffice to illustrate this problem. First, the Draft Report criticizes at extraordinary length the employee compensation studies used by NERC, alleging they "did not have adequate support to justify the reasonableness of compensation" and suggesting that "[a]s a result, NERC incurred considerable personnel costs funded by end-users under section 215." Draft Report at 5. To remedy these alleged deficiencies, the Draft Report recommends that the Commission assume an expansive new role in reviewing employee compensation, recruitment and retention policies. Draft Report at 39, 44 (NERC should "conduct a thorough review of its entire organization," "[c]ontract for new compensation studies" and "[s]ubmit the compensation studies with audit staff" for review).

NERC has multiple concerns with these findings—particularly the fact that they second guess the conclusions of the one of the world's leading compensation consultants who completed a comprehensive study under the oversight of the Corporate Governance and Human Resources Committee of the Board—but the more fundamental problem is that the criticisms are simply matters of Audit Staff's *opinion*. There are no Commission standards or requirements against which to judge the reasonableness of NERC's studies. Indeed, the *only* "Pertinent Guidance" identified by Staff is the requirement in section 215(c)(2) (and the Commission's own regulations) that NERC "has established rules that allocate equitably reasonable dues, fees, and other charges among end users for all activities under this section." Draft Report at 39. That section, of course, says nothing about how NERC's employees should be compensated, thereby leaving Audit Staff with no objective, Commission-approved criteria on which to base its assessment.

Second, a similar problem underlies the Draft Report's criticism of the compensation of the Board of Trustees. The Draft Report alleges that "NERC's shift to a flat-fee compensation methodology [for the Board of Trustees] was not adequately supported" (Draft Report at 6) and suggests this may have resulted in the Board of Trustees being overcompensated. Draft Report at 57 ("NERC significantly increased total and per-trustee compensation levels for the BOT despite the inadequacies in the analysis."). Here again, the Board and NERC strongly disagree with this criticism—including the fact that the Draft Report essentially second-guesses independent third party recommendations—but the more fundamental point is that there was no objective basis upon which Audit Staff could rest its findings. Reasonable minds may disagree on which form of compensation is better, but, with all due respect, it is not the role of Audit Staff to be substituting its judgment for that of the Board of Trustees and NERC's senior management.

In this regard, it is worth considering longstanding Commission precedent on comparable issues. The Commission has consistently held that managers of public utilities have "broad discretion" in conducting their business affairs and are entitled to a "presumption of prudence." *New England Power Co.*, 31 FERC ¶ 61,047 at 61,084, *reh'g denied*, 32 FERC ¶ 61,112 (1985), *aff'd sub nom.*, *Violet v. FERC*, 800 F.2d 280 (lst Cir. 1986); *Iroquois Gas Transmission Sys., L.P.*, 87 FERC ¶ 61,295 at 62,168 (1999) (citations omitted), *order clarified*, 88 FERC ¶ 61,236 (1999); *Minnesota Power & Light Co.*, 11 FERC ¶ 61,312 at 61,645 (1980); *see Anaheim Riverside v. FERC*, 669 F.2d 799, 809 (D.C. Cir. 1981) (*citing Southwestern Bell Telephone Co. v. Missouri Pub. Serv. Comm'n.*, 262 U.S. 276, 289 n.1 (1923)) ("a utility's costs are presumed to be prudently incurred").

Similarly, the Commission has declined invitations to second guess the governance or management of ISOs and RTOs:

> If the RTO or ISO board is well-informed about the needs of customers and various stakeholders, it will set criteria for performance, appropriate goals and targets for the organization and its management and institute measures for achieving those targets. *By focusing our* requirements *on having a well-informed board, we decline to intrude further into board prerogatives regarding management compensation.*"

Wholesale Competition in Regions with Organized Electric Markets, Order No. 719, 73 Fed. Reg. 64100 at P 561 (Oct. 28, 2008), FERC Stats. and Regs. ¶ 31,281 (2008), *order on reh'g*, Order No. 719-A, 74 Fed. Reg. 37776 (Jul. 29, 2009), FERC Stats. and Regs. ¶ 31,292 (2009), *order on reh'g*, Order No. 719-B, 129 FERC ¶ 61,252 (2009).

Not only does the Draft Report decline to follow this approach, it displays a disappointing lack of *balance* in making its highly critical findings. Rather than providing a fair and complete characterization of NERC's positions (and the findings and recommendations of independent consultants retained by NERC), the Draft Report provides a relatively one-sided appraisal of the issues and is dismissive of NERC's positions, or the findings and recommendations of independent consultants, in often harsh tones. Perhaps this is the normal course in enforcement matters, but we do not believe it is a fair one and it is particularly problematic given the important reliability challenges that that Commission and NERC must address in a cooperative fashion. NERC therefore respectfully suggests that Commission Staff take a closer look at Audit Staff's findings and consider whether the Draft Report provides the kind of balanced and accurate analysis of the issues that the public should expect of Commission audits. To be constructive, NERC is offering a blackline of the Draft Report that attempts to remedy the most glaring problems with specific edits, but this, of necessity, does not address all our concerns because it is not NERC's role to redraft the work product of Audit Staff. We would therefore urge Commission Staff to take a second look at the Draft Report in light of the response provided herein.

The Scope of Section 215. In contrast to the issues concerning management practices, the one area of the Draft Report that concerns prior Commission orders is the scope of section 215. The Draft Report suggests that NERC has been performing functions outside its scope. Draft Report at 4 (criticizing NERC for "operat[ing] under the assumption that all of its projects, initiatives, and tools were directly related to section 215"); *see also id.* at 75 ("audit staff is concerned" that certain activities were not "specifically required by the Commission" and therefore may have "exceeded the functions of the ERO explicitly defined in section 215"); *id.* at 4 (suggesting that NERC be "compelled to provide a nexus by which any specific activity [is] related to the three explicit functions in section 215").

NERC does not agree with these criticisms for two principal reasons. First, the issue of whether NERC's existing functions fall under section 215 has been adequately addressed in prior Commission's orders. In certifying NERC as the Electric Reliability Organization, the Commission held that "[w]e generally believe that *anything* required of the ERO or a Regional Entity by the statute, Order No. 672 pursuant to the statute, or any subsequent Commission order pursuant to section 215 of the FPA is a statutory activity." *N. Am. Elec. Reliability Corp.*, 116 FERC ¶ 61,062 at P185 (2006) (emphasis added). Subsequently, the Commission reviewed and approved NERC's functions in six budget orders and reviewed NERC's performance of those functions in depth in 2010. *See, e.g.*, *N. Am. Elec. Reliability Corp.*, 117 FERC ¶ 61,091 at P 28 (2006) ("NERC . . . has provided an explanation for each of its program areas that relates to a function for which the ERO is responsible pursuant to section 215 of the FPA . . . [and] [a]ccordingly, we find acceptable NERC's designation of specific program activities as 'statutory' . . ."); *N. Am. Elec. Reliability Corp.*, 132 FERC ¶ 61,217 at P 45 n.33 (2010) ("The Commission has stated that anything required of the ERO or a Regional Entity by the statute, Order No. 672 pursuant to the statute, or any subsequent Commission order pursuant to section 215 of the FPA is a statutory activity for purposes of mandatory funding of ERO and Regional Entity functions." (quotation omitted)). The Draft Report offers no basis to revisit these findings, much less in a nonpublic audit.

Second, by delving into this jurisdictional issue, the Draft Report regrettably raises questions regarding the Commission's own jurisdiction. The statutory language at issue in the Draft Report applies equally to both NERC and the Commission. *Compare* 16 U.S.C. § 824o(b)(1) ("The Commission shall have jurisdiction . . . over the ERO . . . for purposes of approving reliability standards established under this section and enforcing compliance with this section.") *with id.* § 824o(d), (e) (providing ERO with jurisdiction over standards and enforcement). Thus, if NERC cannot engage in certain activities and functions under section 215, the Commission has no jurisdiction over them either. For example, if NERC cannot use load-serving entity funds to hold a public conference on cyber security, *see* Draft Report at 79 (complaining that "NERC did not seek to involve FERC staff in any oversight of this project" and finding it was not "designed to result in any changes to, or the development of, reliability standards"), then some may question whether the Commission should be holding similar conferences. Or, if NERC cannot function as the Energy Sector - Information Sharing and Analysis Center in connection with section 215 (Draft Report at 82-85), then some may question whether the Commission can require NERC to submit its alerts that are to be issued in executing that function,[1] or, indeed whether the Commission can engage in the activity of collecting and sharing security threat information.

This unduly narrow view of section 215—constraining NERC and FERC only to specific matters "designed to result in any changes to, or the development of, reliability standards" (Draft Report at 79)—is not what Congress intended when it enacted section 215, nor the Commission when it implemented that important new grant of authority. *Mandatory Reliability Standards for the Bulk-Power System*, Order No. 693, FERC Stats. & Regs. ¶ 31,242 at P 24 ("the reliability mandate of section 215 of the FPA addresses not only the comprehensive maintenance of the reliable operation of each of the elements of the Bulk-Power System, it also contemplates the prevention of incidents, acts and events that would interfere with the reliable operation of the Bulk-Power System").

II. <u>Legal Standards and Procedural Matters</u>

A. <u>Auditing Pursuant to Objective Criteria</u>

The traditional purpose of a Commission audit has been to assess compliance with Commission regulations. For example, in the *Revised Policy Statement on Enforcement*, 123 FERC ¶ 61,156 at P 14 (2008), the emphasized that "[t]he Divisions of Audits within the Office of Enforcement helps ensure compliance with the Commission's statutes, regulations, and orders by conducting a wide array of audits of jurisdictional entities." *Accord* 18 C.F.R. § 41.1(a) (audit report under FPA Part II focuses on "findings that the audited person has not complied with a requirement of the Commission"). Similarly, in the very first *Report on Enforcement* issued after enactment of the Energy Policy Act of 2005, the Office of Enforcement stated:

> The Office of Enforcement's Division of Audits (DOA) is instrumental in promoting industry compliance with Commission requirements. These audits provide the Commission with an objective assessment of industry compliance with various aspects of the Commission's rules, regulations, and statutory requirements. DOA plans, conducts, and reports the results of audits of jurisdictional companies in the electric power, natural gas, and oil pipeline industries. Audits vary in type, scope, and objectives, but primarily focus on materially relevant compliance issues associated with significant Commission initiatives. . . . *DOA's goal is to evaluate whether a jurisdictional company is in compliance with the applicable rules and regulations and, where compliance is*

[1] *N. Am. Elec. Reliability Corp.*, 120 FERC ¶ 61,239 at P 12 (2007) (requiring NERC to submit ES-ISAC alerts because they relate to reliability standards evaluation and development).

> *deficient*, to recommend corrective actions and suggest preventive measures to avoid problems in the future.

Report on Enforcement, Docket No. AD07-13-000, pp. 26-27 (November 14, 2007) (footnote omitted) (emphasis supplied). This policy has been reiterated in all subsequent Reports on Enforcement. *See 2008 Report on Enforcement*, Docket No. AD07-13-001, p. 24 (October 31, 2008); *2009 Report on Enforcement*, Docket No. AD07-13-002, p. 19 (December 17, 2009); *2010 Report on Enforcement*, Docket No. AD07-13-003, p. 22 (November 18, 2010); *2011 Report on Enforcement*, Docket No. AD07-13-004, p. 27 (November 17, 2011).

Consistent with this traditional focus, Order No. 672 held that, although the Commission "maintains the flexibility to determine the applicable scope of a particular audit," "[w]e contemplate that a compliance audit of the ERO would typically involve an examination of the ERO's ongoing compliance with statutory and regulatory criteria for certification and its performance in carrying out its responsibility to oversee the compliance with and enforcement of Reliability Standards." *Rules Concerning Certification of the Elec. Reliability Org.; and Procedures for the Establishment, Approval, and Enforcement of Elec. Reliability Standards*, Order No. 672, FERC Stats. & Regs. ¶ 31,204 at P 773, *order on reh'g*, Order No. 672-A, FERC Stats. & Regs. ¶ 31,202, *appeal dismissed sub nom., N.Y. Indep. Sys. Operator v. FERC*, No. 06-1185 (D.C. Cir. Sept. 29, 2006); *see also* 16 U.S.C. § 824o(e)(5) ("[t]he Commission may take such action as is necessary or appropriate against the ERO . . . *to ensure compliance with a reliability standard or any Commission order* affecting the ERO . . . .") (emphasis supplied).

For purposes here, this traditional focus on compliance is important because it means that, in the typical audit, there are *clear and objective criteria*—the Commission's regulations and orders—against which to judge the conduct or practices being audited. Indeed, such criteria are required by Generally Accepted Government Auditing Standards ("GAGAS") which, pursuant to Order No. 675, the Audit Staff must to follow. *Procedures for Disposition of Contested Audit Matters*, Order No. 675, FERC Stats. & Regs. ¶ 31,209 at P 53 (2006), *order on rehearing and clarification*, Order No. 675-A, FERC Stats. & Regs. ¶ 31,217 ("The audit staff follows Generally Accepted Government Auditing Standards as prescribed by the Comptroller General of the United States."). Under the GAGAS, an audit must be performed using specific criteria against which to judge the conduct or procedures being audited:

> Auditors should identify criteria. Criteria represent the laws, regulations, contracts, grant agreements, standards, specific requirements, measures, expected performance, defined business practices, and benchmarks against which performance is compared or evaluated. Criteria identify the required or desired state or expectation with respect to the program or operation. Criteria provide a context for evaluating evidence and understanding the findings, conclusions, and recommendations included in the report. Auditors should use criteria that are relevant to the audit objectives and permit consistent assessment of the subject matter.

GAO Report, *Government Auditing Standards*, GAO-12-331G § 6.37 (Dec. 2011).

In this case, by contrast, Audit Staff has conducted an "economy and efficiency" audit. Although this type of audit can offer value by identifying potential improvements in processes and performance, it can also create challenges due to the lack of clear criteria against which to benchmark these processes and performance. For example, Audit Staff appears to have great concerns with NERC's decision to shift from a meeting-based compensation method for its

Board to a flat-fee method. To be sure, reasonable minds can disagree over which method is superior in particular circumstances, but it is not clear why the Audit Staff should be empowered to pick one or the other or require NERC to "justify" its change from one form of compensation to another, particularly where NERC has provided ample justification for its decision.

Given the inevitable differences of opinion that can emerge in the absence of clear, Commission-approved criteria, we would respectfully suggest that the Commission consider the manner in which it has handled comparable issues under the Federal Power Act. The Commission has long held that managers have "broad discretion" in conducting their business affairs and are entitled to a "presumption of prudence." *New England Power Co.,* 31 FERC ¶ 61,047 at 61,084. Thus, the burden is not on management to justify every practice or expenditure in the first instance; rather, others must create "serious doubt" as to its prudence with credible evidence before those practices or expenses must be explained. *Iroquois Gas Transmission Sys., L.P.*, 87 FERC ¶ 61,295 at 62,168 (1999) (citations omitted), *order clarified*, 88 FERC ¶ 61,236 (1999); *Minnesota Power & Light Co.*, 11 FERC ¶ 61,312 at 61,645 (1980); *see Anaheim Riverside v. FERC*, 669 F.2d 799, 809 (D.C. Cir. 1981) (*citing Sw. Bell Tel. Co.*, 262 U.S. at 289 n.1) ("a utility's costs are presumed to be prudently incurred").

The Commission rejected a similarly intrusive role in reviewing the governance of ISOs and RTOs in Order No. 719. Order No. 719 at P 558. The Commission had initially "request[ed] comment[s] on whether any reforms are necessary to increase management responsiveness to stakeholder concerns," such as whether the Commission "should . . . encourage or require RTOs or ISOs to: . . . [s]et performance criteria for executive managers based in part on responsiveness to stakeholders [or] [r]elate executive compensation to a measure of responsiveness to stakeholders." *Wholesale Competition in Regions with Organized Elec. Mkts.*, Docket No. RM-07-19-000, Advance Notice of Proposed Rulemaking at P 159 (June 22, 2007) ("ANOPR"). The Commission declined to propose any such requirement in Order No. 719, however, holding that it "continues to encourage, but not require, each RTO and ISO to ensure that its management programs, including executive compensation, give appropriate weight to responsiveness to customers and other stakeholders." Order No. 719, at P 561. Indeed, the Commission held that "[i]f the RTO or ISO board is well-informed about the needs of customers and various stakeholders, it will set criteria for performance, appropriate goals and targets for the organization and its management and institute measures for achieving those targets. *By focusing our requirements on having a well-informed board, we decline to intrude further into board prerogatives regarding management compensation.*" *Id.* (emphasis added).

The Commission has provided a similar level of deference in case-specific proceedings involving ISOs or RTOs. *ISO New England, Inc.*, 133 FERC ¶ 61,267 at P 37 (2010) (deference appropriate because "the proper level of executive compensation is more art than science") (citing *Blumenthal v. FERC,* 613 F.3d 1142, 1146 (D.C. Cir. 2010)); *ISO New England, Inc.*, 125 FERC ¶ 61,392 at P 35 (2008), *reh'g denied*, 127 FERC ¶ 61,254 (2009), *rev. denied*, *Blumenthal*, 613 F.3d 1142 (refusing to set for hearing whether the ISO-NE's executive compensation package was just and reasonable because it was "adequately supported"); *ISO New England, Inc.*, 129 FERC ¶ 61,299 at P 25 (2009) (accepting the proposed compensation levels approved by the ISO-NE's Board of Directors).

Indeed, there are limits to the Commission's jurisdiction to in this area. *California Indep. Sys. Operator Corp.*, 372 F.3d at 403 (reversing FERC's assertion of jurisdiction over ISO Board of Directors, finding that, "[i]f FERC can remove a board of directors and dictate the method of choosing a new one because the method of selecting the old one might have made it appear discriminatory, or have even given cause to fear future discrimination, then it would seem that

FERC could also dictate the choice of CEO, COO, and the method of contracting for services, labor, office space, or whatever one might imagine, assuming FERC made the appropriate finding"); *see also Sw. Bell Tel. Co. v. Pub. Serv. Of Missouri*, 262 U.S. 276 (1923) (holding that while a state utility commission has a duty to establish reasonable rates, it cannot substitute its own business judgment for that of the directors of a company absent a showing that the management of the company abused its discretion).

B. Procedures Applicable to a Section 215 Audit

The Commission has established longstanding procedures to address potential disputes that may arise in audits conducted pursuant to Part II of the Federal Power Act. For example, if an audit is contested, the subject of the audit has a right to a hearing before any ruling is made on disputed findings and, importantly, the Commission does not make any findings on the merits of contested matters until a public vetting of all contested issues, including submissions by the audit staff. 18 C.F.R. § 41.1(b); *Procedures for Disposition of Contested Audit Matters*, Order No. 675, FERC Stats. & Regs. ¶ 31,209 (2006), *order on rehearing and clarification*, Order No. 675-A, FERC Stats. & Regs. ¶ 31,217; *Holding Corp.*, Docket No. PA10-13-000 (merits order following submission of briefs on contested audit matters pending); *Wisconsin Elec. Power Co.*, Opinion No. 455, 98 FERC ¶ 61,233 (2002), *order on reh'g and clarification*, Opinion No. 455-A, 105 FERC ¶ 61,002 (2003) (partially affirming initial decision upholding contested audit findings); *Pub. Serv. Co. of Colorado*, Opinion No. 425, 84 FERC ¶ 61,156 (partially affirming contested audit findings after shortened procedures).

The Commission has not yet, however, adopted similar procedures for audits conducted pursuant to section 215. When the Commission expanded its rules on contested audits to cover operational audits in Order No. 675, it had adopted Order No. 672 only two weeks before and had not yet certified NERC as ERO. Understandably, therefore, Order No. 675 excluded reliability audits from the scope of Part 41.1, stating that "[we] may reconsider this decision after an ERO is certified." Order No. 675 at P 21. Since that time, the Commission has not updated its Part 41 regulations to include section 215 audits and, in individual cases, it appears to have adopted varying approaches, including one instance where it appears that disputed findings were resolved on a summary basis. *Compare W. Elec. Coordinating Council,* 132 FERC ¶ 61,149 at PP 19-21 (2010) (summarily resolving disputed findings against the subject of the audit despite its agreement with the recommendations) *with Sw. Power Pool, Inc.,* 126 FERC ¶ 61,045 at PP 21-22 (2009) (considering disputes over findings, but declining to address them because of agreement on recommendations).

The Board and NERC's management sincerely hope that there will be no need to decide what procedures should apply in the event this audit became contested. Rather, we hope that, working with Commission Staff, we can reach agreement on all the recommendations, thereby rendering the audit effectively uncontested and eliminating any need to resolve disputes over the findings. In that event, Audit Staff would issue a final Audit Report to NERC, NERC would review it and respond in writing that it agreed with the recommendations but disagreed with many of the findings (and noting the reasons therefor), and the Commission would then issue an order approving the recommendations without endorsing those disputed findings. However, out of an abundance of caution, we note that, in the event our discussions with Staff are not successful, NERC reserves its procedural rights with respect to any unresolved disputes, including the right to request the traditional procedures that follow the approach under Part 41.1 whereby the Commission does not make summary findings on disputed issue in consultation with Audit Staff on an ex parte basis.

III. As the Commission Has Repeatedly Found, NERC's Activities Are Within the Scope of Section 215 of the FPA

Audit Criteria. The Draft Report describes the findings of several Commission orders that discuss the types of functions that fall under section 215 for purposes of budgeting and funding through ERO assessments. For example, the Draft Report discusses the finding in Order No. 672 that the ERO is "not necessarily precluded from pursuing [non-statutory] activities, [but] it may not use Commission-authorized funding for such activities." Draft Report at 71 (citing Order No 672 at P 34). The Draft Report also notes the subsequent finding that "anything required of the ERO or a Regional Entity by the statute, Order No. 672 pursuant to the statute, or any subsequent Commission order pursuant to section 215 of the FPA is a statutory activity." Draft Report at 72 (quoting *North Am. Elec. Reliability Corp.*, 117 FERC ¶ 61,091 at P 28 (2006)). It also states that the Commission, in that same order, "acknowledge[d] . . . concerns that NERC should provide greater detail and justification for the criteria it uses to designate statutory activities." *Id.* Finally, the Draft Report states that, in response to these findings, NERC provided greater detail, including an explanation that "[e]ach of the program areas [identified by NERC] carries out or supports implementation of one or more of the statutory activities" (*id.* at 73), and that the Commission approved the funding for all such programs. *Id.* at 74.

Audit Findings. The Draft Report criticizes NERC for purportedly "operat[ing] under the *assumption* that all of its projects, initiatives, and tools were directly related to section 215" (Draft Report at 4 (emphasis added) and with a "philosophy that all activities that promote the reliability of the Bulk-Power System (BPS) are statutory" (*id.* at 7 and 70). The Draft Report also criticizes NERC for not having "written criteria to determine whether activities should be funded under [FPA] section 215" and for NERC's alleged "failure to develop written criteria to guide its decisions of what constitutes a statutory activity." *Id.*. The Draft Report then suggests that certain, discrete NERC activities (e.g., a cyber security conference) were not "specifically required by the Commission" and therefore may have "exceeded the functions of the ERO explicitly defined in section 215" (*id.* at 75).

NERC Response. The Draft Report's findings on the scope of section 215 are hard to follow because they are internally inconsistent. One the one hand, the Audit Report acknowledges that the Commission has approved *all* of NERC's functions as statutory on several occasions (and, as noted below, the prior rulings are even more extensive than described by the Draft Report). But, despite this, Audit Staff criticizes NERC for "assuming" its functions are statutory and therefore not having "written criteria" to distinguish those that are not statutory. Audit Staff's findings therefore do not follow the criteria they purport to be based on. Perhaps Audit Staff disagrees with the manner in which the Commission has handled these issues in the past, but that is not a legitimate basis for criticizing NERC. With this overarching concern in mind, NERC will describe below, in some detail, why it disagrees with Audit Staff's findings.

NERC rejects any assertion that it has engaged in non-statutory activities or expended Section 215 funds on non-statutory activities, that it has a "philosophy" or operates under an "assumption" that any activity NERC could engage in to promote the reliability and security of the BPS is thereby a statutory activity, and that it does not consider whether an activity is within the scope of its approved statutory program areas before engaging in it. The central problem with the Draft Report's analysis is the mistaken premise that the statutory function of developing reliability standards is limited to the process for *drafting and balloting* such standards. This has never been the case because such a narrow view would eliminate a broad range of functions that are critical to improving those standards.

Indeed, from the time when NERC initially applied to be the ERO, it has made clear that maintaining the reliability of the BPS requires a "continuous cycle" of activities:

> NERC Council's historic mission and the mission of the ERO are coterminous: to promote and improve the reliability, adequacy, and security of the bulk power system in North America. NERC's philosophy for accomplishing this mission is based on a *continuous cycle* of activities to achieve reliability improvements: (1) measuring reliability performance – past, present, and future; (2) analyzing and benchmarking the results of those measurements; (3) identifying problems and assessing needs for improvement; (4) developing solutions to address those problems and needs, including new or revised reliability standards; and (5) implementing solutions, including expanded compliance monitoring and enforcement. This ongoing cycle of activities promotes continuous, measurable improvements in reliability.
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> * * *
>
> NERC will build upon a set of programs whose goals and objectives include reliability standards, compliance and certification, reliability readiness, training and personnel certification, reliability assessments and performance analysis, and situation awareness and infrastructure security. NERC's mission as the ERO incorporates these fundamental principles:
>
> - Developing, implementing, and enforcing strong reliability standards that are international in scope and consistently applied throughout North America, with regional differences recognized where driven by compelling need.
> - Insisting on strict compliance with reliability standards through an independent and rigorous program of compliance audits conducted by NERC and (pursuant to delegation agreements) the regional entities.
> - Using monetary and non-monetary penalties for noncompliance with reliability standards that encourage compliance and remediation and recognize the relative severity and importance of violations of individual reliability standards.
> - Establishing and promoting a culture of excellence in bulk power system planning and operations by identifying areas for improvement and examples of excellence through periodic reliability readiness audits.
> - Promoting continuous reliability performance improvement through independent reliability and adequacy assessment and reporting; investigating, analyzing, and sharing "lessons learned" about bulk power system events; and developing reliability performance metrics and benchmarks.
> - Developing and implementing personnel training, education, and certification programs that encourage and enable compliance with reliability standards and promote excellence in reliable bulk power system planning and operation.

- Reducing vulnerability and improving mitigation and protection of the industry's critical infrastructure by performing a critical role in real-time situation awareness and by serving as the ESISAC and Sector Coordinating Council.[2]

NERC stated that it believed all the activities it proposed to perform as the ERO are either explicitly required by the statute or are necessary and appropriate corollaries to carrying out the ERO's express statutory responsibilities.[3]

On the basis of NERC's ERO certification application, the Commission certified NERC as the ERO under Section 215. In response to NERC's certification application, a number of commenters had raised objections to some of NERC's proposed statutory activities. The Commission deferred ruling on whether various specific activities were statutory until NERC's first budget filing, but the Commission did articulate a general test that would make an activity, without more, eligible for funding under Section 215:

> We generally believe that anything required of the ERO or a Regional Entity by the statute, Order No. 672 pursuant to the statute, or any subsequent Commission order pursuant to section 215 of the FPA is a statutory activity.[4]

NERC's first Business Plan and Budget filing included a detailed discussion of each of its proposed statutory activities, along with an explanation of how those activities were appropriate under Section 215. NERC detailed the activities it intended to conduct in 2007 in six broad programs (Reliability Standards; Compliance Enforcement and Organization Registration and Certification; Reliability Readiness Audits and Improvement; Training, Education, and Operator Certification; Reliability Assessment and Performance Analysis; and Situation Awareness and Infrastructure Security). NERC specifically requested funding under Section 215 for each of those activities.[5] Subsequently, in an answer to comments that had been filed concerning the scope of its proposals, NERC stated that Congress' goal of preventing a recurrence of the 2003 blackout is not well served by a narrow reading of Section 215 that limits the statutory activities

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[2] *Request of the North American Electric Reliability Council and North American Electric Reliability Corporation for Certification as the Electric Reliability Organization*, Docket No. RR06-1-000, filed April 4, 2006 ("NERC ERO Certification Application"), at 8-10.

[3] NERC ERO Certification Application at 16.

[4] *Order Certifying North American Electric Reliability Corporation as the Electric Reliability Organization and Ordering Compliance Filing*, 116 FERC ¶ 61,062 (2006) ("ERO Certification Order"), P 185.

[5] *Request of the North American Electric Reliability Corporation for Acceptance of its 2007 Business Plan and Budget and the 2007 Business Plans and Budgets of Regional Entities and for Approval of Proposed Assessments to Fund Budgets*, Docket No. RR06-3-000, filed Aug. 23, 2006 ("2007 ERO Budget Filing"), at 21-34.

of NERC and the Regional Entities.[6] The Commission approved NERC's 2007 Business Plan and Budget on October 24, 2006, stating:

> The ERO's budget filing represents another important milestone toward achieving a strong ERO capable of developing and enforcing mandatory Reliability Standards. **To this end the activities identified by NERC as statutory should be funded through the ERO under section 215 of the FPA, as NERC has proposed**.[7]

After reviewing NERC's description of the relationship of its proposed activities to the provisions in Section 215 and evaluating objections from some commenters that certain of NERC's activities were outside the ambit of Section 215 and should be treated as non-statutory, the Commission ruled as follows:

> **We find that NERC's proposed activities reasonably fall within the types of activities the Commission considers to be covered by FPA section 215, *i.e.*, the development and enforcement of reliability standards, and are entitled to receive funding under section 215 of the FPA**. As explained in the *ERO Certification Order*, anything required of the ERO or a Regional Entity by the statute, Order No. 672 pursuant to the statute, or any subsequent Commission order pursuant to section 215 of the FPA is a statutory activity. **NERC, in its budget filing and subsequent response, has provided an explanation for each of its program areas that relates to a function for which the ERO is responsible pursuant to section 215 of the FPA, Order No. 672 or the *ERO Certification Order*.** Accordingly, we find acceptable NERC's designation of specific program activities as "statutory" (our determination regarding the reasonableness of the funding for these activities is discussed later).[8]

In its 2007 Business Plan and Budget filing, NERC had pointed out that two of the Regional Entities had a narrower view of the scope of Section 215 than did NERC. Those Regional Entities excluded from their statutory budgets certain of the program areas that NERC included under Section 215. The Commission required the Regional Entities to adopt the same broad program categories as NERC. The Commission accepted NERC's restatement of those two Regional Entities' budgets for these activities as statutory, with the following finding:

> **NERC's proposed activities are the same that we find to be within the ambit of FPA section 215 and thus entitled to receive funding pursuant to section**

[6] *Motion to Answer and Answer of the North American Electric Reliability Corporation to Comments and Protests to Request for Approval of Proposed Assessments to Fund Budgets*, Docket No. RR06-3-000, filed Sept. 26, 2006, at 3-9; *see* 2007 ERO Budget Order at PP 24-27.

[7] *Order Conditionally Accepting 2007 Business Plan and Budget of the North American Electric Reliability Corporation, Approving Assessments to Fund Budgets, and Ordering Compliance Filing*, 117 FERC ¶ 61,091 (2006) ("2007 ERO Budget Order"), at P 4 (emphasis added).

[8] 2007 ERO Budget Order, P 28 (footnote omitted; emphasis added).

> **215 of the FPA for the ERO** and should be statutory in the context of the Regional Entities. We see no reason why they would differ on a regional basis.[9]

The Draft Report correctly points out that in the 2007 ERO Budget Order, the Commission stated:

> We believe that the 2007 NERC business plan and budget provide sufficient information for the Commission to determine that the proposed designated activities are statutory because they are within the scope of the reliability functions required of the ERO and the Regional Entities under section 215. However, we acknowledge commenters' concerns that NERC should provide greater detail and justification for the criteria it uses to designate statutory activities. Accordingly, we require that, when NERC files its 2008 budget and business plan, it identify the general statutory activity, and which sub-activities, are covered by the 2008 budget and business plan.[10]

As the Draft report also indicates, in its filing for approval of its 2008 Business Plan and Budget, NERC presented a detailed explanation of how each of its six programs falls within the scope of Section 215:

> The principal activities of the ERO as specified in Section 215 of the FPA and in the Commission's regulations promulgated thereunder are development of reliability standards for the bulk power system (§ 215(d) of the FPA; 18 C.F.R. § 39.5); enforcement of compliance with reliability standards, including imposition of penalties and sanctions for violations (§ 215(e) of the FPA; 18 C.F.R. § 39.7); and conducting periodic assessments of the reliability and adequacy of the bulk power system in North America (§ 215(g) of the FPA; 18 C.F.R. § 39.11). In addition, the ERO may delegate functions to regional entities pursuant to delegation agreements approved by the Commission (§ 215(c)(4) of the FPA; 18 C.F.R. § 39.8).
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> NERC has organized and presented its business plan and budget based on six specific program areas. Each of these program areas carries out or supports implementation of one or more of the statutory activities. Specifically: (1) the Reliability Standards Program implements the statutory activity of development of reliability standards. (2) The Compliance Enforcement and Organization Registration and Certification Program implements the statutory activity of enforcement of compliance with reliability standards, including imposition of penalties and sanctions for violations of standards. (3) The Reliability Readiness Evaluation and Improvements Program supports the statutory activity of enforcing and achieving compliance with reliability standards and the statutory activity of conducting assessments of the reliability of the bulk power system. This program also provides information and feedback that supports the statutory activity of development of reliability standards. (4) The Training, Education and Operator Certification Program supports the statutory activity of enforcing and achieving compliance with reliability standards, and also provides information

[9] 2007 ERO Budget Order at P 38 (emphasis added).

[10] 2007 ERO Budget Order at P 30.

> and feedback that supports the statutory activity of development of reliability standards. (5) The Reliability Assessment and Performance Analysis Program implements the statutory activity of conducting periodic assessments of the reliability and adequacy of the bulk power system in North America. This program also provides information and feedback that supports the statutory activities of development of reliability standards and achieving compliance with reliability standards. (6) The Situation Awareness and Infrastructure Security Program supports the statutory activity of enforcing and achieving compliance with reliability standards, and also provides information and feedback that supports the statutory activities of development of reliability standards and conducting assessments of the reliability and adequacy of the bulk power system.[11]

The Commission found NERC's explanations to be satisfactory, concluding in its order approving the 2008 Business Plan and Budget:

> The Commission conditionally accepts NERC's budget and business plan. Section 39.4(b) of the Commission's regulations requires the ERO to file annually with the Commission its proposed budget, business plan, and organization chart. We find that NERC's submitted business plan provides sufficient detail for us to determine whether NERC intends to pursue appropriate activities. NERC's proposed categories of activities are the same as those approved by the Commission for NERC's 2007 budget and reasonably fall within the types of activities the Commission considers to be covered by FPA section 215. As we explained in the 2007 Budget Order, anything required of the ERO or a Regional Entity by the statute, Order No. 672 pursuant to the statute, or any subsequent Commission order pursuant to section 215 of the FPA is a statutory activity.[12]

In each of its subsequent annual Business Plan and Budget filings, NERC has detailed its proposed program areas and how they relate to Section 215. In each year, the Commission has approved the proposed Business Plan and Budget and raised no objection to the scope of NERC's proposed activities as not being within the scope of, or eligible for funding through, Section 215.[13]

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[11] *Request of the North American Electric Reliability Corporation for Acceptance of its 2008 Business Plan and Budget and the 2008 Business Plans and Budgets of Regional Entities and for Approval of Proposed Assessments to Fund Budgets*, Docket No. RR07-16-000, filed Aug. 24, 2007 ("2008 ERO Budget Filing"), at 45-46.

[12] *Order Conditionally Accepting the 2008 Business Plan and Budget of the North American Electric Reliability Corporation and Ordering Compliance Filings*, 121 FERC ¶ 61,057 (2007) ("2008 ERO Budget Order"), at P 21. The Draft Report states that NERC's explanations in the 2008 ERO Budget Filing "vaguely addressed" the directive in the 2007 ERO Budget Order. Draft Report at 76. However, the Commission obviously found NERC's submission in the 2008 ERO Budget Filing to be sufficient.

[13] The Commission's orders approving NERC's annual business plans and budgets for the years 2009 through 2012 are as follows: *North American Electric Reliability Corp.*, 125 FERC ¶ 61,056 (2008) ("2009 ERO Budget Order") (finding that "NERC's 2009 Business Plan provides sufficient details for us to determine whether NERC intends to perform appropriate activities"

In Order No 672, the Commission required that the ERO file an assessment of its performance three years following the date of that Order.[14] NERC filed its Three-Year ERO Performance Assessment Report on July 20, 2009. In that filing, NERC detailed the results of its efforts organized by major program categories, as follows:

- NERC Has Developed a Comprehensive Body of Reliability Standards for the Bulk Power System.
- NERC and the Regional Entities Have Developed and Implemented a Comprehensive Organization Registration Program.
- NERC and the Regional Entities Have Developed a Comprehensive and Effective Program for Monitoring and Enforcing Compliance with Reliability Standards.
- NERC Has Developed an Effective Program for Disseminating Alerts on Potential Reliability Issues to Owners, Operators and Users of the Bulk Power System.
- NERC Has Analyzed and Disseminated Information on System Events Affecting Reliability.
- NERC Has Developed Independent Short- and Long-Term Assessments of the Reliability and Adequacy of the Bulk Power System and Focused Attention on Emerging Issues Important to Reliability.
- NERC Has Developed and Provided Useful Metrics and Benchmarks for Measuring Reliability Performance.
- NERC is Taking an Industry Leadership Role in Critical Infrastructure Protection.
- NERC Continues to Play an Important Role in Situational Awareness and Infrastructure Security as Coordinator of the ES-ISAC and Through Other Programs and Initiatives.[15]

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and that "NERC's proposed categories of activities for 2009 . . . reasonably fall within the types of activities the Commission considers to be covered by FPA section 215," *id.* at P 18) and *North American Electric Reliability Corp.*, 128 FERC ¶ 61,025 (2009); *North American Electric Reliability Corp.*, 129 FERC ¶ 61,040 (2009) ("2010 ERO Budget Order"); *North American Electric Reliability Corp.*, 133 FERC ¶ 61,062 (2010) ("2011 ERO Budget Order"); *North American Electric Reliability Corp.*, 137 FERC ¶ 61,071 (2011) ("2012 ERO Budget Order").

[14] Order No. 672 at PP 32 and 187-191; adopted in 18 C.F.R. §39.3(c).

[15] *North American Electric Reliability Corporation, Three-Year Electric Reliability Organization Performance Assessment Report Submitted in Accordance with 18 C.F.R. §39.3(c)*, Docket No. RR09-7-000, filed July 20, 2009 ("Three-Year ERO Performance Assessment Report").

The Three-year ERO Performance Assessment Report contained an extensive, detailed discussion and analysis of NERC's activities and achievements in each of its statutory program areas since certification as the ERO.[16] On September 16, 2010 the Commission accepted NERC's Three-Year ERO Performance Assessment of NERC as the ERO, and the Regional Entities, and found that they continue to satisfy the statutory and regulatory criteria for certification.[17] As part of its assessment, the Commission reviewed each of NERC's program areas. Nowhere in that Order is there a suggestion that any of NERC's program areas are outside Section 215 or that NERC is engaging in activities that are outside Section 215.

The Draft Report appears to attach some significance to the fact that NERC's statutory programs were also its "historical" activities before becoming the ERO, and suggests that NERC inappropriately assumed that its "historical" activities carried over to be statutory activities. However, this assertion simply second-guesses the Commission's own orders. The Commission has repeatedly (and annually) accepted, approved and confirmed these NERC program areas as statutory activities to be funded pursuant to Section 215. In light of this extensive history of Commission review and approval, there is no basis for, and no merit to, the Draft Report's suggestion that the scope of NERC's permissible Section 215 activities should be "revisit[ed]."

Despite the Draft Report's extensive discussion of whether all of NERC's activities are statutory activities, and despite spending many months and hundreds of hours of field work time carefully examining NERC's activities, the Draft Report identifies only three specific activities that it questions as to whether they should be considered statutory activities. Those three specific activities are conducting presentations and speeches at universities encouraging students to pursue electric power industry careers ("Aging Workforce"); the "GridEx" cybersecurity incident readiness exercise NERC conducted (with industry participants) in November 2011; and the Grid Security Conference NERC conducted for industry and governmental participants in October 2011.[18] Draft Report at 78-80.

Before addressing each of these discrete activities individually, we note four general concerns that apply broadly to Audit Staff's analysis.

First, although the Draft Report questions whether these activities are statutory ERO activities, there is no allegation that the activities were not designed to further the reliability and security of the BPS. It is therefore hard to understand why Audit Staff would single them out for criticism.

Second, Audit Staff's apparent premise that, to qualify as statutory, a particular activity must be specifically "designed to result in any changes to, or the development of, reliability

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[16] Three Year ERO Performance Assessment Report, Attachment 1, at 42-117.

[17] *North American Electric Reliability Corp.*, 132 FERC ¶ 61,217 (2010), at PP 1 and 54 ("We find that NERC has demonstrated that it satisfies the statutory and regulatory requirements set forth in section 215(c) of the FPA and section 39.3(b) of our regulations").

[18] The Draft Report also expresses concern as to whether NERC's operations as the ES-ISAC should continue to be regarded as a statutory activity, but the Draft Report addresses the ES-ISAC under a different finding which focuses on other concerns with respect to the ES-ISAC. Draft Report at 78; *see* §VII below.

standards" (Draft Report at 79) is simply wrong, as discussed above. Rather, the Commission has approved NERC's approach that fosters a "continuous cycle" of activities that are necessary to ensure sound standards that protect the reliability of the Bulk Power System. Indeed, the Commission has long decried any process that would produce "lowest common denominator" reliability standards. Order No. 693, at 5 ("A Reliability Standard must do more than simply reflect stakeholder agreement or consensus around the 'lowest common denominator'"); Order No. 672 at P 29 ("A mandatory Reliability Standard should not reflect the "lowest common denominator" in order to achieve a consensus among participants in the ERO's Reliability Standard development process"). Yet that is the process that Audit Staff would encourage by arguing that NERC's standards development function limits its employees to participating in the drafting and balloting process and nothing else.

Third, as NERC explained above, the Draft Report's narrow interpretation of section 215 should be troubling to the Commission because the statutory language at issue in the Draft Report applies equally to both NERC and the Commission. *Compare* 16 U.S.C. § 824o(b)(1) ("The Commission shall have jurisdiction . . . over the ERO . . . for purposes of approving reliability standards established under this section and enforcing compliance with this section") *with id.* § 824o(d), (e) (providing ERO with jurisdiction over standards and enforcement). The functions of the Commission, like NERC, are circumscribed by federal statutes and thus, if NERC cannot engage in certain activities and functions under Section 215, it necessarily raises the question of whether the Commission has jurisdiction over them either. For example, if NERC cannot use load-serving entity funds to hold a public conference on cyber security, *see* Draft Report at 79 (complaining that "NERC did not seek to involve FERC staff in any oversight of this project" and finding it was not "designed to result in any changes to, or the development of, reliability standards"), then some may question whether FERC should be holding similar conferences. NERC strongly urges the Commission to reject any such limited view of Section 215.

Fourth, as a practical matter, Audit Staff's mistakenly narrow view of Section 215 would be difficult, if not impossible, to implement in a rational fashion. For example, under the Audit Staff's standard, NERC employees could apparently not attend a wide variety of events, including Commission-sponsored conferences, because they could not be documented as specifically "designed to result in changes to, or the development of, reliability standards." The Draft Report avoids addressing this uncomfortable reality, but it should not be lost on the Commission how unwieldy the standard Audit Staff proposes would be to implement.

We now turn to the three discrete activities criticized by Audit Staff and describe why they fall within the scope of NERC statutory program areas and are (were) statutory activities.

Aging Workforce. The activity of making presentations and speeches at universities encouraging students to pursue careers in the electric power industry, which has been carried out by NERC's Vice President and Director of Reliability Assessment and Performance Analysis, was initiated because NERC's assessments of the reliability and adequacy of the BPS have identified the electric industry's aging workforce and consequent prospective loss of accumulated knowledge and expertise, and the apparent lack of younger persons seeking and training for careers in the industry to replace the current workforce as its members reach retirement, as a potentially serious problem for the reliability and adequacy of the BPS.[19] Thus, this activity is a logical component of NERC's statutory responsibility to assess the reliability and adequacy of the BPS, and the Draft Report's statement that there is "no linkage to ERO functions" is incorrect. Draft Report at 79. Further, as noted above, NERC's description of its programs in the Three-Year ERO Performance Assessment Report, which the Commission accepted, included "Develop[ing] Independent Short- and Long-Term Assessments of the Reliability and Adequacy of the Bulk Power System and **Focus[ing] Attention on Emerging Issues Important to Reliability**" (emphasis added). NERC has participated in five such events at universities over the period 2007-2011, or one per year on average. *Id*. at 78-79.[20]

Grid Security Exercise. The overall objectives of the Grid Security Exercise, which was conducted by NERC's Situation Awareness and Infrastructure Security Program, were to (1) validate the current readiness of the electric industry to respond to a cyber incident and provide input for security program improvements, (2) exercise NERC and industry crisis response plans and identify gaps in plans, security programs and skills, and (3) assess, test, and validate existing command, control, and communications plans for key NERC stakeholders.[21] Seventy-five industry and government organizations from the U.S. and Canada, including the Commission, participated in the Grid Security Exercise. Much of the exercise focused on incident reporting and response planning, which is the subject matter of CIP Standard CIP-008, Incident Reporting and Response Planning, and on recovery plans, which is the subject matter of CIP Standard CIP-009, Recovery Plans for Critical Cyber Assets. The findings and recommendations from the exercise included: (1) utility participants reported that the overlapping nature of certain compliance procedures found in NERC Reliability Standards CIP-001, CIP-008 and EOP-004 as well as the Department of Energy's OE-417 requirements created redundancies in a period of severe resource constraints in dealing with the hypothetical cyber attacks in the exercise; and (2) the NERC emergency standards process should be coordinated to avoid interference with incident response activities at the entity level.[22] The exercise produced many findings and recommendations which can and will be pursued to strengthen the readiness of NERC and the industry to identify, defend against and respond to a cyber attack or incident that threatens the security and reliability of the Bulk Power System – including, where appropriate, through development of new Reliability Standards and modification of existing Reliability Standards. Moreover, while the Draft Report states that the Grid Security Exercise related primarily to NERC's activities as the ES-ISAC (Draft Report at 79), the Commission has repeatedly approved NERC budgets that included the ES-ISAC as part of the statutory Situation Awareness and Infrastructure Security Program.

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[19] *See 2006 Long-Term Reliability Assessment* at 9-10; *2007 Long-Term Reliability Assessment* at 20-21; *2009 Long-Term Reliability Assessment* at 64-65 (provided in response to Data Request No. 5, Question No. 123).

[20] *See* responses to Data Request No. 1, Set Request No. 1, Question No. 31, and Data Request No. 5, Question No. 123.

[21] *See* responses to Data Request No. 5, Question No. 124, and Data Request No. 6, Question No. 139.

[22] NERC's After Action Report on the 2011 Grid Security Exercise, released in March 2012, is available at: http://www.nerc.com/files/NERC_GridEx_AAR_16Mar2012_Final.pdf.

Additionally, the activities of NERC's Situation Awareness and Infrastructure Security Program, as set forth in §1003 of its Commission-approved Rules of Procedure, include:

- NERC shall encourage and **participate in coordinated Critical Infrastructure protection exercises**, including interdependencies with other Critical Infrastructure sectors. (Emphasis added.)

- NERC shall improve methods to better assess the impacts of a possible physical attack on the Bulk Power System and means to deter, mitigate, and respond following an attack.

Thus, the Draft Report's concerns that the Grid Security Exercise had no relationship to, and was outside the scope of, NERC's Commission-approved statutory program areas (*id.*) are unfounded.

Grid Security Conference. The Grid Security Conference focused on security threats to BPS reliability, including threats to control systems, hacker exploits, facility threats and violence, and how the CIP Reliability Standards support BPS reliability. More than 260 industry and government security professionals attended the conference, including representatives from the Commission. The conference was within the scope of the activities of NERC's Situation Awareness and Infrastructure Security Program as set forth in §1003 of its Rules of Procedure, including:

- NERC shall strengthen relationships with federal, state, and provincial government agencies on Critical Infrastructure Protection matters.

- NERC shall work closely with the United States Department of Homeland Security, Department of Energy, Natural Resources Canada, and Public Safety and Emergency Preparedness Canada.

- NERC shall strengthen and expand these functions and working relationships with the electricity sector, other Critical Infrastructure industries, governments, and government agencies throughout North America to ensure the protection of the infrastructure of the Bulk Power System.

- NERC shall support implementation of the Critical Infrastructure Protection Standards through education and outreach.

- NERC shall conduct education and outreach initiatives to increase awareness and respond to the needs of the electricity sector.

Thus, the conference, in addition to being a logical activity within NERC's statutory Situation Awareness and Infrastructure Security Program, provided useful training and education to the industry and governmental participants on the importance of maintaining compliance with the CIP standards.

Based on the above discussion, and particularly in light of the long history of Commission approval of NERC's program areas as statutory activities to be funded under Section 215, the Draft Report's two recommendations on this topic, as written (Recommendations 37 and 38 – Draft Report at 81) are unnecessary and unwarranted. NERC does not object to developing a set of general criteria to use in determining that proposed activities are statutory. However, because these are matters affecting the Commission's jurisdiction and NERC's budget, NERC's activities should not be subject to approval or change by Audit Staff. Any review of NERC's activities that the Commission determines should be undertaken can be performed in the context of the review of NERC's annual business plan and budget findings.

NERC does, however, recognize the appropriateness both of (i) providing more detailed explanation and discussion of its planned activities and greater granularity in its budgets, in the annual business plan and budget filings, and (ii) adopting additional internal procedures and controls in connection with the initiation of new, unbudgeted activities during the course of the year. These issues are raised in a different topical area of the Draft Report, and are addressed in §III, below. Therefore, NERC submits that Recommendations 37 and 38 under "NERC Activities" should be changed to read as follows:

37. Establish written criteria for determining whether an activity is a statutory activity and should be funded under section 215.

38. In its annual business plan and budget filings, provide an explanation as to why the proposed activities to be undertaken by each program area for the budget year are statutory, including, at a minimum: a description and the purpose of the major activities to be undertaken by each program area and an explanation for why the activity is a statutory activity.

IV. <u>Accounting, Budgeting and Cost Reporting</u>

Audit Criteria. The Draft Report identifies the Commission's regulations concerning NERC's budget filings, as well as NERC's Rules of Procedure respecting these filings, as providing the relevant criteria for the audit in this area. Draft Report at 23-24. For example, Audit Staff identifies 18 C.F.R. §39.4(b), which requires the ERO to submit its budget and supporting materials "in sufficient detail to justify the requesting funding collection and budget expenditures," and NERC Rule of Procedure 1103 that tracks this regulation.

Audit Findings. The Draft Report has three major findings and a total of 15 recommendations (Recommendations 1 through 15) on budgeting, accounting and cost reporting issues. The Draft Report asserts that NERC's budget process does not provide sufficient transparency to allow the Commission, the NERC Board and stakeholders to efficiently and effectively evaluate annual budget requests and subsequent requests to change approved budgets; and that NERC lacks procedures and controls to "address the use of section 215 funds for unbudgeted activities as well as the redirection of unused budgeted funds from approved statutory activities to unbudgeted activities" and to advise the Commission, the Board and stakeholders of "significant deviations from requested budget targets." Draft Report at 5 and 23. The Draft Report also contends that NERC lacks adequate procedures for reporting and tracking employee time for specific projects and activities, has insufficient functionality in its accounting system, and as a result "failed" to track employee time and attendance on a project-specific basis or to "properly classify" expenses in its accounting system at a level that provides sufficient transparency to permit effective budget oversight. *Id.* at 5 and 34. Finally in this area, the Draft Report asserts that NERC's current process of reviewing Regional Entity budgets is "inadequate" and "lacks appropriate qualitative procedures to efficiently and effectively assess Regional Entities' annual budgets." *Id.* at 5 and 30. To address these perceived deficiencies, the Draft

Report recommends, among other things, that NERC establish more robust procedures and controls over the use of working capital reserves; develop a process that allows the Commission, the Board and stakeholders opportunity to authorize the expenditure of funds budgeted for specific statutory activities to be redirected to unbudgeted activities; submit requests to the Commission, between the annual budget filings, for approval to use budgetary funds for activities not included in the most recent annual budget; increase the granularity of its budget filings and annual true-up filings; implement various improvements to its time and expense reporting systems and related accounting systems, procedures and controls; and implement specified improvements to its processes for reviewing the Regional Entities' annual budgets. Draft Report at 7-8, 28-29, 33, and 38.

NERC's Response. NERC finds many of the Draft Report's recommendations acceptable, with some modifications, and plans to implement them. In fact, NERC has already taken actions that implement several of the recommendations, such as implementing a new time reporting system that allows NERC employees to report time by function and activity to the particular activity and, where necessary, project (Recommendations 9 and 10). NERC has, of course, also provided training to employees on the use of the new time and expense reporting system (Recommendation 11).

However, NERC disagrees with other findings and recommendations in this area, as well as with the tone of some of the discussion in the Draft Report, and with the incomplete or inaccurate manner in which the Draft Report presents the underlying "facts" supporting its findings and recommendations. One area in which NERC acutely disagrees with the Draft Report's discussion and recommendations involves the need and appropriateness to obtain Commission approval, between the annual business plan and budget filings, to (1) expend more funds on budgeted activities that are proving to require more expenditures than budgeted, whether those additional funds come from working capital reserves or from spending less than was budgeted for other activities, and (2) expend funds on new activities, within the scope of a Program Area, that were not included in the most recent annual budget but that emerge as necessary as the budget year unfolds but can be funded with available working capital.

NERC also wishes to emphasize at the outset that Audit Staff appears to recognize that its concerns relate to the process the Commission itself has approved in reviewing NERC's budgets, not whether NERC's budget process complies with NERC's Rules of Procedures or prior Commission orders:

> NERC has a budget development and review process that allows the active participation of its BOT, the Commission, and stakeholders. The process is iterative and permits the BOT, the Commission, and stakeholders to offer input. While audit staff recognizes the current budget development and review process is consistent with NERC's Rules of Procedure, we believe that there are several areas where increased transparency could improve budget formulation, administration, and execution to achieve improved performance as the ERO. (Draft Report at 25.)

A. <u>NERC Budget Process</u>

As an initial matter, the Draft Report refers in numerous places to the need for stakeholders to approve NERC's budgets and any deviations from its budgets. *See, e.g.*, Draft Report at 23, 27, 28. While stakeholders (specifically, NERC Members, the NERC Member

Representatives Committee ("MRC") and the NERC Standing Committees) have numerous opportunities to provide, and do provide, advice and input on NERC's proposed budgets through the NERC budget development process, stakeholders do not approve NERC's budgets. NERC's budgets are approved by the NERC Board and then by the Commission. *See* Article XIII, sections 2, 4 and 6 of the NERC Bylaws, and Sections 1103.1 and 1105 of the NERC Rules of Procedure.

The Draft Report acknowledges that NERC's "current budget development and review process is consistent with NERC's Rules of Procedure." Draft Report at 25. NERC's annual process for developing its business plan and budget and those of the Regional Entities is in fact extremely open and transparent. It includes posting of NERC's goals and objectives and the NERC and Regional Entity common the business plan and budget assumptions for stakeholder comment, posting of drafts of the NERC and Regional Entity business plans and budgets for stakeholder comment, and presentation and discussion of the proposed business plans and budgets at open meetings of the NERC Board Finance and Audit Committee ("FAC"), the MRC and the full Board of Trustees.[23] Stakeholders have the opportunity to listen to and participate in all of these meetings and to attend the Board meetings.[24] NERC also holds meetings and conference calls with stakeholders and stakeholder groups during the budget development process to discuss the draft budgets and receive comments. NERC and the Regional Entities also meet with Commission budget staff to review drafts of the business plans and budgets. During each business plan and budget preparation cycle, several successive drafts of the business plan and budget are typically posted in the NERC website for review and comment. NERC's annual business plan and budget filings include a discussion of the process that was employed to develop the NERC and Regional Entity business plans and budgets, including the stakeholder participation opportunities.[25]

Nevertheless, NERC agrees with the recommendation that its annual budget filings can be improved by increasing the granularity of the budgets, specifically by breaking out certain budgeted expenses, such as contractor and consultant expenses, into more detailed cost categories. (Recommendation 4.) NERC also agrees that any increase in the granularity of the budgets should be matched by comparable increased granularity in the annual true-up filings. (Recommendation 5.)

However, NERC disagrees with the Draft Report's discussion and recommendations that would place limits on management's ability to reallocate budgeted funds from one budgeted activity to another as needs require, or to new activities that were not anticipated in the business plan and budget but must, based on changing circumstances, conditions and requirements, be initiated during the year, or to use working capital reserves for these purposes, and would require

[23] *See* responses to Data Request No. 1, Set Request No. 1, Question No. 12, and Data Request No. 1, Set Request No. 2, Question Nos. 20, 28 and 29.

[24] Additionally, after the business plan and budget is filed with the Commission for approval, the Commission provides an additional comment period for interested parties.

[25] *See, e.g.*, *Request of the North American Electric Reliability Corporation for Acceptance of its 2012 Business Plan and Budget and the 20012 Business Plans and Budgets of Regional Entities and for Approval of Proposed Assessments to Fund Budgets*, Docket No. RR11-7-000, filed Aug. 24, 20011 ("2012 ERO Budget Filing"), at 13-16.

NERC to obtain Commission approval for such actions. Rather, the ability to devote a greater amount of funds to activities that require more expenditures than was anticipated in the budget, so long as those activities (be they budgeted or unbudgeted) are appropriately within the scope of NERC's statutory programs, is an ordinary and necessary exercise of management discretion. Requiring NERC to obtain Commission approval for deviations from strict application of the specific amounts of budgeted funds to the specific budgeted activities, where an increase in overall funding and assessments from that presented and approved in the annual business plan and budget is not needed, would be a costly and burdensome administrative exercise and would hamstring management's ability to manage NERC's activities in response to changing circumstances, conditions and requirements.

The Draft Report's discussion and recommendations on this topic manifest a lack of appreciation of the difficulty of foreseeing and identifying in detail all the activities that will need to be performed and costs that will need to be incurred during the budget year to carry out NERC's ERO responsibilities, in light of the very long lead time for preparation and submission of the annual business plan and budget in accordance with Commission requirements. The Commission's regulations require NERC to file its annual business plan and budget by on or about August 24 each year for the following year.[26] In order for NERC to submit a final, approved business plan and budget to the Commission by this deadline, NERC must commence business plan and budget preparation late in the second preceding year and must essentially complete preparation of the business plan and budget by July of the preceding year.[27] As a practical matter, it is impossible to accurately identify, 18 or more months in advance, all costs and activities that will be required to carry out NERC's responsibilities as the ERO over the course of the budgeted year. Rather, it is inevitable that the budget for some activities will not be fully spent, the budget for other activities will need to be exceeded, and that new, unforeseen needs and activities will arise and have to be carried out.

The Draft Report's recommendations that NERC should be required to seek Commission approval to spend funds on budgeted or unbudgeted statutory activities from working capital reserves, or from funds that were not required to the full extent budgeted for other activities, would result in the Commission micro-managing NERC's activities, is unworkable, and lacks foundation in the Commission's regulations and orders. It is unworkable because any such filings would require preparation time at NERC, an opportunity for stakeholder comment, NERC Board approval, a petition filing with the Commission, and issuance of a Commission order. It is unrealistic to think that this entire process would take any less than four months; most likely, it would take longer. In the meantime, NERC would be unable to continue budgeted statutory activities for which the amounts specifically budgeted had been exhausted, or to engage in a statutory activity that had not been reflected in the annual budget – for example, perhaps the investigation of a significant BPS event.

Further, such a process is not provided for in the Commission's regulations. The Draft Report states that Audit Staff "believes that NERC should use the Commission-approved process set forth in section 39.4(d) of the Commission's regulations for requesting annual funding for

[26] 18 C.F.R. §39.4(b).

[27] The Regional Entities must complete their business plans and budgets even earlier than this, so that may obtain approval of their respective boards prior to submitting their business plans and budgets to the NERC Board for approval.

projects that are initiated or completed outside of the budget cycle. Draft Report at 26. The Commission's regulation at 18 C.F.R. §39.4(d) actually specifies that:

> On a demonstration of **unforeseen and extraordinary circumstances requiring additional funds** prior to the next Electric Reliability Organization fiscal year, the Electric Reliability Organization may file with the Commission for **authorization to collect a special assessment**. Such filing shall include supporting materials explaining the proposed collection in sufficient detail to justify the requested funding, including any departure from the approved funding formula or method. After notice and an opportunity for hearing, the Commission will approve, disapprove, remand or modify such request. (Emphasis added.)

Thus, the only process for budget amendment filings between the annual filings provided for in the Commission's regulations requires (1) unforeseen and extraordinary circumstances, (2) a need for additional funds for the ERO, and (3) a need for the ERO to collect a special assessment from LSEs. This procedure is not applicable or available where NERC simply needs to use working capital funds, or funds budgeted for one activity but not fully needed for that activity, for another statutory activity (whether or not originally included in the annual budget). Further, although the Draft Report cites §1108 of the NERC Rules of Procedure in its recommendation (Recommendation 3), §1108 is based on, and is intended to be coterminous with and implement, §39.4(d) of the Commission's regulations. Moreover, Article XIII, section 5 of the NERC Bylaws provides for development and Board approval of a "modified or supplemental funding mechanism" if additional funds are required between annual budgets.

Finally, with respect to the use of working capital funds for emerging, unbudgeted activities or for budgeted activities that require more funds than budgeted, this is specifically one of the purposes of maintaining working capital reserves. The Commission has stated that "working capital reserves provide readily available funds, which are available without a charge for or restriction on their use, to meet unforeseen expenditures."[28] The Draft Report's statement that "Audit staff believes that working capital should be used to cover short-term operating cash flow concerns due to timing differences between when expenses are paid and when funding is received (Draft Report at 26) is inconsistent with this Commission pronouncement. While NERC agrees it is important to have funds available to cover cash flow needs, it is also necessary to have funds available for contingencies. The Draft Report's recommendation appears to recognize this but recommends that working capital funds for contingencies be specifically budgeted.

With respect to transparency in its reallocation of budgeted funds among projects and its use of working capital reserves, NERC points out that management prepares quarterly variance (actual to budget) reports, including explanations for significant deviations, for the NERC FAC. These reports are posted on the NERC website, are discussed at open, quarterly meetings of the FAC, and are available to stakeholders and the Commission staff.[29]

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[28] 2010 ERO Budget Order at P 24.

[29] The quarterly variance reports are posted on the NERC website as part of the agendas for the quarterly meetings of the FAC, at: http://www.nerc.com/filez/finance.html.

The Draft Report's discussion of its principal example of NERC's use of working capital reserves and "unused funding" for purportedly "unbudgeted" activities – the substantial completion of NERC's headquarters office relocation, data center relocation, and Washington, D.C. office relocation in 2011 (Draft Report at 25-26), is incomplete and incorrectly depicts management as acting in isolation and without oversight to complete these projects.

The plans to relocate NERC's headquarters from Princeton to Atlanta, and to expand the Washington, D.C. office, were justified internally, including Board approval, and the plans and the basis for the decisions were extensively described in the 2011 Business Plan and Budget filing,[30] which was accepted by the Commission. Extensive documentation of the analysis and of the basis for the decisions to relocate the headquarters office, to choose Atlanta, to relocate its Washington office, and to relocate its data center, was provided to Audit Staff.[31] The Draft Report has not raised any question that the decisions to relocate the headquarters to Atlanta and to expand the Washington office, or to relocate the NERC data center, were not appropriate and fully justified.[32]

With respect to the specific discussion of the office relocations and expansion in the Draft Report, NERC agrees that, as set forth in its financial statements (and therefore readily apparent to all observers, including the Commission, prior to the audit), NERC's 2010 year end working capital reserves increased significantly over the projected working capital reserves for 2011. The significant increase in working capital reserves was generated primarily from unused funds, resulting from such factors as (as noted above), the lag in hiring new employees to fill open budgeted positions by the dates assumed in the approved budgets, or the unexpected departure of existing employees, resulting in unfilled positions. NERC also acknowledges that it used monies included in its working capital reserves to pay for the relocations and expansion. NERC disclosed in its 2011 Business Plan and Budget filing that it would use working capital reserves to fund relocation costs over and above what was included in the budget.[33] NERC also agrees that in its 2011 Business Plan and Budget filing, it stated that the budget included expenses in 2011 for the relocation totaling $1,175,000, including $200,000 in moving expenses, $750,000 in unspecified relocation expenses, and $225,000 in startup costs for the data center relocation.[34]

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[30] *Request of the North American Electric Reliability Corporation for Acceptance of its 2011 Business Plan and Budget and the 2011 Business Plans and Budgets of Regional Entities and for Approval of Proposed Assessments to Fund Budgets*, Docket No. RR10-13-000, filed Aug. 24, 2010 ("2011 ERO Budget Filing"), at 48-51.

[31] *See* responses to Data Request No. 1, Set Request No. 1, Question No. 19; Data Request No. 1, Set Request No. 2, Question Nos. 35, 36 and 37; Data Request No. 2, Set Request No. 1, Question No. 51; Data Request No. 2, Set Request No. 2, Question No. 61; Data request No. 4, Question No. 111; Data Request No. 5, Question No. 118; and Data Request No. 6, Question No. 143.

[32] Documentation was also provided regarding the competitive processes NERC followed in designing, procuring and managing the buildout of the Atlanta and Washington offices and relocating the data center. *See* responses to Data Request No. 2, Set Request No. 2, Question Nos. 66, 78 and 79.

[33] 2011 ERO Budget Filing at 51 and Attachment 2 at 22.

[34] 2011 ERO Budget Filing, Attachment 2 at 22 and 86.

NERC further spent a total of $6,375,000 (including $747,000 of rent expense that was abated and did not require a cash expenditure) in 2010, 2011 and 2012 on the relocation of its offices and data center in 2011, completing the entire headquarters and data relocation effort and the majority of the Washington, DC, office expansion during that year.[35] NERC specifically pointed out in its 2011 Business Plan and Budget filing that because the decision to relocate to Atlanta was approved by the Board in June 2010 and it was necessary to have the 2011 Business Plan and Budget completed for Board approval in early August 2010 followed by filing with the Commission, "it was not possible to assemble definitive cost estimates for the overall office relocation for inclusion in NERC's 2011 Budget."[36]

NERC tracked and reported the amount of expenditures on the relocations and expansion as part of its variance reports, which were discussed in open session during quarterly meetings of the Board FAC. NERC provided Audit Staff with an analysis of NERC's accounting records showing that approximately $3,278,000 of NERC's additional expenditures over the budgeted amount to fund the relocation came primarily from excess working capital reserves available at the beginning of 2011.[37] NERC notes that the Draft Report does not contend, and the analysis NERC provided to Audit Staff does not show, that the office relocations and expansion were funded by diverting funds away from other budgeted activities in a manner that left any other budgeted activities under-funded. In fact, performance reports and other documentation provided to Audit Staff showed that notwithstanding the expenditure of substantial working capital funds on the office relocations and expansion, NERC met its corporate and departmental goals in 2010 and 2011.[38]

As NERC explained to audit staff, NERC elected to use working capital reserves to complete the office relocations and expansion in 2011 for these reasons:

- to accommodate the hiring of budgeted and replacement (for those choosing not to relocate) staff positions into permanent space rather than attempting to hire and place them in Princeton (if even possible given the office relocation planning) or allowing them to work remotely until the new space was available;

- due to the space limitations in the existing Washington office space;

[35] Response to Data Request No. 6, Question No. 143. The $6,540,000 figure stated at page 26 of the Draft Report was a preliminary figure as of September 15, 2011, that NERC provided to Audit Staff and included estimates of costs for work not yet completed or fully recorded.

[36] 2011 ERO Budget Filing at 50.

[37] *See* responses to Data Request No. 2, Set Request No. 1, Question No. 49; Data Request No. 5, Question No. 119; and Data Request No. 6, Question No. 144. The quarterly variance reports are included with the agendas for the FAC meetings which are available on the NERC website at: http://www.nerc.com/filez/finance.html.

[38] *See* response to Site Visit No. 1, Request for Data, Category No. 15, and response to Data Request No. 6, Question No. 130.

- NERC's existing data center (the relocation of which accounted for $1,953,000 of the aggregate cost of these projects[39]) was outdated, did not contain back up power or sufficient fire protection; and
- once the relocation was announced, accomplishing the relocation quickly would minimize disruptions to the organization and accelerate the benefits of the overall office relocation strategy, which had been reviewed and endorsed by NERC's Board.

The Board specifically reviewed and approved management's plans for the office relocations and expansion, and was kept informed of management's initiatives to accelerate these projects to complete them in 2011.

NERC rejects any suggestion that it did not attempt to be transparent with the Commission with respect to its office relocation and expansion plans. As noted above, the plans to relocate the headquarters and to expand the Washington office, and the basis for those decisions, were described in NERC's 2011 Business Plan and Budget filing. Prior to that filing, on July 16, 2010, NERC's Chief Financial and Administrative Officer ("CFAO") contacted Commission budget staff (with whom NERC interacts frequently during the budget preparation process) to arrange a meeting to provide staff with background on the office relocation, the rationale behind it, preliminary thinking on costs, and how NERC planned to manage the cost of relocation. The CFAO indicated it was NERC management's desire for Commission staff to understand the rationale behind the move, how it fits with NERC staffing and resource needs, and NERC's commitment to do it in a manner which would not adversely affect, and would in fact enhance, NERC's ability to successfully perform its responsibilities as the ERO. NERC's CEO, CFAO, and General Counsel subsequently met with Commission budget staff on September 23, 2010 and provided further information regarding the relocation, the fact that only some costs would be contained in the 2011 budget, that additional costs would be paid for out of working capital, and that the relocation would be staged in a manner so as not to jeopardize the budget or funding of statutory program area activities. After this meeting, no further information was requested by Commission staff regarding the relocation. However, actual and projected budget impacts of the relocation were included in the quarterly variance reports that NERC posted on its website and reviewed at open meetings of the NERC Board Finance and Audit Committee.

Focusing on the Draft Report's specific recommendations with respect to the budget process, NERC does agrees that greater granularity and detail in its business plans and budgets and in its annual true-up reports would be appropriate, and also that it would be appropriate to develop and implement additional procedures and controls with respect to the use of working capital reserves. NERC submits that Recommendations 1 through 5 should be revised to read as follows:

1. Establish more robust procedures and controls over NERC's use of working capital reserves. [No change from the Draft Report.]
2. Continue to make improvements in budget transparency that informs the Commission, the Board of Trustees and stakeholders concerning the expenditure of funds approved for specific budgeted statutory activities on unbudgeted activities, and

[39] Response to Data Request No. 6, Question No. 143.

develop and obtain Board approval of enhanced guidelines governing such expenditures, including criteria for determining when Board approval is required.[40]

3. [For the reasons discussed above, this recommendation is unnecessary and inappropriate and should be deleted in its entirety.]

4. Increase the granularity of the NERC budget filings by: (1) breaking out budgeted expenses, such as budgeted contractor and consultant expenditures, into more detailed cost categories; and (2) separating working capital reserves needed for operations from working capital reserves needed for contingencies and identifying those contingencies to the extent they are known during business planning.

5. Increase the granularity of the NERC true-up filings in line with the budget filings. [No change from the Draft Report.]

B. <u>Time Reporting and Accounting System</u>

Turning to the Draft Report's discussion of NERC's time reporting and accounting systems (Draft Report at 34-38), NERC rejects the characterization that NERC "failed" to track time and attendance on a project-specific basis or properly classify expenses in its accounting system at a level that provided sufficient transparency to permit effective budget oversight; or that NERC has "deficiencies" or "shortcomings" in this area. Draft Report at 34. The Draft Report cites no Commission requirements that NERC "failed" to comply with. To the contrary, NERC has recorded costs in accordance with its System of Accounts that was submitted to and approved by the Commission early in NERC's tenure as the ERO. NERC submitted its System of Accounts (which was also to be used by the Regional Entities, as well as by NERC) to the Commission in a filing date April 1, 2008. In that filing, NERC stated that:

> From a financial accounting and reporting perspective, the NERC System of Accounts provides a sufficiently detailed set of Functional Categories and Accounts to result in proper recording of income and expenses by function/activity and type. For example, each item of expense received or incurred by NERC or a Regional Entity (e.g., invoices received for services and products, disbursements for salaries, payroll tax payments and medical benefits, and so forth) must be coded by Functional Category and Expense Account and then recorded accordingly in the entity's general ledger. In addition, proper charging of Personnel Expenses (including Salaries, Payroll Taxes, Employee Benefits and Savings and Retirement expenses) incurred by employees whose activities involve more than one Functional Category is typically supported by a daily or other periodic time reporting system in which the employee is required to report the number of hours or percentage of his/her time spent during the reporting period on activities in each Functional Category.[41]

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[40] The need for such procedures has been discussed in recent meetings of the NERC Finance and Audit Committee, and will be on the agenda for the May 2012 FAC meeting. *See also* response to Data Request No. 2, Set Request No. 2, Question No. 69.

[41] *Additional Compliance Filings of the North American Electric Reliability Corporation in Response to October 18, 2007 Order*, Docket No. RR07-16-1, filed April 1, 2008, at 7.

In that filing, NERC not only submitted the proposed System of Accounts, but also provided a detailed description of the System of Accounts.[42] The Commission issued an order accepting the NERC System of Accounts, with no directives for further changes to or additional detail in the System of Accounts.[43]

The Draft Report quotes a portion of the above-quoted excerpt from the April 1, 2008 filing – "proper charging of Personnel Expenses (including Salaries, Payroll Taxes, Employee Benefits and Savings and Retirement expenses) incurred by employees whose activities involve more than one Functional Category is typically supported by a daily or other periodic time reporting system in which the employee is required to report the number of hours or percentage of his/her time spent during the reporting period on activities in each Functional Category" – and states that NERC did not implement a "time-reporting system" as described in the filing. Draft Report at 34-35. However, the Draft Report takes the quoted passage out of context and thereby draws an incorrect conclusion. In the context of the discussion in the April 1, 2008 filing, NERC was generically describing the types of procedures used by NERC and the Regional Entities. The reference to "typically supported by a daily or other periodic time reporting system . . ." was a general description of the systems used by the nine organizations, not a specific description of a system that NERC used or intended to use.[44]

In addition to implementing and following the System of Accounts as approved by the Commission, NERC has established financial reporting policies and procedures for the preparation of internal and external financial reports, accounting policies and procedures for billing and collection of assessments, handling funds received and expended by the corporation, maintaining inventory records of NERC's personal property, payroll management and processing, timekeeping, and lobbying activities. NERC's policies and procedures include:

1. A chart of accounts approved by the Commission that includes account numbers for assets, liabilities and expenses, and program or department codes for accumulating costs by the five statutory programs as defined by the Rules of Procedure and administrative program areas.[45] NERC has also established a set of subsidiary department codes to provide increased granularity and accumulate expenses based on the responsibilities within the department.

2. Process documentation for each of the functions or areas of (i) Billing, Revenue Recognition and Cash Receipts, (ii) Cash Disbursements, (iii) Payroll, (iv) Fixed Assets, (v) Delegations of Authority for Purchasing Goods and Services, (vi) Procurement Policy, (vii) Request for Contract Authorization, (viii) Reimbursement of Relocation Expenses, and (ix) Accounting for Lobbying Activities and Associated Expenses, defines the process, describes the separations of duties, identifies proper

[42] *Id*. at 5-7.

[43] *Order Conditionally Accepting Compliance Filing*, 123 FERC ¶ 61,282 (2008).

[44] Audit Staff's concern that NERC had not adopted a timekeeping system of the type described in the April 1, 2008 filing was not raised with NERC during the on-site audit.

[45] *See* response to Data Request No. 1, Set Request No. 1, Question No. 17.

authorizations for transactions, identifies risks of fraud and/or inaccurate accounting, and the controls established to prevent or mitigate the risk.[46]

To ensure costs are properly classified, reviewed, approved and presented accurately in NERC's accounting system, the following processes are documented and followed:

1. Contracts
    1. Require the consent of the CFO and legal review prior to execution
    2. Are evaluated for inclusion in the budget and/or availability of funding
    3. Default account codes are established at the time of vendor setup to ensure proper classification
    4. All invoices are reviewed and approved by the Program director prior to payment, and require the signature of the controller or CFO for invoices up to $5,000 and the controller and CFO for invoices over $5,000.
2. Payroll and Timekeeping
    1. All new employee payroll setups, adjustments to salaries, and payments upon termination as well as normal payroll transactions are reviewed and approved by the Controller prior to payment.
    2. Employees are assigned to the "sub-department" codes for proper recording. Assigned sub-department codes are reviewed and approved by the controller.
    3. Entitlements within the payroll system have been set to ensure separation of duties to prevent inappropriate payments.
    4. NERC implemented a new timekeeping system in January, 2012, which is linked to its payroll system, that requires each employee to submit timesheets on a timely basis.
3. Employee Travel Expenses
    1. All employee travel expenses are approved by the employee's supervisor.
    2. Three (3) members of the Accounting and Finance Department staff audit expense reports for compliance with NERC's Travel and Expense Reimbursement Policy and for receipts supporting all transactions.
    3. The Senior Accountant further reviews all transactions for compliance with NERC's Travel and Expense Reimbursement Policy and for proper classification by account and sub-department code prior to posting to the general ledger.
4. Billing of Assessments and Cash Receipts
    1. The senior accountant and Controller review the quarterly assessment billings to ensure consistency with the approved budget
    2. The Controller reviews outstanding accounts receivable on a weekly basis with the accounts receivable specialist to ensure timely payment of all billing

[46] *See* responses to Data Request No. 1, Set Request No. 2, Question Nos. 26 and 33; Data Request No. 2, Set Request No. 1, Question Nos. 44 and 54; and Data Request No. 6, Question No. 135; and responses to Site Visit No. 1 Data Request, Category Nos. 14, 17 and 18.

5. Lobbying Activities and Associated Expenses
    1. With the implementation of the new timekeeping system in January, 2012, employees record the hours spent preparing for and engaging in activities that may be considered as lobbying. All entries are reviewed by the General Counsel and costs associated with the employee's time are accumulated and reported by the Controller.
    2. Expenses associated with lobbying activities are identified in the expense system on separate expense reports for inclusion in the quarterly lobbying report.

In addition to the above-described processes, the senior accountant and Controller prepare monthly variance reports by sub-department and review variances with the Program directors, the CFAO and the CEO. As noted earlier, quarterly variance reports are also prepared and reviewed by the FAC and the full Board. The monthly and quarterly variance reports include analysis of year-to-date actual to year-to-date budget and year-end projected results to the total budget at the Program and sub-department level.[47] Further, NERC's annual budgets are developed at the same sub-department level, but are summarized at the statutory Program level to be consistent with the Rules of Procedure (§1103).

Although NERC has extensive accounting policies, procedures and processes in place, as described above, NERC acknowledges that it does not have a single-source, comprehensive accounting manual in which all the policies, procedures and processes can be located. NERC will develop such a comprehensive manual, in accordance with Recommendation 15 (Draft Report at 14).

As the Draft Report notes (p. 36), NERC has recently procured and implemented a new time-tracking system with the functionality to track employee time by project and department, and with the functionality to create and activate activity codes to allow time to be reported by specified activities.[48] NERC has also trained, and continues to train, employees in the use of the new system. NERC believes that the acquisition and implementation of the new system thus far satisfies Recommendations 9 and 11. NERC has not set up the time reporting system to allow for recording time on non-statutory activities, since NERC does not, and does not intend to, engage in non-statutory activities. With respect to implementing activity codes in its accounting system, or acquiring yet another accounting system with project accounting capabilities as recommended in the Draft Report, it is not clear that for an organization the size of NERC, and given the benefits its anticipates from utilizing the additional functionality of its new time accounting system, that the cost of designing, procuring, installing, operating and maintaining an activity-based accounting system would be justified by the additional benefits it would provide. NERC believes that an activity code-based accounting system should not be implemented until it is established that it is justified on a cost-benefit basis, and that NERC should first fully implement and realize the capabilities and benefits of its new time accounting system prior to analyzing the costs and benefits of procuring and installing yet another completely new accounting system with additional functionalities.

[47] *See* responses to Data Request No. 2, Set Request No. 1, Question Nos. 48 and 49, and Data Request No. 5, Question Nos. 119 and 144.

[48] *See* response to Data Request No. 4, Question No. 117.

In summary, the Draft Report's recommendations on Time Reporting and Accounting System should be revised to read as follows:

9. Continue implementation of a time reporting system with the functionality to track employees' time based on the amount of time spent on functional activities or key specific projects.

10. Develop and implement more comprehensive policies and procedures governing employee time reporting and tracking.

11. Provide training to NERC employees on the proper use of the new time reporting system. [No change from Draft Report.]

12. [This recommendation, as presented in the Draft Report, should be deleted; it is effectively replaced by revised Recommendation 13.]

13. As part of its business plan and budget, in 2013 conduct a cost-benefit analysis of implementing project level budgeting and accounting systems. [This is a complete replacement of Recommendation 13 in the Draft Report.]

14. Improve automated controls in its accounting system, such as flags and alerts.

15. Establish a comprehensive, single-source accounting manual consisting of comprehensive accounting policies, procedures, controls, guidance, and other materials to ensure costs are properly classified, reviewed, approved, and presented accurately in NERC's accounting system, financial statements, and budget filings.

C. <u>NERC Oversight of Regional Entity Budgets</u>

NERC disagrees that its current processes for reviewing Regional Entity budgets are "inadequate" and "lack appropriate qualitative procedures to efficiently and effectively assess" the Regional Entities' annual budgets. Draft Report at 5 and 30. NERC has an extensive, thorough and transparent process for reviewing, and requesting revisions to, the Regional Entities' annual business plans and budgets before they are submitted to the NERC Board and to the Commission for approval.[49] However, as discussed below, NERC agrees that Audit Staff has identified one specific aspect in which NERC's processes for reviewing the Regional Entities' business plans and budgets can be improved.

Before getting into the specifics of the Regional Entity budget development process, NERC notes that the Draft Report gives the impression that the only oversight NERC exercises over the Regional Entities' activities is through the business planning and budgeting process. That would be a very inaccurate impression. NERC's statutory Program Area personnel engage in ongoing contacts with and oversight of the activities of their Regional Entity counterparts, including regional standards development, compliance monitoring and enforcement, and regional assessments of the reliability and adequacy of the Bulk Power System. At the senior executive level, the ERO Executive Management Group, comprised of the chief executive officers and

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[49] *See* responses to Data Request No. 2, Set Request No. 2, Question Nos. 83, 84, 85, 86, 87, 88, 89, 90 and 92; and responses to Site Visit No. 1 Data Request, Category Nos. 11 and 37.

associated management staffs of NERC and the eight Regional Entities, provides strategic policy guidance and operational direction for the activities of the ERO enterprise (NERC and the Regional Entities) through joint decision-making to execute the Regional Entities' responsibilities under the delegation agreements and the NERC Rules of Procedure. As part of its efforts to ensure efficient and effective use of resources while executing the statutory responsibilities of the ERO across the ERO enterprise, the ERO Executive Management Group also manages a series of working groups and subcommittees, including:

- Regional Standards Group
- Certification and Registration Working Group
- ERO Compliance & Enforcement Management Group
- Compliance Monitoring Processes Working Group
- Enforcement, Sanctions and Mitigation Working Group
- CIP Compliance Working Group
- Training and Education Group
- Reliability Assessments and Performance Analysis Group
- Legal Working Group
- Information Management Group
- Information Technology Steering Group
- Regional Communicators Group
- ERO Finance Group

As the names of these working groups and subcommittees suggest, they are typically comprised of one or more NERC managers in the particular substantive (statutory program) or administrative function and his or her counterparts at each Regional Entity. The ERO working groups and subcommittees are actively engaged in achieving the goals and objectives of the ERO enterprise, as set forth in the business plans and budgets, delegation agreements, and Rules of Procedure. The working groups and subcommittees operate pursuant to approved charters or scope documents and work plans and have specific deliverables. They are charged with making informed decisions regarding the efficient use of NERC and Regional Entity resources and industry resources. Each work group or subcommittee periodically delivers reports of its activities to the ERO Executive Management Group.

Turning specifically to the development of the Regional Entity business plans and budgets, NERC currently has a formal, detailed, extensive, and iterative review process for Regional Entity budgets, culminating in approval by the NERC Board before submission to the Commission. The Draft Report recognizes that, as is the case for NERC's processes for developing its own budgets, NERC's method of reviewing the Regional Entity budgets is in accordance with the NERC Rules of Procedure. Draft Report at 32. During the budget development period stretching from late in the second year preceding the budget year to July of the preceding year, NERC Finance and Accounting staff works with the Regional Entities on business plan and budget development on an ongoing basis. NERC's review process focuses particular attention on the following areas:

- Developing common goals, together with common business plan and budget assumptions, to be used by NERC and all the Regional Entities.
- Ensuring that each Regional Entity's business plan and budget is presented using the common format or template, with all information required by the template provided.
- Ensuring that each Regional Entity's business plan and budget provides adequate explanations of the reasons for budget and staffing increases, by program, compared to the previous budget.
- For those Regional Entities that have non-statutory activities, ensuring appropriate separation of statutory and non-statutory costs, including allocation of general and administrative costs to the non-statutory functions where appropriate.
- Ensuring the Regional Entity budgets include adequate provision for Working Capital Reserve with an explanation where appropriate for proposed increases or decreases.
- Ensuring overall clarity of the narrative presentations and explanations in the business plan and budget documents.

Over the past several years NERC has been working closely with the Regional Entities to coordinate business plan and budgeting efforts, including the development of common goals, objectives, business plan and budget assumptions, and long term budget forecasts. Here too the Draft Report recognizes that "in recent budget cycles NERC has improved consistency by coordinating with Regional Entities to develop a common set of assumptions." Draft Report at 32. Additionally, the process includes providing proposed budget changes and recommendations to the Regional Entities at various points in the budget development process, and steps have also been taken to provide the Regional Entities with NERC input earlier in the business plan and budgeting process. The draft Regional Entity business plans and budgets are presented to the Commission's budget staff in May of each year, three months before they are formally filed with the Commission for approval. Additionally, the draft Regional Entity business plans and budgets are reviewed with the Finance and Audit Committee of NERC's Board in meetings of that Committee. NERC will continue to work with the Regional Entities to further improve NERC's review of and input to the draft Regional Entity business plans and budgets. With respect to the timing of NERC input, and in consideration of Recommendation 8, NERC's objective will be to improve the input it provides to the Regional Entities as they initially formulate their business plans and budgets, so that the initial drafts can reflect NERC management input and guidance.

The Draft Report states that "NERC should address the significant costs incurred by the Regional Entities for processing compliance violations," and that "[g]reater qualitative oversight in this area may improve the efficiency and effectiveness of the process, yielding significant savings for the ERO." Draft Report at 32-33. But NERC has in fact taken significant steps, which the Draft Report ignores, to address the costs incurred (as well as the amount of time spent) by the Regional Entities for processing compliance violations, by implementing the "Find, Fix, Track and Report" ("FFT") and the "Spreadsheet Notice of Penalty" ("Spreadsheet NOP") enforcement alternatives to the development of a full NOP for every Alleged Violation. NERC presented the FFT and Spreadsheet NOP enforcement alternatives to the Commission in a petition filed on September 30, 2011,[50] and the Commission accepted this filing in an order

[50] *Petition Requesting Approval of New Enforcement Mechanisms and Submittal of Initial Informational Filing Regarding NERC's Efforts to Refocus Implementation of its Compliance Monitoring and Enforcement Program*, Docket RC11-6-000, filed Sept. 30, 2011.

issued March 15, 2012.[51] The FFT and Spreadsheet NOP enforcement mechanisms will be used for Possible Violations that pose lesser risk (minimal risk in the case of the FFT) to the Bulk Power System and satisfy other criteria. Where a Possible Violation is dispositioned using the FFT or the Spreadsheet NOP mechanism, the Regional Entity will not have to expend time and resources to the same extent as to develop the documentation required for a full NOP filing; rather, the record is aligned to the risk posed by a given Possible Violation and all relevant information is included in a spreadsheet format. Where a Possible Violation is dispositioned through the FFT mechanism, the Regional Entity will not have to expend the time and resources to negotiate a formal settlement agreement, process a separate formal Mitigation Plan through acceptance and approval, or determine a Penalty or sanction for the violation. The availability of the FFT and Spreadsheet NOP enforcement mechanisms will significantly reduce the total amount of resources expended by the Regional Entities in processing compliance violations. In the FFT Order, the Commission stated that NERC's proposal "will be the first step to a more efficient and effective compliance and enforcement process"[52] and that "we believe that the FFT proposal may significantly reduce the time and resources needed to resolve minor possible violations of Reliability Standards and thereby permit NERC and the Regional Entities to reprioritize their compliance efforts toward more important violations and matters."[53]

Earlier, NERC had adopted other approaches to improve the efficiency of Regional Entity violations processing and dispositioning, including an Abbreviated Notice of Penalty Format, a Deficiency Notice of Penalty Format, and an Administrative Citation Notice format. The Commission has stated that the Abbreviated Notice of Penalty Format and Deficiency Notice of Penalty format "have been successful in increasing efficiency" and that it expected the Abbreviated Citation Notice Format "will be a successful tool in improving the efficiency of NERC's enforcement process, thereby reducing the time and resources expended by the Regional Entities, NERC and Commission staff while still achieving transparency and consistency in penalty determinations for violations that are appropriate for this format."[54] It is surprising that the Draft Report contains no mention of the implementation of the FFT and Spreadsheet NOP enforcement mechanisms, nor of the earlier process streamlining initiatives, since the FFT and Spreadsheet NOP initiatives were probably the most significant and talked-about NERC initiatives of 2011.

The Draft Report also states that there is an "issue" concerning the composition and skills of the Regional Entity CIP audit staffs and that NERC should have addressed this issue through its oversight of the Regional Entity budgets. (In a separate section, on the NERC CIP Program, the Draft Report states that NERC itself has not been adequately staffed to oversee the Regional Entities' CIP compliance audit activities. Draft Report at 66-68.) The data shows that the NERC and Regional Entity Compliance Program and CIP staffs have been extremely active in discovering violations of the CIP standards and the related activity of processing requests for

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[51] *North American Electric Reliability Corporation, Order Accepting with Conditions the Electric Reliability Organization's Petition Requesting Approval of New Enforcement Mechanisms and Requiring Compliance Filing*, 138 FERC ¶ 61,193 (2012) ("FFT Order").

[52] FFT Order at P 41.

[53] FFT Order at P 40.

[54] *North American Electric Reliability Corporation, Notice of No Further Review of Initial Administrative Citation Notice of Penalty*, 134 FERC ¶ 61,157 (2011) at P 7.

Technical Feasibility Exceptions ("TFE"). Most Registered Entities were required to be "auditably compliant" with CIP-002 through CIP-009 in 2010. In 2010 and 2011, a total of 2,511 violations of the CIP standards were discovered, including 772 violations through compliance audits and spot checks. In 2010, eight of the ten most frequently violated standards were CIP standards, and in 2011, seven of the most frequently violated standards were CIP standards. In fact, more than one-half of the violations now being processed are violations of the CIP standards. Further, as reported in NERC's annual report to the Commission on wide area analysis of TFEs, for the period January 1, 2010 through June 30, 2011, NERC and the Regional Entities accepted 3,492 TFE Requests, rejected 448 TFE Requests, accepted and approved 3,369 TFE Requests, and accepted and disapproved 782 TFE requests.[55] These statistics do not evidence NERC and Regional Entity CIP Compliance staffs that are significantly under-staffed, under-qualified or lack direction.

NERC acknowledges, however, that the degree of review and analysis of the sufficiency of the Regional Entity's budgeted resources to carry out their delegated statutory functions, provided by the corresponding NERC statutory function departments, can be improved. Therefore, NERC will implement Recommendations 6 and 7 by providing for increased review, analysis and feedback by/from the NERC statutory function departments of the sufficiency and appropriateness of the resources budgeted by the corresponding departments of the Regional Entities to carry out their delegated statutory responsibilities.

Therefore, NERC submits that the Draft Report's recommendations under NERC Oversight of the Regional Entities' Budgets should be revised to read as follows:

6. Increase the level of NERC review of proposed Regional Entity business plans and budgets, including qualitative and quantitative analysis, with a specific focus on increasing the amount of review provided by NERC's statutory program departments to the business plans and budgets of their counterpart Regional Entity functions.

7. Establish policies and procedures for using information gained and lessons learned from NERC's oversight of Regional Entity operations in the review process for Regional Entity budgets.

8. Provide budget changes and recommendations to the Regional Entities during the earlier stages of the Regional Entity budget process so there is sufficient time to incorporate NERC's recommendations prior to final review and approval of such business plans and budgets by the Board.

V. NERC's Employee and Board Compensation Levels Are Supported by Appropriate Compensation Studies and the Need to Attract Qualified Personnel in a Timely Manner, and its Method of Board Compensation is Appropriate and Justified

Audit Criteria. The only criteria identified by the Draft Report is the requirement in section 215(c)(2) (and the Commission's own regulations) that NERC "has established rules that allocate equitably reasonable dues, fees, and other charges among end users for all activities under this section." Draft Report at 39.

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[55] *See Annual Report of the North American Electric Reliability Corporation on Wide-Area Analysis of Technical Feasibility Exceptions,* Docket RR10-1-001, filed Sept. 28, 2011, at 8-10.

Audit Findings. The Draft Report asserts that NERC used inadequate compensation studies to support the compensation levels paid to its employees, and has not systematically assessed its organizational staffing needs to determine the competencies and skills required of its employees. Draft Report at 5 and 39. The Draft Report also criticizes NERC's employee recruitment practices and questions certain employee retention actions. *Id.* at 47-50. Additionally, the Draft Report questions NERC's move to an annual retainer method of compensating its Board of Trustees. Draft Report at 6 and 56. Finally in the area of compensation, the Draft Report questions certain components of NERC's "pension" plan.[56] Draft Report at 6 and 62.

NERC Response. NERC recognizes that earlier compensation studies performed for it had deficiencies, but in 2011, at the direction and under the active supervision of its Board, NERC contracted with one of the country's leading compensation consulting firms for extensive compensation studies, which have now been completed.[57] The Draft Report's criticisms of the most recent compensation study are unwarranted. Assuming that the ultimate purpose of the audit is to identify improvements to be implemented going forward, the compensation studies initiated by NERC in 2011 and completed in 2012 satisfy Recommendation 17 ("contract for new compensation studies that use comparability data that target the required skill sets and competencies needed to carry out NERC's mission as the ERO"). With respect to systematically assessing its organizational staffing needs, NERC has position descriptions for all its positions, but recognizes the value of periodically performing a systematic assessment of the type suggested by the Draft Report.

NERC's movement to an annual retainer method of compensating its Trustees is also well supported and justified; further, this approach is increasingly being adopted by U.S. corporations, and in fact may now be the prevailing approach.[58] Finally, the Draft Report's criticisms of NERC's "pension" (retirement) plans do not evidence a complete understanding of the plan provisions in question or the related tax law provisions. In any event, NERC has already taken or is taking steps that address some of the Draft Report's concerns in this area.

Moreover, as indicated above, the intrusive nature of the Draft Report's critique and recommendations of NERC's employee and Board compensation levels and practices goes well beyond what Commission precedent indicates is appropriate. In the context of similar organizations as NERC that are subject to Commission jurisdiction, the Commission has largely

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[56] The Draft Report's use of the term "pension plan" to describe NERC's retirement plan is not accurate. NERC does not have a "pension" plan (*i.e.*, a defined benefit plan in which the employer bears the market risk of investments), and has not had a "pension" plan since prior to becoming the ERO. NERC has a defined contribution 401(k) retirement plan for its employees (*i.e.*, a plan in which the employees bear the market risk of the investments in the plan).

[57] *See* responses to Data Request No. 2, Set Request No. 2, Question Nos. 56, 79, 80 and 81; Data Request No. 6, Question No. 131; and response to Site Visit No. 3 Data Request, Category No. 5.

[58] *See* response to Site Visit No. 3 Data Request, Category No. 9; and e-mail provided to Bryan Craig *et al.* on March 21, 2012; Subject: Board Compensation Survey (containing Attachment SSB1_2011_final.pdf).

left the setting of compensation to the discretion of the entity's management and Board. For example, the Commission has stated:

> If the RTO or ISO board is well-informed about the needs of customers and various stakeholders, it will set criteria for performance, appropriate goals and targets for the organization and its management and institute measures for achieving those targets. By focusing our requirements on having a well-informed board, we decline to intrude further into board prerogatives regarding management compensation.[59]

The Commission has also noted that "the proper level of executive compensation is more art than science."[60] Further, the Commission has recognized that for nonprofit corporations such as NERC and the ISOs, there is an independent check on management compensation levels in the form of Treasury (Internal Revenue Service) regulations which require that the compensation paid to executive officers of Internal Revenue Code §501(c)(3) entities meet a standard of reasonableness, defined as compensation that falls within a range of competitive practices for total compensation paid by similarly-situated organizations, both taxable and tax-exempt, for functionally comparable positions.[61] Here, by contrast, Audit Staff has declined to defer to NERC's Board and management and has ignored the real-world evidence that NERC continues to encounter challenges in maintaining even its budgeted number of employees due to competition with industry and government for personnel with the specialized expertise and qualifications that NERC requires. Indeed, the Draft Report actually <u>criticizes</u> NERC for not having sufficient qualified staff in one such highly technical area. Draft Report at 65.

A. <u>Employee Compensation</u>

The Draft Report criticizes the adequacy of compensation studies prepared for NERC between 2007 and 2011, prior to the most recently-completed compensation study which is discussed in detail below. In particular, the Draft Report questions NERC's use of a study conducted in 2010 even though NERC recognized the deficiencies in the study, and ultimately decided to commission a new study to be used going forward. Draft Report at 39-42.

As background to this issue, NERC notes that compensation studies conducted for NERC in 2007 warned NERC that for the foreseeable future, there would be upward pressure on compensation levels for personnel employed in the electric utility industry and by industry associations with which NERC would compete for employees.[62] This expectation was based on a number of drivers including the aging workforce issue, *i.e.*, that a substantial fraction of the electric industry workforce would become eligible to retire over the next 3 to 5 years; and the fact that mandatory reliability standard would become a focus for companies and regulators in the electric utility industry, resulting in increased competition for the types of employees that

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[59] *Wholesale Competition in Regions with Organized Electric Markets*, Order No. 719, 111 FERC Stats. & Regs., Regs. Preambles ¶ 31,281 (2008) at P 561.

[60] *ISO New England, Inc.*, 133 FERC ¶61,247 (2010) at P 37, *citing Blumenthal v. FERC*, 613 F.4d 1142 (D.C. Cir. 2010) at 1147.

[61] *Id*. at P 37.

[62] *See* response to Site Visit No. 3 Data Request, Category No. 5.

NERC would be looking to hire and retain to execute its responsibilities as the ERO. The 2007 study also concluded that cash compensation for NERC's existing positions was below market when adjusted for the new scopes of responsibilities associated with NERC's role as the ERO. The consultant noted that most of the ISOs had adopted a compensation philosophy that approximates the 75th percentile of the national utility sector, to recognize the challenges they face in competing for the available talent in the marketplace. The consultant also noted that, similar to the ISOs and the regional reliability organizations, NERC would require extremely senior, experienced personnel to staff its leadership positions; and that job responsibilities in the NERC organization may span what would be the responsibilities of several positions in a utility, with limited backup staffing available. Further, the study noted that salaries for higher-end positions in the industry, *i.e.* managers and directors, could be expected to increase at a faster rate than for all positions. Based on these and other factors, the study recommended that NERC adopt the following compensation strategy to be competitive: (1) Salary structure that targets the national utility 75th percentile, with broad use of annual incentives but no use of long-term incentives; (2) annual incentive payments that target the 50th percentile of the market; and (3) a threshold/maximum range of ± 50% of target. As a result, NERC began its tenure as the ERO with a compensation strategy that targeted compensation to be somewhat above the average for the market as measured by national utility data, but competitive with ISOs.

As indicated by the Draft Report, NERC was dissatisfied with the compensation study conducted in early 2011, primarily because the consultant did not have data for, and therefore did not include, many representative companies that NERC was recruiting from or targeting to recruit from.[63] The consultant did opine that inclusion of the larger group of companies NERC desired would have only a nominal, 2 to 2.5% impact, which provided some perspective. Although NERC did decide that there was no value to trying to improve this study given the year-end timing of compensation decisions, it was a source of information that needed to be used until a new study could be commissioned and completed. The data in this study generally showed that NERC's compensation was on average above market, with significant variations above and below market for particular positions. The variation was reduced when additional compensation components in the utility industry but not available at NERC, such as stock options and other types of compensation provided by utilities to their employees, were included in the peer group comparison data. Nonetheless, the overall results of the study showed NERC compensation to be on average somewhat above market. However, this result seemed illogical to NERC, because even though it was offering and paying compensation at levels the study indicated in some cases to be above market, NERC was in fact having difficulty recruiting qualified staff and was also losing existing staff to other employers.[64]

In 2011, therefore, at the direction of the Corporate Governance and Human Resources ("CGHR") Committee of the NERC Board, NERC commissioned Mercer Group, Inc., an internationally-recognized compensation consulting firm, to conduct a new, comprehensive set of compensation studies.[65] A principal reason that Mercer was selected to conduct the new

[63] *See* responses to Data Request No. 2, Set Request No. 1, Question No. 38; and Data Request No. 2, Set Request No. 2, Question No. 81.

[64] *See* responses to Data Request No. 1, Set Request No. 2, Question No. 23 and Data Request No. 2, Set Request No. 2, Question No. 56.

[65] The Mercer compensation studies were provided to Audit Staff in the responses to Data Request No. 2, Set Request No. 2, Question No. 80 and Data Request No. 6, Question No. 131.

study, rather than the previous consultant, was the depth of Mercer's data bases. Work on the new compensation studies began in earnest in the third quarter of 2011, under the active oversight of the CGHR Committee, including a December 2011 meeting to discuss the goals and objectives of the studies, the comparison groups to be used, and deliverables to be provided. For example, Mercer representatives were questioned about the inclusion of gas and water utilities in the comparison groups, and Mercer explained the inclusion of these entities as follows:

> We understand a potential concern may be including all Utilities (Gas, Water, Electric, etc.) Mercer's recommendation is to use Utility data, even though non-Electric Utilities are included. This is common practice across our Utility clients which include Gas, Water and Electric companies. Although you may not hire from Water utilities, there are similar jobs in those companies which increases the sample size of data. Overall, we are not seeing a clear difference in the pay levels between the Utilities industry data and the custom comparator list that was created for NERC.[66]

When the studies were completed, the NERC Board met with Mercer in a six-hour meeting (a portion of which was without management present) in February 2012 to review the studies, and then held a meeting with management to give specific direction on how the results of the studies should be implemented. In summary, the Mercer studies were initiated at the specific direction, and were conducted and are being implemented with the active oversight and involvement of, the NERC Board.[67]

As noted, the Mercer studies were completed in early 2012. In this effort, Mercer conducted separate compensation studies relating to NERC executive direct compensation, executive retirement and supplemental benefits, and NERC staff total compensation. As reported in the table on page 41 of the Draft Report, NERC expended approximately $160,000 on these comprehensive studies, which far exceeded the funding for any previous NERC compensation studies conducted from 2007-2011, and in fact exceeded the aggregate cost of the prior studies.

Although Audit Staff may not have reviewed all of the supporting materials for the Mercer studies that were made available to it at the time the Draft Report was issued (see Draft Report at 43), the Draft Report nonetheless raises several questions concerning the Mercer studies. The questions relate to whether the metrics (type and size range of comparison companies) used for comparison in the executive direct compensation study were appropriate; why Mercer did not use the same comparator group to evaluate executive retirement and supplemental benefits that it used to evaluate executive direct compensation; and whether the staff compensation study reflected an adequate understanding of the skill and qualifications required for NERC staff positions. Draft Report at 43. On the basis of these questions, the Draft Report recommends that NERC "contract for new compensation studies that use comparability data that target the required skill sets and competencies needed to carry out NERC's mission as the ERO." *Id*. at 44. The questions raised in the Draft Report concerning the Mercer studies are readily answered, and in any event do not detract from the overall robustness and usefulness of

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[66] *See* response Supplemental Information No. 2 to Data Request No. 6, Question No. 131.

[67] *See* response to Data Request No. 6, Question No. 131; and response to Site Visit No. 3 Data Request, Category No. 2.

the Mercer studies, nor do they support the recommendation to expend ERO resources for another compensation study.

NERC and Mercer worked closely together, using position descriptions and executive interviews, to ensure Mercer had a precise understanding of the skills and competencies required for the officers and staff of NERC to perform the essential functions of their roles. The position descriptions provided to Mercer provided information on the skills and competencies needed for each NERC position. In its interviews with NERC executives, Mercer engaged each executive in discussions of the skills needed by the staff that reported to the executive, obtained clarification on any unique positions, discussed any positions for which the position description may not be representative of the job responsibilities, and gained additional knowledge on where staff talent was recruited from or lost. The interviews helped to document the scope of work, the communications/interactions with internal and external constituents, the breadth of the impact and contribution of the positions to NERC, and the skills that that each position requires. These discussions aided in ensuring that Mercer matched each NERC position to both the correct survey job and to the correct labor market.

For the executive compensation studies, Mercer used (as noted in the Draft Report) two different reference groups to review the compensation levels at NERC. The Primary Reference Group that was used consisted of organizations in which the executives have the same required skill sets and competencies as are required to carry out NERC's mission as the ERO. The organizations in the Primary Reference Group included seven Regional Entities, five ISOs, and the American Public Power Association. Each of these organizations (1) is an organization that NERC has either recruited from, hired from or lost executive talent to, (2) is servicing the utility market, and (3) has responsibilities for governance and oversight over the utility industry. These are characteristics that have direct relevance to the required skill set needed by the NERC executives. The Secondary Reference Group that was used was based on published survey data from two compensation surveys conducted by Mercer and by Towers Watson, another leading compensation consulting firm.

For the staff compensation study, Mercer used two different reference groups to review the compensation levels for the staff at NERC: (i) general industry data for "functional" jobs (*i.e.*, jobs that do not specifically require utility industry expertise) and (ii) utility data for jobs that require utility industry expertise. Mercer performed the initial matches of the staff jobs and then vetted the results with NERC to ensure that Mercer had captured the correct skills, competencies and levels with the survey match selected.

Mercer used publicly available information on compensation from the select group of relevant organizations in the Primary Reference Group to provide relevant and robust compensation data. This data was supplemented with Mercer's knowledge of the ISO market, gained from working with several of the ISOs, and knowledge gained from conducting a custom survey of the ISOs. Further, the Secondary Reference Group was also used in the executive studies to allow NERC to better understand total remuneration (compensation plus benefits), as the benefit data was not available for the Primary Reference Group without contracting with Mercer for a custom survey. As noted, the Secondary Reference Group was based on published survey data from two compensation surveys conducted by Mercer and by Towers Watson. The Mercer survey was based on a broad scope of data from companies in many industries, including public and private companies and nonprofit organizations. This data set provided a reasonable comparison group as a secondary reference source, even though it was not limited to companies in the utility industry, because several of NERC's executive positions require skills that can be found in the executives of companies other than those included in the Primary Reference Group, and it is not essential for every NERC executive to have had experience with a utility or a utility-like organization in order to perform his or her job responsibilities at NERC.

NERC decided not to ask Mercer to conduct a custom survey, based on (i) its high cost, which would have been much higher than the cost of the studies that were performed, and (ii) Mercer's experience that only a limited number of data points may be obtained in a custom survey due to reluctance of many potential respondents to provide information. In other words, NERC determined that it was very unlikely that the results of a custom survey would be sufficiently robust to justify the costs.

As noted, the Draft Report questions the size of the companies included in Mercer's executive direct compensation study, which ranged between $100-$400 million annual revenues. The Draft Report states that whereas the total budget of NERC and the Regional Entities approximates $200 million, NERC's annual budget is only approximately $53 million. Draft Report at 43. However, NERC is in fact responsible for the entire funding and budgets for the Regional Entities' statutory activities. Moreover, NERC engages in substantive oversight over the Regional Entity's statutory activities (all of which are performed pursuant to delegated authority from NERC), including regional standards development, compliance monitoring and enforcement, and regional reliability assessments.[68] Indeed, other areas of the Draft Report recommend that NERC should engage in <u>greater</u> supervision and oversight of the Regional Entities' activities, including substantive development of their business plans and budgets, thereby recognizing that NERC in fact has significant oversight responsibilities for the regional Entities' statutory activities. More importantly, however, a revenue scope of $200 million for comparison companies was targeted because the executive skills and competencies of the organizations in the $100-$400 million range are similar to those required at NERC and at the organizations with which NERC regularly competes for talent. Additionally, to limit the comparison group to companies with annual revenues at or around $50 million could eliminate many of the organizations (such as ISOs) that are most comparable to NERC in terms of their functions, positions in the energy industry, and skills required of their managements and staffs, and which NERC has targeted as companies from which to recruit employees. Finally, the Mercer study was centered on finding the specific <u>positions</u> in this group of companies that are most comparable to the NERC positions being evaluated.

The Draft Report also questions why Mercer used different comparison groups for the executive direct compensation study and the executive retirement and supplemental benefits study. Draft Report at 43. Mercer used its Primary Reference Group as the main source of comparison for the executive direct compensation study and two different sets of published survey data as the secondary reference point. However, there was not enough publicly disclosed data available for the Primary Reference Group to enable Mercer to gain a complete understanding of the benefit programs offered to the executives, and therefore to determine the value of benefits provide to, executives in the Primary Reference Group companies. Therefore, to assess the value of benefits and to determine the competitiveness of total remuneration (base salary, incentive compensation, and benefits) Mercer assessed the total remuneration using the Secondary Reference Group. For this purpose, Mercer used a combination of nonprofit

[68] *See* responses to Data Request No. 2, Set Request No. 2, Question Nos. 83, 84, 85, 86, 87, 88, 89, 90 and 92, and Data Request No. 6, Question No. 139; and responses to Site Visit No. 1 Data Request, Category Nos. 11 and 37.

organizations (revenues \$100-\$400 million, averaging \$200 million) and utility companies (revenues \$1 billion) from its proprietary databases. The nonprofit organization data was the primary comparison for benefits; the utility data was used for informational purposes. The companies included in these surveys are not exactly the same as used for the executive direct compensation study but are consistent with respect to the scope and size. Mercer works with numerous tax-exempt organizations and did not see any substantial difference in benefit programs offered in tax-exempt organizations based on size of the organization. However, Mercer does find that there is a difference between tax-exempt and public/private companies with respect to benefits. The primary driver of the value of the benefits is the fact that at much larger organizations, the base compensation would tend to be higher. Mercer validated that the base compensation levels were not higher at organizations with revenues between \$100-\$400 million and the Primary Reference Group. Thus, the Draft Report's concerns in this area are unwarranted.

The Mercer executive compensation studies found that overall total direct compensation (base pay plus bonus plus long term incentives) for the NERC executives was below the 25th percentile by 11% and below the market median by 23% when compared to the Primary Reference Group. Mercer also found that overall actual total cash compensation (base pay plus bonus) for the NERC executives was 5% below the market median, and that the maximum total cash that could be paid to the NERC executives was positioned just 1% above the market median when compared to the Primary Reference Group. Further, the majority of annual incentive plans have an upside opportunity whereas NERC's incentive program provides for no upside. Thus, the Mercer studies demonstrated that the direct compensation levels for the NERC executives were reasonable as compared to a set of comparable employers.

The Mercer staff total compensation study concluded that NERC's current base salaries are 9% above the 50th percentile with respect to the comparators and 4% below the 75th percentile, with individual pay levels of NERC staff falling below the 25th percentile and above the 75th percentile. Further, for all career levels, base pay and target total cash compensation is below the 75th percentile. For all career levels, total remuneration (*i.e.*, taking into account benefits) is above the 50th percentile and close to the 75th percentile. The somewhat better positioning with respect to total remuneration as compared to base pay is primarily due to (i) the additional discretionary compensation made under NERC's 401(k) plan and (ii) the lower-than-market employee contribution requirements for the medical plan. (In response to these findings, the Board CGHR Committee, in February 2012, directed management to take actions to bring benefits more into line with market.)[69]

Mercer is an expert compensation and benefits advisor from a premier consulting firm and it relies on expertise it has achieved from working with hundreds of organizations. Taking into account both Mercer's expertise and the specific methodologies used (as described above), NERC is confident that the compensation comparisons provided by the Mercer studies are reasonable. In light of the extensive nature and depth of the Mercer compensation studies and the reasonableness of the comparison data used, as detailed above, and the considerable resources NERC expended on them, there is no reason for NERC to now undertake yet another compensation study as recommended in Recommendation 17. NERC does recognize the importance of updating compensation studies and data on a regular, periodic basis, and its Board is committed to doing so. Further, the Mercer executive and staff studies are based on total

[69] *See* responses to Site Visit No. 3 Data Request, Category No. 2 and Category No. 10.

compensation (total remuneration) of employees, which NERC agrees is the most appropriate measure, and therefore the Mercer studies satisfy Recommendation 18.

Additionally, NERC submits that analysis of its actual management compensation increases over the period 2007-2012, which is not presented in the Draft Report, would show that the average management salary increases over this period have been modest. Salary freezes were in effect for senior executives for three of the six years, and for other management employees in some of these years as well.

With respect to Recommendation 16, which is that NERC should conduct a review of its organization to determine the particular skills and competencies that are required to perform the tasks of each position in the organization, this was addressed in part through the work done with Mercer in the performance of its studies, as described above. Further, as noted, NERC has position descriptions for each position in its organization. NERC recognizes the importance of performing or updating this type of analysis periodically.

NERC submits that the Draft Report's recommendations concerning Employee Compensation should be revised to read as follows:

16. Continue to conduct on a routine and periodic basis a thorough review of its entire organization to determine the particular skills and competencies that are required to perform the necessary tasks of each organizational position.

17. Continue to perform routine and periodic updates to employee compensation studies, using comparability data that targets the required skill sets and competencies needed to carry out NERC's mission as the ERO.

18. Continue to use total compensation, and update policies to reflect the use of total compensation as the relevant guideline in assessing salaries, retirement benefits, bonuses and other forms of compensation.

B. <u>Employee Recruitment and Employee Retention</u>

Under "Standard for Determining the Reasonableness of Expenses," the Draft Report criticizes certain practices of NERC relating to employee recruitment and employee retention. Draft Report at 47-50. As with employee compensation, these comments must be considered in the context of the fact that NERC has continuously had challenges in attracting and retaining employees with the skills and qualifications it requires, to fill all its budgeted positions. Further, given the skills and qualifications required for most NERC positions, employee recruitment and retention efforts, in most instances, must be individually focused and negotiated.

The Draft Report criticizes NERC for having only limited formal policies and procedures governing the recruitment of employees. Draft Report at 47-48. NERC acknowledges that it has had only limited formal written policies and procedures in this area, and accepts the recommendation (Recommendation 21) to develop more formalized policies and procedures for employee recruitment. However, NERC cautions that efforts to recruit employees with specialized skills, expertise and experience, such as NERC is often seeking, in an intensely competitive market for the services of such employees, cannot be entirely "rule-based." Rather, significant negotiation is often involved, and it may be necessary for management to depart from the employment offer terms that may be dictated by policy or procedure, in order to successfully recruit a candidate with the desired skills and capabilities.

The Draft Report also describes the recruitment of a particular employee that occurred, and expressed concern that the employee was hired on an "at will" basis and without an obligation to reimburse NERC for certain relocation-related costs that NERC agreed to cover, if the employee did not remain with NERC for at least a minimum defined period. Draft Report at 48. NERC recognizes that a policy of "at will" employment places certain risk on the employer. However, the Draft Report does not acknowledge the potential benefits of the "at will" employment policy, including that the employee may be terminated if he or she is no longer needed or is underperforming, without a need for NERC to determine if there is "cause" for termination under an employment contract or to pay monies or benefits which may be due for termination under the terms of an employment contract. In developing more formalized policies and procedures for employee recruitment, NERC will consider adopting a formal policy requiring the employee to reimburse NERC for relocation-related costs that were paid by NERC, if the employee does not remain with NERC for at least a defined period of time.

The Draft Report discusses the general relocation policy that was made available to all affected NERC employees in connection with the 2011 headquarters relocation from Princeton to Atlanta (which the Draft Report notes "provided sufficient incentives for employees to relocate to their new duty station"), as well as retention bonuses given to a limited number (nine) of employees. The Draft Report also discusses relocation timing requirements that were negotiated with three executives. The Draft Report does not appear to be criticizing the nature or amount of any of these relocation policies or arrangements ("Audit staff is not asserting that NERC should not be able to exercise appropriate managerial discretion in these matters"), but expresses concern that the costs of the relocation policies and payments were not developed through the normal budget process, approved by the NERC Board, or reporting separately in NERC's accounting system as relocation costs. Draft Report at 49-50.

The general relocation policy described at page 49 of the Draft Report offered employees the option to choose a one-time cash payment or reimbursement for <u>certain</u> defined expenses (not "all" expenses) related to moving, including a limited number of house-hunting trips and shipment of personal goods using a qualified national moving company which NERC procured through a competitive process. The relocation (moving expense) program included significant limits on the extent of costs which would be reimbursed, as reflected in the documentation on this topic that NERC provided to Audit Staff.[70] Further, retention benefits for key support staff in the event of a relocation, such as the retention bonuses referred to in the Draft Report, are customary in major relocations such as NERC undertook (or in other situations that raise the possibility that some key employees may need additional incentives not to leave the organization, such as in the period leading up to a sale or merger). Additionally, such benefits are typically maintained as confidential within the organization (so that they are not demanded by additional employees), and in fact the information on retention bonuses was designated as confidential when it was provided to Audit Staff.

The description in the Draft Report of the relocation packages provided to three executives is not accurate. The dates on which these employees were required to relocate from the Princeton office and be required to work full time out of the Atlanta office were negotiated

[70] *See* responses to Site Visit No. 1 Data Request, Category Nos. 14 and 17.

on a case by case basis over a period of months, taking into account the unique facts and circumstances affecting each employee. The date that was established for each of these individuals to be based in the Atlanta office was January 1, 2012. Prior to that date, Princeton was the employees' assigned duty location, and therefore they were reimbursed for travel expenses to the Atlanta office in accordance with NERC's business expense reimbursement policy. This was a very limited and temporary accommodation that was determined to be necessary to facilitate the orderly transition of key personnel. The arrangements for these three employees were negotiated with and approved by the NERC CEO.[71]

NERC does accept Recommendation 21 essentially as presented in the Draft Report, but again states the caveat that in recruitment or retention efforts involving candidates or employees with particular, needed skills, expertise or qualifications, it may be necessary for management to depart from a strictly rule-based approach to what it can offer the employee or candidate.

21. Devise formalized recruitment and hiring policies, procedures, and strategies that address, among other things, controls over the total compensation packages, salary, retention bonuses, benefits, and other accommodations offered to prospective employees. The policies and procedures should also address the qualifications and experience of prospective employees.

C. <u>Board of Trustees Compensation</u>

The compensation of the NERC Trustees was changed to an annual retainer from a per-meeting payment approach, for several reasons.[72] The principal reason was the philosophy, which was fully supported by the Board members, that the objective and purpose of Board compensation is to compensate the Trustees for a full year's work in carrying out their responsibilities as Trustees – not simply to compensate them for putting in the time to attend meetings. The fixed fee annual retainer approach also properly recognizes that a considerable amount of work is required of Trustees, beyond simply attending meetings, in order to carry out their responsibilities. For example, the members of the Board FAC and Compliance Committees must do a considerable amount of reading of materials in order to be prepared for committee meetings.[73] Other reasons supporting the use of the annual retainer approach include:

- To enable NERC to more accurately budget the annual expense for Trustee compensation, since each Trustee's projected compensation would be based on a fixed annual fee. This approach also eliminates the need to dip into working capital reserves to pay the Trustees if the number of meetings, calls and other activities during a year turns out to be greater than was embedded in the budget projections.

- To enable NERC to give potential candidates for current or upcoming Board vacancies a fairly accurate estimate of the compensation the candidate would receive

[71] *See* response to Data Request No. 4, Question No. 107.

[72] *See* response to Site Visit No.3 Data Request, Category No. 9.

[73] The Board of Trustees Compliance Committee reviews all dispositions of Alleged Violations of Reliability Standards, including the determinations of the Penalties to be imposed, and must do significant amounts of pre-meeting reading to carry out these responsibilities.

as a NERC Trustee, to enable the candidate to better evaluate the Trustee position against other opportunities he or she may have.

- To relieve NERC staff of the administrative burden of tracking which Trustees attended which Board, committee, and other meetings, participated in which Board and committee conference calls, and participated in other activities, in order to keep track of the bases on which each Trustee's compensation would be based.

- To remove the incentive inherent in the per-activity approach for more meetings or calls to be scheduled (or, from management's perspective, the inherent incentive to discourage meetings or calls that are otherwise useful in the Trustees' execution of their responsibilities, because "every meeting or call costs us money").

- To eliminate the inequities inherent in the per-activity compensation system in which the same amount of compensation would be paid for a Board or committee conference that lasts 30 minutes as for one that lasts three hours or as for one that requires a full day.

- To enable the Trustees to more accurately estimate their compensation, and therefore their estimated tax obligations, over the course of the year (*i.e.*, compensation is not variable over the course of the year depending on the numbers of meetings, calls and other activities occurring in each quarter).

The annual retainer approach adopted by NERC does not result in the same annual fee being paid to each Trustee, but rather provides for differing annual fees that recognize the differing responsibilities of different Trustees. For example, higher annual fees are paid to the Board Chairman, to committee chairs, and to Trustees serving on certain Board committees that are recognized as requiring more work than other committees. In adopting the annual retainer approach, the Board committed to reviewing the approach (as well as the overall level of Board compensation) in one to two years.

In moving to the annual retainer compensation approach, the Board obtained an evaluation from SMN Associates, a leading consulting firm on board compensation in the utility industry, which endorsed the annual retainer approach.[74] The consultant's report noted that recent survey data showed increasing use of the fixed fee annual retainer approach by corporations, with some 20% to 30% of companies using this approach as of 2010. SMN Associates also provided recommendations for the range of annual compensation that should be paid to the Trustees based on their levels of Board roles. The annual compensation structure provided for four levels of Board roles with increasing responsibilities, as follows: (1) Trustee serves on a committee, other than those in Level 2; (2) Trustee serves on either the Board Compliance Committee or the Electricity Sub-Sector Coordinating Council (formerly the Electricity Sector Steering Group), or serves as a committee chair; (3) Trustee serves in more than one of the roles in level 3; and (4) Trustee is the Board Chair.[75]

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[74] *See* response Supplemental Information to Site Visit No. 3 Data Request, Question No. 5.

[75] The Draft Report states that SMN Associates "did not investigate NERC's claims that the current method of compensating the BOT imposed an administrative burden upon NERC." Draft Report at 58-59. NERC's management and Board did not need to have a consultant investigate

More recently, SMN Associates reported to NERC on several 2011 surveys which showed even greater use of the annual retainer approach, and decreasing use of per-meeting compensation, by U.S. companies.[76] These surveys included (1) a 2011 survey of director compensation by The Conference Board which showed that 40% of non-financial service firms (industrials) and 43% of financial services firms no longer pay per-meeting fees; and (2) a 2011 survey by AonHewitt which indicated that 51% of organizations, across diverse industries, now use only the retainer approach, and that the frequency of paying meeting fees is declining. Additionally, a 2011 report by SpencerStuart, another leading executive search and compensation consultant, states that "The shift to a simplified board compensation structure continues," and reports that only 37% of boards are paid per-meeting fees, down from 72% in 2001 and 57% in 2006. Further, just 35% of companies pay fees for Board committee meetings, down from 68% in 2001 and 58% in 2006.[77]

NERC notes that various mechanisms are in place to review the Trustees' performance and attention to their duties and thereby support "Board accountability" (Draft Report at 59). First, Trustees must be renominated by the Nominating Committee (which is not comprised solely of Board members but includes other stakeholder representatives as well), and then must stand for re-election by the Member Representatives Committee, at the end of their terms. Second, it is the responsibility of the Board Chairman, as well as of other Trustees, to monitor that all Trustees are carrying out their fair shares of the overall workload. Third, NERC has adopted a process by which the Board surveys the MRC members periodically to obtain their evaluation of the performance and effectiveness of the Trustees. The results of these surveys and evaluations (the most recent of which was conducted through a third-party consultant) are made available on the NERC website and are discussed at open meetings of the Board CGHR Committee.

The Draft Report questions the depth and adequacy of a Board compensation study conducted for NERC in 2008, on the basis of the number of comparison companies used, but does not provide any other information to suggest that the per-Trustee compensation of the NERC Board is excessive. Draft Report at 57-58. NERC notes that the data summarized in the Draft Report shows that the per-Trustee compensation in 2011 was only 6.8% higher than in 2009, which was prior to the adoption of the annual retainer compensation structure. Further, while the Draft Report questions the sufficiency of the SMN Associates reports with respect to both the method of Board compensation and the amounts, there was no one, to NERC's knowledge, on the Audit Staff team with the qualifications or experience to make judgments in this area.

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whether keeping Trustee time and attendance records placed an administrative burden on NERC staff.

[76] *See* response Supplemental Information No. 1 to Data Request No. 6, Question No. 131 (containing Attachment SB1_2011_final.pdf).

[77] SpencerStuart, 2011 SpencerStuart Board Index (November 2011), at 37 and 39 [available at: http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI2011.small022212.pdf].

Based on the considerations that went into and support the move to the annual retainer compensation model, NERC sees no need to return to the per-meeting method of compensating the Board, as recommended by the Draft Report, nor to expend resources to "track" Trustee time and participation in Board activities and conduct a Board "time study." Draft Report at 60-61. As noted, there are already sufficient means to evaluate the quality and extent of each Trustee's effort and attention to his or her responsibilities. Accordingly, Recommendations 25, 26, 27 and 28 in the Draft Report, concerning Trustee compensation, should be deleted and replaced with the following Recommendation (which, as noted earlier, is consistent with the NERC Board's plans):

28. Continue to conduct periodic updates and reviews of the Board compensation model and compensation levels, taking into account Board time and participation on Board activities and market comparability data of appropriate comparator organizations.

D. <u>Pension [Retirement] Plans</u>

The Draft Report offers the following findings with respect to NERC's "pension" [retirement] plans: (1) NERC contributed 10 percent of salaries for each employee participating in the plan, which is "above energy sector norm," and was in addition to an up to 4.5% matching contribution for employees participating in the 401(k) plan; (2) both base salaries and bonuses were included in the determination of "pension contribution obligations for employees;" and (3) NERC paid excess amounts above the allowable IRS limits for pensions contributions to certain employees when it should have maintained these amounts in a tax-deferred account. Draft Report at 6 and 62.[78]

When NERC converted from a defined benefit to a defined contribution plan, which occurred prior to NERC becoming the ERO, NERC amended its 401(k) plan to provide that it would contribute annually an additional 10 percent of the salary and bonus for each employee participating in the 401(k) plan, in addition to an up to 4.5 percent matching contribution for employees participating in the 401(k) plan. The intent of the additional 10 percent contribution was to provide a benefit that employees and candidates could compare to company profit- or performance-based compensation components, such as stock options, that for-profit companies with which NERC competes for talent commonly offer employees. NERC paid any amounts above the allowable IRS limit for 401(k) contributions to certain employees as ordinary income, pursuant to IRS requirement. These payments were taxable to the employees but not to NERC. Employees were free to invest these funds as part of their overall retirement planning.

The 2011-2012 Mercer compensation studies, discussed earlier, were based on total remuneration, including retirement benefits, and therefore provided information that management and the Board could use to re-evaluate NERC's retirement plan contribution levels. In February 2012, NERC's CGHR Committee and Board adopted a revised compensation policy based on total compensation and taking into account electric power industry practices and other relevant factors. At the May 2012 Board meeting, based on the results and recommendations of the Mercer study, NERC's Board will be presented with a proposal to amend the employee Savings and Investment Plan (401(k) plan) to (1) eliminate the inclusion of bonuses in calculating the supplement retirement contribution and (2) require the percentage contribution to

[78] As noted earlier, NERC does not have a pension plan, it has a 401(k) defined contribution plan.

be determined annually in the discretion of the Board. Therefore, assuming Board approval of this proposal, the actions described in this paragraph satisfy Recommendations 32 and 33 of the Draft Report. NERC notes, however, that its retirement plan provisions and its overall compensation policies will be the subject of periodic review by the CGHR Committee and the Board.

Additionally, NERC has established a 457(b) plan which permits eligible employees to defer additional compensation on a tax-deferred basis over and above what can be contributed to the employee's 401(k) plan.[79] Establishment of the 457(b) plan addresses Recommendation 34 of the Draft Report. Whether the employee chooses to take full advantage of opportunities to defer and maintain deferrals of employee retirement contributions is not something that is completely within the control of the employer. As before, the employee is free to invest all or a portion of his or her after-tax compensation towards retirement.

Accordingly, Recommendations 32, 33 and 34 in the Draft Report should be revised to read as follows, and, as described above, have already been addressed by NERC.

32. Determine its retirement policies using relevant comparability and other data that reflects current market conditions.

33. Work with the Board to craft a total remuneration policy based on principles of total compensation, electric power industry practices, and other relevant factors. This policy should include procedures to justify the 401(k) retirement plan contribution levels are appropriate and reasonable.

34. Continue to use the mechanism that has been adopted and consider additional mechanisms to allow employees to address tax deferred retirement savings of contributions in excess of the IRS cap on 401(k) contributions.

VI. NERC Has Adequately Staffed for and Carried Out its Oversight Responsibilities with Respect to the Regional Entities' CIP CMEP Activities

Audit Criteria. The only criteria identified by the Draft Report is NERC Rule of Procedure §402.1, which specifies that NERC "shall have a program to monitor the compliance enforcement program of each regional entity" and that the "objective of this monitoring program shall be to ensure that the regional entity carries out its compliance enforcement program in accordance with these rules and the terms of the delegation agreement . . . ." Draft Report at 65.

Audit Findings. The Draft Report asserts that NERC has inadequately staffed for the needs of its CIP program. Draft Report at 6-7 and 65. The Audit Staff contends that "NERC should have established strong oversight of compliance with these emerging [CIP] standards," but "[i]nstead . . . focused its attention on what it perceived were higher-priority demands," including "dealing with Commission directives in the operating and planning standards" and in "expanding the functionality of NERC's ES-ISAC." Draft Report at 66. The Draft Report argues that NERC had an inappropriate "low level of staffing" for CIP compliance because it "only had two CIP staff dedicated to compliance activities." *Id.*

[79] *See* response to Data Request No. 6, Question No. 132.

NERC's Response. NERC is disappointed with the perspective and tone taken by Audit Staff in its findings. As a matter of perspective, it is hard to understand why Audit Staff would criticize NERC for placing a 'high priority" on "dealing with Commission directives in the operating and planning standards." *Id.* The Commission has, on numerous occasions, expressed frustration with the backlog of directives that have not yet been completed. It is not clear whether Audit Staff disagrees with the Commission's view of the importance of those issues or whether it simply lacks appreciation for the resources required to deal with the hundreds of standards-related directives that have issued since Order No. 693.

Although NERC recognizes the need to continue to add resources in this growing and important reliability area, the Draft Report fails to recognize that NERC does not have unlimited resources, its staff has grown rapidly and there are limits to how many new staff can be efficiently added in a given year, and NERC must therefore make hard choices on resource allocation—particularly, in determining whether, as Audit Staff appears to suggest, NERC Staff should be participating actively in many of the scores of CIP audits conducted by the eight Regional Entities. Because of the Regional Entities have front line responsibilities for these audits, and because CIP compliance is a new and rapidly evolving area of reliability standards regulation, NERC made a conscious decision to focus on education and training of the industry to understand, identify and respond to cyber threats. The highly technical nature of the CIP standards, the relative newness of the subject matter to the industry, and the ongoing evolution of requirements in the CIP standards, have required significant effort to put the CIP standards and requirements into context for the industry and to assist industry in developing and supporting infrastructure security programs to support cyber reliability. As a result, during 2010-2011, NERC focused on assistance, training and education to the industry on the broader CIP and infrastructure security concerns.

The Draft Report suggests that NERC selected the Regional Entity CIP audits to send its auditors to by checking which audits the Commission would be sending its staff to. Draft Report at 68. NERC does not know how Audit Staff reached that conclusion. NERC provided Audit Staff with NERC's CIP Audit Observation Criteria, which are:

> The NERC CIP Audit Observers maintain a process based on location, Regional Entity and available resources. Each calendar year, the NERC Critical Infrastructure Department (CID) assesses U.S. and Canadian entities scheduled for a 706 audit using the master audit schedule maintained by the NERC Compliance group. In accordance with the list, NERC then takes in to account the following:
>
> 1. NERC registration of the Registered Entity (RC, BA, TOP, GO, GOP, etc.)
>
> 2. Geographic location. It is NERC's intent to attend an observation in all eight regional footprints. NERC also takes into account entities within multiple regions and states.
>
> 3. Prior NERC observations. Has NERC attended an audit of the registered entity in the past?
>
> 4. FERC attendance. NERC staff also considers what audits FERC observers attend and strives to have representation on those audits.

5. Compliance history of a registered entity.

6. Regional Entity auditing a Regional Entity Reliability Coordinator.[80]

Additionally, by focusing on the fact that NERC has had only two CIP auditors on staff, the Draft Report understates the number of personnel that NERC has devoted (fully or in part) to CIP compliance monitoring and oversight activities. In addition to the two CIP auditors, personnel in NERC's Compliance Operations Department are involved in overseeing the CIP audit reports, training CIP auditors, maintenance and revision of the Reliability Standard Audit Worksheets ("RSAWs") that are used by Regional Entity CIP auditors in conducting audits, development and issuance of Compliance Application Notices ("CANs," which provide guidance to auditors) relating to the CIP standards, and other activities to support NERC and Regional Entity CIP audit activities. NERC Legal staff also works closely with the Regional Entities with respect to the posting of Case Notes that pertain to the CIP standards. Further, personnel in NERC's Compliance Enforcement and Legal Departments provide support and guidance to the Regional Entities in CIP compliance monitoring, auditing and enforcement.[81] For example, all Possible Violations, including Possible Violations of CIP standards, are processed and reviewed in the NERC Compliance Enforcement and Legal Departments. NERC staff works closely with the Regional Entities in the ultimate disposition of the CIP Possible Violations to ensure the records are complete and support the ultimate disposition. NERC staff also fields questions and addresses issues that may arise in the context of compliance monitoring activities by the Regional Entities, including audits. NERC's Compliance Enforcement and Legal staffs also work closely with its CID staff in the review of violations and dismissals of CIP standards. NERC internal department meetings, as well as ERO working group meetings, are opportunities to provide ongoing guidance on CIP matters.

NERC disagrees with the implications of the discussion in the Draft Report that the only way to provide oversight to Regional Entity CIP compliance monitoring activities is to have NERC CIP auditors participate in or observe in person the Regional Entity CIP audits. Other oversight activities, such as CIP auditor training, maintenance of the RSAWs, development of CANs relating to the CIP standards, and review of CIP audit reports, are important components of support for the CIP compliance monitoring process.

The data on the large numbers of violations of CIP standards discovered in 2010 and 2011, and the large number of TFE requests processed from January 1, 2010 through September 28, 2011, presented in §IV.C above, shows that the CIP Compliance staffs of NERC and the Regional Entities have in fact been extremely active. Further, in 2010 and 2011, a total of 1,733 violations of CIP standards were identified through Self-Reports and Self-Certifications. This statistic indicate that NERC's CIP education and outreach activities have been effective, as Registered Entities are recognizing the need to self-identify, report and correct noncompliances with the CIP standards.

NERC's overall staffing for its Critical Infrastructure Protection Program has increased significantly in recent years as the CIP standards have become enforceable. For example, in its

[80] *See* response to Data Request No. 2, Set Request No. 2, Question No. 87.

[81] *See* responses to Data Request No. 2, Set Request No. 2, Question No. 87, and Data Request No. 6, Question No. 137.

2011 Business Plan and Budget, NERC increased its budget for the CIP Program to $6,351,709 from $917,551 in the 2010 budget, and increased the full-time equivalent employee ("FTE") staffing for the Situational Awareness and Infrastructure Security Program (which includes the CIP Program) from 9.75 FTE to 25.83 FTE.[82] NERC is continuing to make appropriate program adjustments for additional oversight of Regional Entity CIP audits. In NERC's 2012 Business Plan and Budget, two additional FTEs were approved for the CIP oversight team, consisting of one additional CIP auditor and one CIP Compliance Manager. Additionally, NERC is in the process of procuring independent contractors to assist in its CIP oversight, as well as its auditor training programs.

Accordingly, Recommendations 34 and 36 in the Draft Report should be modified to read as follows:

35. Conduct an assessment of existing CIP-related staffing levels to ensure there are adequate resources to accomplish CIP work, particularly with respect to Regional Entity CIP auditing and other Regional Entity CIP-related CMEP activities.

36. Devote greater resources to carry out its duties under the CMEP as to the CIP-002 through CIP-009 standards and provide effective oversight of CIP CMEP activities by the Regional Entities.

VII. NERC's Role as the ES-ISAC is an Important Function in Assuring the Reliability and Security of the BPS and Supports NERC's ERO Responsibilities

Audit Criteria. The only criteria stated by the Draft Report for auditing this area are: (i) two sentences from Order No. 672 stating that the ERO may perform statutory and non-statutory functions, (ii) a sentence from the ERO Certification order stating that NERC is approved as he ERO, and (iii) the NERC Rules of Procedure provision that states that NERC shall serve as the ES-ISAC.

Audit Findings. The Draft Report finds that the NERC's role as the ES-ISAC "may need to undergo additional significant changes to improve its effectiveness." Draft Report at 83-84. For example, Audit Staff contends that NERC staff performing ES-ISAC duties "were not clearly designated as such" and that this has caused "confusion." *Id.* at 84. More broadly, the Draft Report argues that, although "the Commission approv[ed] of NERC's ES-ISAC role for funding under section 215," NERC must now "show how the ES-ISAC continues to fall within the rubric of NERC's statutory activities and the Commission's oversight responsibilities." *Id.* at 84-85.

NERC Response. NERC strongly disagrees with these findings. *First*, we do not understand the basis for Audit Staff to question the Commission's own findings that the ES-ISAC as a statutory function. NERC's role in connection with the Electric Sector Information Sharing and Analysis Center (ES-ISAC) is set out in the Rules of Procedure as one of the functions through which NERC will accomplish the goals related to the Infrastructure Security

[82] 2011 ERO Budget Filing, Attachment 2 at 24-25. In contrast, NERC's staffing for the Situation Awareness and Infrastructure Security Program in its 2008 business plan and budget (before Registered Entities were required to be compliant with CIP standards) was only 5.0 FTE. 2008 ERO Budget Filing at 33.

Program (ROP § 1003). These provisions were filed by NERC with the Commission at the time of NERC's application for certification as the electric reliability organization and were accepted by the Commission as part of NERC's certification in the ERO Certification Order. Subsequently, in the order accepting NERC's 2007 Business Plan and Budget, FERC considered comments by intervenors who questioned the statutory nature of several of NERC's activities. In that order, FERC expressly found that NERC's proposed activities, including those related to the Infrastructure Security Program, are "covered by FPA section 215, i.e., the development and enforcement of reliability standards, and are entitled to receive funding under section 215 of the FPA."[83]

The Commission was correct to find the ES-ISAC to be a function that can be funded under Section 215. NERC's role as the ES-ISAC is an important function in assuring the reliability and security of the BPS, and supports NERC's ERO responsibilities. In Order No. 672, the Commission stated that the statutory functions of the ERO include "monitoring the reliability of the Bulk-Power System."[84] By serving as the ES-ISAC, NERC performs a critical role in real-time situation awareness and in protecting the electric industry's critical infrastructure against vulnerabilities. The ES-ISAC information sharing and analytical functions support the reliability of the BPS through dissemination of information to the industry regarding threats and vulnerabilities, disturbances, and off-normal occurrences. The information-sharing functions directly move analyses of threats to and impacts on the BPS from the ES-ISAC staff to the industry through a variety of means, such as the "Alerts" and "Notification" processes, web portals, webinars, and industry outreach presentations. These activities directly benefit the reliability and security of the BPS by educating industry on reliability issues and informing the industry on risks, vulnerabilities and mitigation strategies, as detailed in §1003 of the NERC Rules of Procedure. The ES-ISAC's activities therefore fall squarely within the ERO function identified in Order No. 672 of "monitoring the reliability of the Bulk-Power System."[85]

Second, NERC disagrees with the ES-ISAC role is creating "confusion." NERC has responded to industry concerns regarding potential conflict between the Compliance Monitoring and Enforcement Program and the ES-ISAC's information-sharing functions, by realigning all of the ES-ISAC functions within one unit and creating a protected communications corridor to facilitate greater industry engagement and information sharing.[86] Neither the Commission nor (by the Board-approved policy) NERC CMEP personnel will have access to the protected information (including entity attribution) that the ES-ISAC handles.[87] However, the Commission will continue to receive drafts of Alerts and Notifications generated from the ES-ISAC. Further, the ES-ISAC will remain a resource for the Commission.

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[83] 2007 ERO Budget Order at P 28.

[84] Order No. 672 at P 202.

[85] *Id*.

[86] The final, approved policy, which has been approved by the NERC Board, is available at: http://www.esisac.com/Public%20Library/Documents/ESISAC%20communications%20protocol.pdf.

[87] While the Commission may have legal means to demand access to this information, doing so would result in significant negative impacts to the ES-ISAC's functionality and usefulness.

Nevertheless, NERC recognizes that further analysis, and discussion with stakeholders, is appropriate to ensure the continued effective operation of the ES-ISAC. These questions include the impacts of "walling off" the ES-ISAC and its staff from NERC's compliance-related activities, what the flow of information between the ES-ISAC and the Commission should be, and how and why operation of the ES-ISAC continues to support NERC's ERO responsibilities and should continue as a statutory activity. Accordingly, the Draft Report's recommendations concerning the ES-ISAC should be combined into the following comprehensive recommendation, which incorporates the topics in Recommendations 39-41:

39. Provide additional information in NERC's 2013 Business Plan and Budget regarding NERC's role as the ES-ISAC and provide opportunities for stakeholder input regarding NERC's role as the ES-ISAC during the 2013 business plan and budget process. This should also include: (1) an evaluation of the impact, if any, on NERC's compliance-related activities of "walling off" certain staff from these activities; and (2) clarification of the flow of information between the ES-ISAC and the FERC staff for situational awareness and compliance purposes.

VIII. Employee and Board Expenses[88]

Audit Criteria. The only criteria identified by the Draft Report are: (i) the statutory requirement that the ERO "allocate equitably reasonable dues, fees and other charges among end users" and (ii) a description of NERC's accounts concerning travel, telephone, internet, office supplies, and miscellaneous expenses. Draft Report at 45, 51.

Audit Findings. The Draft Report criticizes NERC's budgeting and accounting for, and controls over, employee meals and hotel expenses, dinner expenses incurred in connection with Board of Trustee meetings, and employee "entertainment" expense. The Draft Report cites several instances in which, it contends, expenditures for meals and "entertainment" for employees and Trustees were not subject to appropriate controls or accounting, or were not broken out with sufficient granularity, in Audit Staff's opinion, in budgets or accounts.[89] Draft Report at 45-47, 51-55, 59-60.

NERC Response. This is another area where Audit Staff is not applying objective criteria, but rather criticizing NERC extensively with respect to its *opinion* on a wide variety of matters, ranging from when Board members or employees can be reimbursed for meals to how

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[88] This section covers several related issues which the Draft Report raises under "Standard for Determining Reasonableness of Expenses," "Employee Entertainment," and "Board of Trustees Compensation and Entertainment." Collectively, the topics discussed in this section relate to Recommendations 19, 20, 22, 23, 24, 29, 30 and 31 of the Draft Report.

[89] The "entertainment" expenses discussed in the Draft Report were primarily meal expenses provided and paid for by NERC for NERC employees and Trustees, not expenses incurred by NERC or a NERC employee for the entertainment of a third party such as a customer. NERC believes that referring to the types of expenses under discussion as "entertainment" expenses is inaccurate and inconsistent with the typically-understood meaning of the term "entertainment." These expenses are more accurately referred to as dinner or meal expenses, or, where the meal is purchased or provided as a reward for or in recognition of employee performance or effort, as employee reward or recognition expenses.

much those meals should cost. Given this lack of objective criteria, NERC responds only briefly below to each category of allegation.

The Draft Report states that NERC has defined $50 as a reasonable level of dinner expense for employee dinners (*e.g.* while traveling on behalf of NERC), but that on numerous occasions NERC has reimbursed employees for dinner expenses in excess of $50. Draft Report at 46-47. However, NERC has not defined $50 as a "reasonable" level of dinner expense. Rather, $50 per person on dinner expense reimbursement requests is used as a flag to signal the need to verify that all attendees at the dinner have been identified on the reimbursement request.

The Draft Report also recommends that NERC establish additional standards and controls for determining and enforcing "reasonable" employee meal expenses, including expenses for meals that are provided to employees as a reward for outstanding performance or effort. Draft Report at 46-47. NERC management advised Audit Staff that in very limited and special circumstances, NERC sometimes rewarded staff who had put in extraordinary efforts to complete work requirements by treating them to a dinner. A specific example discussed was that the Information Technology Manager took IT staff members, who had worked a considerable number of hours including nights and weekends to complete NERC's data center relocation as early as possible, to dinner as a reward for their efforts. This expense was approved as a routine business expense. In another such instance that Audit Staff identified, Audit Staff was informed that the NERC CFAO had counseled the manager who submitted the reimbursement request regarding the cost of the meal. NERC believes that instances of employee meals being provided as a reward for performance or effort, such as the occurrences identified by or discussed with Audit Staff, are isolated and limited.

The Draft Report also states that NERC department managers expend a considerable amount of time reviewing employee expenses, and that this responsibility should be shifted to accounting staff. Draft Report at 47. NERC does not disagree that reviewing employee expense reports requires department manager time. However, NERC believes that to establish procedures by which its accounting staff reviews all employee expense reports would require NERC to hire one or more additional staff in its Finance and Accounting department. Therefore, NERC believe that it should first have an opportunity to implement improved controls, procedures and guidelines concerning these expenses prior to adding administrative and overhead costs to its operations.

With respect to employee reward and recognition expenses, the Draft Report expresses concern that NERC incurred significant costs for year-end employee meetings and dinners in 2010 and 2011, but that the expenses for these events were not separately budgeted, and were accounted for as routine business expenses. Draft Report at 52-55. As shown by the table on page 53 of the Draft Report, the expenses for the year-end employee dinners were $29,785 in 2010 and $39,721 in 2011. The higher cost figures cited in the Draft Report included the costs for employee travel to Princeton and Atlanta to attend meetings and training sessions that were scheduled in conjunction with the year-end events, and expenses for those meetings and training sessions. Such meetings and training sessions will continue, regardless of whether the year-end employee dinner continues. NERC did record the specific costs of the year-end employee dinners as Miscellaneous expenses, which appears to be the accounting Audit Staff believes to be appropriate (*see* Draft Report at 53). NERC does agree that, in the unlikely event such year-end parties are ever planned and held in future years, the projected expenses should be provided for and separately identified in NERC's budget and separately tracked.

Finally, with respect to Board of Trustee "entertainment" expenses, the Draft Report states that NERC "incurred various expenses to entertain BOT members outside the official BOT meetings." Draft Report at 56. However, these "various expenses to entertain BOT members outside the official BOT meetings" were actually payments or reimbursements for Trustee meal expenses in connection with Board, Board committee and other Board meetings (e.g., dinners for Board members the night before a Board meeting, when the meeting was to start in the morning and it therefore was necessary for the Board members to travel to the Board meeting location city to arrive the evening before the meeting; or where the Board or committee meeting spanned more than one day, which is usually the case for the regular quarterly Board meetings). These are ordinary and customary travel expenses associated with attendance at a business meeting – they are not "entertainment expenses." Contrary to the implication that might be created by the Draft Report's characterization of these costs as "entertainment expenses," NERC did not pay for or provide tickets to events or other such items which are more commonly referred to as "entertainment expense."

The Draft Report notes several instances where the dinner expenses incurred in connection with Board meetings exceeded the level NERC has defined as "reasonable."[90] The Draft Report recommends that such Board of Trustee dinners should be separately budgeted and that the expenses should be recorded as miscellaneous operating expenses. Draft Report at 59-60. Although NERC does not agree with the Draft report's characterization of these dinner expenses as "entertainment expenses," NERC does plan to clearly identify Board meeting meal expenses in its budget and to track those expenses. Additionally, NERC will adopt a policy regarding gifts to Trustees paid for by NERC or by an officer or employee. NERC already has a policy in place regarding the acceptance/prohibition of gifts to NERC employees from third parties.

The recommendations relating to the foregoing topics – Recommendations 19, 20, 22, 23, 24, 29, 30 and 31 – should be revised to read as follows:

19. Enhance formal policies, procedures, and guidance governing expenses incurred by employees to include the following: (1) developing a well-documented reasonableness standard for employee and Trustee meal, hotel and other travel expenses, including guidance on what constitutes a reasonable cost; (2) detailed steps for reviewing and approving expenses; and (4) other necessary procedures to facilitate appropriate review and provide clear guidance regarding expenses.

20. [This recommendation is deleted as it is subsumed by revised Recommendation 19.]

22. Explicitly budget for employee rewards and recognition expenses, if any, by including line items of sufficient granularity in the budget filings.
23. Use miscellaneous expense accounts to track employee expenses which are primarily social in nature, if any, separately from other business-related expenses in its accounting system.

24. Ensure such expenses are clearly and transparently included in budgets submitted to the Board and Commission.

[90] As noted earlier, NERC has not defined $50 as the maximum "reasonable" dinner expense.

29. [This recommendation is deleted as it is subsumed by Recommendation 30.]

30. Track expenses actually incurred for Board activities to the budgeted amounts for such expenses.

31. Develop appropriate policies for the giving of rewards and recognition, funded from NERC's own resources or paid by any NERC officer or employee, to a Trustee or payment of Trustee meals by a NERC officer or employee.

Respectfully submitted,

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Federal Energy Regulatory Commission

Audit Staff Comments to NERC Response to Draft Audit Report

Docket No. FA11-21-000
May 4, 2012

Office of Enforcement
Division of Audits

DIVISION OF AUDIT'S COMMENTS TO NERC'S RESPONSE TO THE DRAFT AUDIT REPORT

Overview

The Division of Audits (DA) in the Office of Enforcement commenced a performance audit of the North American Electric Reliability Corporation (NERC) on August 22, 2011, covering the period from August 23, 2006 to March 14, 2012. DA completed its draft audit report, containing 11 audit findings and 42 audit recommendations, on March 23, 2012. The extensive analysis underlying the report, which consisted of the gathering and examination of supporting documentation, emails, and reports, and conducting site visits, face-to-face meetings, and phone conferences with NERC employees, former NERC employees, and NERC's Board of Trustees, is detailed in the report.

DA sent the draft report to NERC on March 23, 2012. Although the subject of an audit is usually given 15 days to respond, DA provided until April 23, 2012, 32 days, to NERC and invited NERC to meet with staff to raise any concerns that it had with the draft report. On April 23, 2012, NERC provided its written response to the draft report, which, shortly thereafter, it also circulated to the Commission.

In its response, NERC agreed to adopt four of the 42 audit recommendations as presented, agreed to accept with proposed modifications 29 others, and disputed the remaining eight in their entirety. It also disputed certain aspects of the audit findings related to those recommendations. DA is hopeful that this suggests that NERC and Commission staff will be able to work together to help improve NERC's efficiency and effectiveness and improve the Commission's ability to carry out its oversight role with respect to NERC's budget and expenditures.

Many of the objections raised by NERC to the draft audit report reflect a misunderstanding as to the nature of the audit DA performed of NERC. Unlike most of the entities which fall under the Commission's jurisdiction, the Commission is mandated by statute to determine that an entity designated as an Electric Reliability Organization (ERO) "allocate equitably reasonable dues, fees, and other charges among end users for all activities under [section 215 of the Federal Power Act]."[1] Furthermore, Commission regulations require that the ERO

[1] Section 215(c)(2)(b) of the FPA, 16 U.S.C. § 824o (2006).

file with the Commission its proposed entire annual budget, for both statutory and non-statutory activities, with supporting materials that explain "the proposed collection of all dues, fees and charges and the proposed expenditure of funds collected in sufficient detail to justify the requested funding collection and budget expenditures."[2]

The Commission's obligations with respect to NERC's expenditures make it imperative that NERC reflect and track its expenditures in such a way as to provide the Commission with the transparency and accountability needed for it to perform its oversight role. During the audit period, NERC filed six annual budgets with the Commission, beginning with its first year of operation in 2007. Although the Commission has approved each of those budgets, it has expressed the need for and the importance of NERC providing greater transparency, greater detail and justification for the criteria it uses to designate statutory activities, and true-ups of actual versus budgeted expenses.[3]

The Commission is by regulation specifically empowered to conduct audits of the ERO's performance.[4] In order to enhance the transparency and accountability needed by the Commission to perform its statutory obligations, DA undertook a financial performance audit of NERC, focusing on the specific areas of economy and efficiency. This type of audit, unlike the more common compliance audit, is designed to assist the subject in improving its performance and to facilitate decision-making by those charged with the responsibility to oversee or initiate corrective action.[5] In its audit, as described in its commencement letter to NERC, DA evaluated NERC's budget formulation, administration, and execution. In furtherance of that evaluation, DA examined the policies, procedures, practices, and controls NERC used, focusing on costs and resources, with a view of determining whether NERC's documentation of costs supported the actual costs incurred, and whether staff was being used to carry out NERC statutory responsibilities.

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[2] 18 C.F.R. § 39.4 (2011).

[3] *See*, *e.g.*, *North American Electric Reliability Corporation*, 117 FERC ¶ 61,091 at P 30, 84 (2006); *North American Electric Reliability Organization*, 121 FERC ¶ 61,057 at P 23 (2007).

[4] 18 C.F.R. § 39.9 (b) (2011).

[5] *See Government Auditing Standards*, (2011 revision), Section 2.10, for a description of performance audits. Because the generally accepted government auditing standards (GAGAS) embody sound auditing standards, they provide helpful guidance to DA in the auditing process.

Because of the nature of a performance audit, DA's goal was not to identify instances of potential violations by NERC, but rather to determine whether greater transparency and clarity were needed in NERC's budgetary and accounting practices.

As is typical of a performance audit, audit staff brought its varied expertise to bear in making recommendations to NERC as to how to strengthen its tracking and recording of expenses. All of this has been done with the ultimate aim of assisting NERC in providing the Commission with the improved transparency and accountability needed to enhance the Commission's performance of its oversight role.

In some instances, NERC has taken exception to what it assumed to be a criticism of certain of its expenditures. NERC misapprehends the purpose for which DA cited these expenditures. As noted, the nature of the audit was a performance audit, centering on economy and efficiency. It was not a prudence audit. For that reason, DA has not directly considered whether the expenditures it examined were appropriate or not; its concerns were whether NERC clearly and correctly accounted for those expenditures, whether NERC's controls were adequate for it to ensure the reasonableness of expenditures, whether adequate tracking procedures were in place for the redirection of funds from one activity to another, whether the justifications for expenditures have sufficient granularity for the Commission to evaluate them, and whether NERC has used funds for the purposes for which they have been designated.

NERC also questions DA's concern over whether NERC has adequate criteria in place to distinguish statutory from non-statutory expenditures. As discussed in the draft audit report, Section 215 of the Federal Power Act provides that FERC's oversight of NERC's statutory expenditures is limited to the development of Reliability Standards and their enforcement, and monitoring the reliability of the Bulk-Power System. The ERO can pursue other activities, but such activities must be funded from other sources.[6]

NERC asserts that any activity falling within the six broad functional categories it has developed for its internal use are statutory.[7] It is indeed correct that the Commission has acknowledged that NERC's description of these

[6] 117 FERC ¶ 61,126 at P 202.

[7] These categories are: standards development and maintenance; compliance registration, certification, and enforcement; reliability assessment and performance analysis; reliability readiness audits; situation awareness and infrastructure protection; and training and education. See Draft Audit Report at 3.

categories qualify as statutory.[8] But that is not the end of the question. NERC's budget requests must demonstrate that the particular expenditures for each year under consideration properly meet the description of what the Commission has acknowledged to be statutory. Thus, it cannot be said in advance, as NERC apparently would have it, that any expenditure it makes is necessarily statutory if it has chosen to classify it into one of its six categories. This act of classification must also be correct. And in order to assure that the classification is correctly done, it is imperative that NERC have adequate procedures in place.

In some of its remarks, NERC seems to be under the impression DA has determined that certain examined activities were non-statutory. That is not the case. Rather, DA is concerned with ensuring there are adequate procedures in place for NERC to determine whether an activity is statutory, and further that it adequately present that determination to the Commission during the budget review process.

The bulk of the objections NERC raised in its response to DA's draft audit report fall within the ambit of the foregoing observations. For that reason, and because NERC has expressly stated that it is committed to improving its operations and performance as the ERO, DA is confident that NERC and Commission staff can work together to implement the recommendations made in the report. Further discussion with NERC is necessary to determine whether some of NERC's proposed modifications to the recommendations are workable; others DA has accepted and included in its revised report. DA is hopeful that an accommodation can be reached with NERC regarding some of the other proposed modifications during the implementation phase of the audit.

NERC has raised a number of additional issues that fall within the following general categories: (i) accounting, budgeting, and cost reporting, (ii) employee and board compensation, (iii) oversight of regional CIP activity, (iv) NERC's role as the ES-ISAC, and (v) employee and board expenses. These are discussed below.

Accounting, Budgeting, and Cost Reporting

A. NERC Budget Process

[8] 117 FERC ¶ 61,091 at P 28.

DA examined the budget formulation, administration, and execution phases of NERC's budget process in order to determine if improvements could be made to enhance transparency and thereby assist the Commission in performing its oversight role.[9] NERC agreed with four of the five audit recommendations, albeit with significant modifications to two of them. The areas of disagreement, as discussed below, concern redirection of funds, working capital reserves, and project-specific granularity.

1. Redirection of Funds

NERC objects to DA's insistence that the Commission be provided with the necessary tools to review NERC's redirection of funds from one activity to another. It argues that this oversight limits NERC's discretion. Its position here echoes a theme mentioned in several places in NERC's response, in which it contrasts its own treatment by the Commission against the Commission's stated policy of deference to the decisions made by the boards of directors of regional transmission organizations (RTOs) and independent transmission operators (ISOs).[10] But there is a significant difference in the Commission's relationship to the RTOs and ISOs and its relationship to NERC. The Commission is obligated by law to review NERC's expenditures, and to ensure that the dues, fees and charges collected from end users are correctly allocated to statutory activities. This is not the case with respect to RTOs and ISOs.

During its examination of documents, DA determined that significant sums were redirected by NERC to pay for headquarters and D.C. office moving expenses and to fund holiday parties. NERC's own Board of Trustees, as well as the Commission, needs to be able to review such redirection of funds for appropriateness. Indeed, the Commission has specifically commented upon the need for NERC to present adequate true-ups between actual and budgeted

[9] NERC pointed out that in some instances DA mentioned stakeholders in its general summary statements about approval of NERC's budget. As noted in several other places in the draft audit report, stakeholders provide input to and comment on the budget, but it is the Board of Trustees and the Commission that approve the budget. This misstatement has been corrected in the revised audit report.

[10] *See Wholesale Competition in Regions with Organized Electric Markets*, Order No. 719, 73 Fed. Reg. 64100 at P 561 (Oct. 28, 2008), FERC Stats. and Regs. ¶ 31.281 (2008), *order on reh'g*, Order No. 719-A, 74 Fed. Reg. 37776 (Jul. 29, 2009), FERC Stats. and Regs. ¶ 31,292 (2009), *order on reh'g*, Order No. 719-B, 129 FERC ¶ 61,252 (2009).

expenditures.[11] In order for the Commission and the Board to review these deviations, adequate controls and procedures need to be in place to ensure transparency.

2. Working Capital Reserves

Working capital reserves are designed to provide readily available funds to meet unforeseen expenditures. NERC suggests that DA contends otherwise; this is a misunderstanding on its part. DA's concern with the manner in which NERC treats working capital reserves stems from its observation that NERC on occasion appears to treat such reserves as a holding fund for the redirection of substantial sums of money from one budgeted project to a different project. That is not the purpose of such reserves, and for that reason, DA recommends that adequate controls and procedures be put in place to address their use.

3. Project-Specific Granularity

NERC has agreed to increase granularity in its budget process, but not the granularity in its budget and true-up filings through project-specific tracking and reporting. DA is of the view that such project-specific granularity is necessary, based in part on the fact that NERC was unable during the audit process to readily produce documentation that showed the actual time and cost expended to support particular activities. Fortunately, NERC has software in place with the functionality to adequately track time at this level. Therefore, such tracking would not appear to place significant cost burdens on the organization.

B. Time Reporting and Accounting Systems

DA reviewed the functionality and use of NERC's time reporting and accounting systems to understand and verify: (1) the amount of time spent by NERC employees on projects and other activities; (2) how the accounting systems were used to capture and record accounting information; and (3) the linkage between the time reporting and accounting systems and the budget formulation, administration, and execution processes. The draft audit report contained seven audit recommendations to address the concerns DA had as a result of its examination. Although NERC disagreed with some aspects of the audit finding in

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[11] *North American Electric Reliability Organization*, 121 FERC ¶ 61,057 at P 23 (2007): "In the future, we also expect to compare proposed budgets to actual expenditures....the Commission will require NERC to provide the true-up for the ERO...on or before April 1 of each year in sufficient detail and with sufficient explanations for the Commission to determine, by program area, the reasons for deviations from the budget and the impacts of those deviations."

this area, it agrees with six of the seven recommendations, with proposed modifications.

Employee compensation is the single largest element of NERC's expenditures, representing about 60 percent of its 2012 budget. It is thus imperative that compensation be tracked and presented in a sufficiently transparent manner to the Commission. This requires a time-reporting system that accurately tracks time by project. NERC protested that it records costs in accordance with its System of Accounts, and therefore has not committed any violation in this regard.

NERC misapprehends DA's concerns. DA does not quarrel with whether NERC has complied with its System of Accounts (although it did find several misclassified expenses); rather, it believes further granularity is needed to enable the Commission to determine relative cost levels for the various projects undertaken by NERC. This is an essential element of the Commission's oversight obligations, and DA recommends that time-tracking software be used for this purpose.

As noted above, DA was informed that NERC already has software with this functionality. However, in order to reflect NERC's concerns over prudency of expenditures, DA has replaced its original recommendations 12 and 13 with modified recommendations, which are included in the revised audit report. These recommendations add the caveat that development of the functionality be consistent with sound business practices.

C. NERC Oversight of Regional Entity Budgets

NERC suggests that the draft audit report conveys the impression that the only oversight NERC exercises over the regional entities' (REs) activities is through the business planning and budgeting process, and protests that this is not the case. However, this was neither DA's actual nor its stated concern. Rather, DA is concerned about how NERC's various oversight activities over the REs are linked to and inform the budget processes. It also is of the view that NERC should develop a formal review program for the RE budgets, integrating qualitative and quantitative analyses, and establish policies and procedures to apply lessons learned to the review process.

<u>Employee and Board Compensation</u>

A. Employee Compensation

NERC has agreed to the audit recommendations related to employee compensation, with only minor proposed modifications. These recommendations focus on conducting a review of the organization to determine the skills needed to perform its various tasks, to contract for new compensation studies that use comparability data targeting the required skill sets, and to use total compensation as a more meaningful guideline in assessing salaries, benefits, and bonuses. NERC also acknowledges it shares at least some of DA's concerns about the adequacy of the 2007-2011 compensation studies it commissioned. However, it disagrees with DA's concerns over the most recently-completed compensation study. And it also accuses DA of questioning the actual levels of compensation.

DA did not, however, make any comment or value judgment about the level of compensation. DA's concerns center on the need for comparability data by which to measure remuneration, a matter recognized as important in NERC's own compensation policy. Since, as noted above, compensation is the largest cost component of NERC's budget, DA took pains to review NERC's studies and adherence to its policies concerning compensation.

With respect to NERC's most recent compensation study, NERC provided additional detail in its response that it had not shared before with DA. However, this new information does not alter DA's objection to the study's use of an inflated budget figure to support compensation levels,[12] or to the other matters addressed in the draft audit report. The new information, however, should be discussed in the implementation phase of the audit, with a view to providing a solid foundation for determining the staffing competencies necessary and the corresponding compensation to recruit and retain the staff necessary to perform its duties as the ERO, while minimizing additional costs that would be incurred in obtaining new studies.

B. Employee Recruitment and Employee Retention

DA examined NERC's policies, procedures, and practices in the area of recruitment and retention, and presented a number of recommendations in this area. NERC did not disagree with DA's audit findings, and accepted DA's recommendations with slight modifications and the deletion of one recommendation it believes is subsumed in another recommendation.

[12] The study used a budget of $200 million, whereas NERC's actual budget for 2012 was $53 million. The $200 million figure lumps in the budgets of the REs.

In support of its recruitment efforts, NERC cites the difficulties it has had in hiring qualified personnel. DA does not take issue with that assertion. Rather, it recommends that NERC implement a documented recruitment strategy with adequate controls and procedures to cover accommodations sought by candidates. This might, for instance, have prevented those situations in which certain new employees were granted substantial monetary concessions, only to leave within a short period of time without being obligated to reimburse NERC for any portion of those concessions. And with respect to the at-will contracts NERC employs, DA is concerned that the absence of a value assessment concerning such contracts may have resulted in unnecessary hiring and recruitment expenses.

NERC asserts that DA's description of the relocation packages provided to three executives is inaccurate, contending that the packages received CEO approval and were negotiated on a case-by-case basis over a period of months. However, NERC was unable to provide evidence of CEO approval of the relocation packages, nor did it provide documented evidence of the asserted negotiations. This failure illustrates the need for adequate accounting and controls.

C. Board of Trustees Compensation

NERC disagrees with various aspects of DA's audit findings with respect to Board compensation and expenses, and proposes to delete three of the four audit recommendations and substantially alter the fourth. DA does not accept NERC's proposed modifications and deletions. This concern centers on NERC's decision to change its method of Board compensation from a performance-based approach to a flat fee approach.

DA is not recommending that NERC immediately return to a performance-based arrangement, as NERC suggests. Rather, DA's recommendations reflect its concerns that NERC did not conduct a time study of Board activities to support the shift to a flat-fee arrangement, and that the consultant engaged by NERC to study the question did not investigate the degree of administrative burden associated with the current method of compensation (which investigation might have altered his conclusions). DA's actual recommendation is simply that NERC <u>consider</u> returning to the performance-based method of compensation until it gains the necessary experience to support a change to a flat-fee model. It is quite possible that once NERC puts into place DA's audit recommendations, it will have the necessary tools to permit it to confidently use a performance-based method, or at least to conduct an adequately thorough study to determine which method would be preferable.

NERC also suggests that DA has taken issue with the level of Board compensation. That is not the case. DA simply questioned the quality of the comparability data used by NERC, and what appears to be an inherent bias on the part of the entity conducting the third-party study.

D. Retirement Plans

DA made three recommendations regarding technical aspects of NERC's retirement plans.[13] NERC did not raise any objections to DA's audit finding in this area; however, it does propose changes to the audit recommendations. DA believes there is a meeting of the minds on these recommendations, but is not entirely sure from the language NERC proposed. DA has therefore modified NERC's proposed language, and included those modifications in the revised audit report.

<u>NERC Critical Infrastructure Protection Program (CIP)</u>

NERC is tasked with evaluating and monitoring the REs' oversight of CIP compliance. While NERC contests the audit findings questioning the adequacy of its work in this area, it proposes only minor changes to the audit recommendations themselves (one of which DA accepts). In its discussion, however, NERC attempts to characterize DA's position on the issue as suggesting NERC should take away funds from other statutory activities in order to apply them to CIP oversight. That is emphatically not the case. DA found no indication in the documents it examined during the audit process that suggest such posited trade-offs would be necessary, or that the Commission has limited the funding of all of the statutory activities at issue. Nor has NERC provided any evidence to that effect.

NERC also questions the accuracy of DA's comment that NERC would send its auditors only to audits where Commission staff would also be present. However, DA learned this fact during interviews with senior NERC management.

[13] DA defers to NERC's nomenclature of these plans as "retirement" plans, and so characterizes them in the revised audit report.

And, while DA acknowledges that NERC has attempt to increase its staffing in this area, that does not mean the staffing was adequate at the time of the audit; indeed, it suggests the opposite.

DA cautions that its remarks should not be construed as suggesting that hiring more personnel is necessarily the solution; rather, DA proposes that NERC first conduct an assessment of staffing levels and resources with the aim of determining the appropriate levels needed to carry out its duties relating to CIP oversight by the REs.

NERC's Role as the ES-ISAC

In addition to its role as the ERO, NERC functions as the Electric Sector Information Sharing and Analysis Center (ES-ISAC), having been so designated by the Department of Energy. In that role, NERC receives reports concerning physical security, cyber security, and operational security events and incidents, and shares information with industry participants regarding infrastructure protection. DA presented a number of recommendations in the draft audit report concerning the definition of NERC's role as ES-ISAC, the evaluation of that role in connection with its dual role as ERO, the impact of "walling off" certain staff within NERC, clarification of the flow of information between NERC as the ES-ISAC, and a determination of whether funding of the ES-ISAC should, in whole or in part, be treated as non-statutory and, if so, how to manage such funding.

NERC disputes all of DA's recommendations on the ES-ISAC and concentrates its discussion on whether NERC's role as ES-ISAC is statutory. However, DA is not asserting otherwise; it is merely raising the question for determination. More importantly, DA suggests that NERC work with Commission staff to resolve the various other complex issues raised by NERC's dual roles.

Employee and Board Expenses

DA made a number of recommendations regarding employee and Board expenses, centering on accountability and transparency and the need for NERC to develop formal guidance to determine whether entertainment, meal, and hotel expenses are reasonable and reimbursable. NERC takes issue with these recommendations, arguing that staff is merely asserting its opinion as to whether certain expenses were reasonable. Again, NERC misapprehends DA's concerns. In order for management and the Board in the first instance, and the Commission upon review, to analyze and approve various entertainment, meal, and hotel expenses, they must be able to calibrate them against an objective standard. NERC in fact has an objective standard with regard to meals, but insists that the standard is merely a flag. NERC senior management, however, in interviews with DA and in CFO written guidance, appears to consider it otherwise, citing the figure of $50 per meal as “high-end.”

DA’s recommendations in this area center on the need to enhance formal policies, procedures, and guidance governing expenses incurred by employees, including the implementation of a reasonableness standard, and proposes other reforms to ensure that the dues, fees and charges imposed on end users are spent appropriately.

Summary of Recommendation Status

An appendix is attached to this Answer, detailing the status of DA’s recommendations in the revised audit report. This appendix sets out which recommendations were accepted or rejected by NERC, which NERC proposed to modify, and DA’s action on those proposed modifications.

Appendix I

Current Status of Audit Recommendations

1. NERC Budget Process

Recommendation 1, accepted

Recommendation 2, disputed; modifications proposed by NERC; DA modifies as follows:

> Develop a transparent process that permits the Commission, the BOT and stakeholders opportunity for authorizing the expenditure of funds approved for specific statutory activities to be redirected to unbudgeted activities, and develop and obtain Board approval of enhanced guidelines governing such expenditures, including criteria for determining when Board and Commission approval is required.

Recommendation 3, disputed; deletion proposed; DA modifies as follows:

> Request budgetary funds for activities initiated between budget cycles that were not included in the annual budget filing in a manner similar to section 1108 of the NERC Rules of Procedure.

Recommendation 4, disputed

Recommendation 5, accepted

2. NERC Oversight of the Regional Entities' Budgets

Recommendation 6, modifications proposed by NERC; DA accepts

Recommendation 7, modifications proposed by NERC; DA accepts

Recommendation 8, modifications proposed by NERC; DA accepts

3. Time Reporting and Accounting Systems

Recommendation 9, disputed; modifications proposed by NERC; DA rejects:

Recommendation 10, modifications proposed by NERC; DA accepts

Recommendation 11, accepted

Recommendation 12, disputed, modifications proposed by NERC; DA rejects

Recommendation 13, disputed; DA modifies as follows:

> To the extent consistent with good business practices, NERC should expeditiously implement functionality in the expense reporting software to allow the tracking of expenses on a project and activity basis

Recommendation 14, disputed; modifications proposed by NERC; DA rejects

Recommendation 15, modifications proposed by NERC; DA accepts

4. <u>Employee Compensation</u>

Recommendation 16, modifications proposed by NERC; DA accepts

Recommendation 17, modifications proposed by NERC; DA accepts

Recommendation 18, modifications proposed by NERC; DA accepts

5. <u>Standard for Determining the Reasonableness of Expenses</u>

Recommendation 19, modifications proposed by NERC; DA accepts

Recommendation 20, deletion proposed; DA modifies as follows to show being subsumed in recommendation 19 as proposed by NERC:

> In the enhancements under recommendation 19, NERC should evaluate the effectiveness of dividing its process for approving expenses into two steps, leaving managers responsible for approving the purpose and rationale for incurring expenses and designating accounting staff to be responsible for evaluating the reasonableness of expenses;

Recommendation 21, modifications proposed by NERC; DA accepts

6. Employee Entertainment

Recommendation 22, disputed; modifications proposed by NERC; DA rejects

Recommendation 23, disputed; modifications proposed by NERC; DA rejects

Recommendation 24, disputed; modifications proposed by NERC; DA rejects

7. Board of Trustees Compensation and Expenses

Recommendation 25, disputed; deletion proposed; DA rejects

Recommendation 26, disputed; deletion proposed; DA rejects

Recommendation 27, disputed; deletion proposed; DA rejects

Recommendation 28, disputed; modifications proposed by NERC; DA rejects

Recommendation 29, disputed; modifications proposed by NERC; DA rejects

Recommendation 30, disputed; modifications proposed by NERC; DA rejects

Recommendation 31, disputed; modifications proposed by NERC; DA rejects

8. Retirement Plans

Recommendation 32, modifications proposed by NERC; DA modifies as follows:

> Determine its retirement obligations using relevant comparability and other data that reflects current market conditions.

Recommendation 33, modifications proposed by NERC; DA modifies as follows:

> Work with the BOT to craft total remuneration policy based on principles of total compensation, electric power industry practices, and other relevant factors. This policy should include procedures to justify that all retirement plan contribution levels are appropriate and reasonable.

Recommendation 34, modifications proposed by NERC; DA modifies as follows:

> Develop an alternative mechanism for addressing retirement contributions in excess of the IRS cap that maintains the payment as a retirement benefit and not as additional compensation to the employee.

9. <u>NERC Critical Infrastructure Protection Program</u>

Recommendation 35, modifications proposed by NERC; DA accepts

Recommendation 36, modifications proposed by NERC; DA accepts

10. <u>NERC Activities</u>

Recommendation 37, disputed; modifications proposed by NERC; DA rejects

Recommendation 38, disputed; modifications proposed by NERC; DA rejects

11. <u>NERC as the Electric Sector Information Sharing and Analysis Center</u>

Recommendation 39, disputed; modifications proposed by NERC; DA rejects

Recommendation 40, disputed; deletion proposed; DA rejects

Recommendation 41, disputed; deletion proposed; DA rejects

Recommendation 42, disputed; deletion proposed; DA rejects

<u>With respect to the four recommendations made in Part I, section F:</u>

1. Submit quarterly reports to DA describing the company's progress in completing each corrective action recommended in the final audit report. NERC should make these nonpublic quarterly filings no later than 60 days after the end of each calendar quarter, beginning with the first quarter after the final audit report is issued, and continuing until NERC completes all recommended corrective action.

    - DA accepts NERC's modification to submit its implementation plan within 60 days instead of 30

2. Submit quarterly reports to DA describing the company's progress in completing each corrective action recommended in the final audit report. NERC should make these nonpublic quarterly filings no later than 30 days after the end of each calendar quarter, beginning with the first quarter after the final audit report is issued, and continuing until NERC completes all recommended corrective action.

    - Accepted without change

3. Submit copies of any written policies and procedures developed in response to recommendations in the final audit report, in the first nonpublic quarterly filing subsequent to NERC completion of documents containing such policies and procedures.

    - Accepted without change

4. Select an independent third party, with DA staff approval, to review NERC's budget formulation, administration and execution processes. The third-party auditor shall submit a report contemporaneously directly to DA staff and to NERC. If DA staff so requests, NERC will contract for a second independent audit for the following year.

    - Disputed, modifications proposed by NERC; DA rejects

Document Content(s)