127 FERC ¶ 61,120
FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D.C. 20426

May 6, 2009

In Reply Refer To:
New York Independent System Operator, Inc.
Docket No. PA08-3-000

New York Independent System Operator, Inc.
10 Krey Boulevard
Rensselaer, NY 12144

Attention: Robert E. Fernandez
General Counsel

Dear Mr. Fernandez:

1. In this order, the Commission approves the attached Audit Report (Report) prepared by the Division of Audits in the Office of Enforcement (OE). The Report contains staff's findings and recommendations with respect to New York Independent System Operator, Inc.'s (NYISO) responsibilities as an Independent System Operator (ISO). The audit evaluated NYISO's compliance with: (1) the NYISO Agreement;[1] (2) the NYISO Membership Agreement;[2] (3) the NYISO Market Services Tariff; [3] and (4) NYISO's Open Access Transmission Tariff.[4]

2. Staff informed NYISO of its audit findings and recommendations in a draft audit report on February 20, 2009. The draft audit report found that NYISO did not provide

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[1] *Central Hudson Gas & Electric Corporation, et al.*, 88 FERC ¶ 61,229 (1999) (order accepting NYISO agreement on governance).

[2] *New York Independent System Operator, Inc.*, 90 FERC ¶ 61,015 (2000) (order accepting, among other things, revised NYISO Service Tariff).

[3] *New York Independent System Operator, Inc.*, FERC Electric Tariff Original Volume No. 2.

[4] *New York Independent System Operator, Inc.*, FERC Electric Tariff Original Volume No. 1.

adequate assurance that its internal Marketing Monitoring Unit (MMU) has sufficient independence from the market design function of NYISO. Also, the report found fault with NYISO's failure to consistently notify the Commission and market participants on a timely basis when NYISO discovers tariff-related problems. The audit findings and recommendations occurred during the audit period of January 2006 through January 2009.

3. On March 18, 2009, NYISO submitted a response to the Report indicating it agreed to adopt all of the Report recommendations and NYISO has already begun implementing the recommended corrective actions.[5]

4. As explained below, we direct NYISO to implement the Report's audit recommendations, including the procedures outlined in this order.

5. For the audit period, staff found two areas of concern, discussed more fully below, involving (1) independence of NYISO's internal MMU; and (2) untimely notification to the Commission and market participants of tariff-related problems.

6. First, the Report found that NYISO's internal MMU is not sufficiently independent of its Market Structures unit, which includes a number of functions related to market design and product development. Several provisions of the NYISO Market Monitoring Plan require the MMU to be responsive to NYISO's Chief Executive Officer (CEO). Specifically, the Market Monitoring Plan requires the MMU to act at the direction of the CEO.[6] It also subjects the MMU to the management oversight of the CEO in retaining consultants and other experts and in developing and implementing methods, procedures, staffing and other resources for meeting the objectives of its Market Monitoring Plan.[7] The Report notes that while the Market Monitoring Plan calls for the MMU to be responsible to the CEO, the audit revealed that the head of the MMU was reporting to the Vice President of Market Structures. This raises a potential conflict because the Vice President of Market Structures also has responsibility for market design. The Report found that this is inconsistent with the Market Monitoring Plan and Order No. 719, which requires MMUs to report to the Board of Directors, rather than management, to give them the separation needed to foster independence.[8]

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[5] NYISO Response at p. 1.

[6] Market Monitoring Plan, section 3.3.

[7] Market Monitoring Plan, sections 3.2. and 5.1.1.

[8] *Wholesale Competition in Regions with Organized Electric Markets*, Order No. 719, 73 Fed. Reg. 61,400 (October 28, 2008), FERC Stats. & Regs. ¶ 31,281 (2008).

7. The Report found that while there was insignificant evidence the MMU was denied access to necessary resources or that the market design function (or any other business unit in NYISO) otherwise impeded the efforts of the MMU, there was cause for concern that the existing organizational structure does not foster sufficiently the independence of the market monitoring function. To illustrate this concern, the Report cites an instance in which a request for new staff was denied by the VP of Market Structures with a recommendation that less costly alternatives could be pursued, suggesting that the MMU function competes with the market design function in staffing decisions. The Report also notes that the VP of Market Structures evaluates the performance of and awards bonuses to the head of the MMU, creating the possibility that the head of the MMU could be biased toward actions requested by Market Structures, even if they might be disadvantageous to the MMU.

8. Second, the Report found that NYISO has not always informed market participants on a timely basis and notified the Commission when it uncovered tariff-related problems. The Report noted that the Commission recently ordered NYISO to file a report with the Commission explaining why it did not self-report a tariff-related error to the Commission's Office of Enforcement and whether it notified its market monitor of the violation.[9] The Commission also agreed with the market participants in that case, who expressed concern with the length of time it took NYISO to inform them of the error.[10]

9. The Report also noted earlier instances when the Commission told NYISO that it expected NYISO to report tariff-related problems to the Commission and to notify market participants of such problems.[11] It found several additional instances of NYISO's failure to act in a timely manner after discovering tariff-related problems.[12]

10. The Report includes recommended remedies to address the audit findings and recommendations and to help ensure NYISO's future compliance. The Report recommends NYISO:

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[9] *New York Independent System Operator, Inc.*, 126 FERC ¶ 61,100, Ordering Paragraph A (2009).

[10] *Id*. P 19.

[11] *New York Independent System Operator, Inc.*, 115 FERC ¶ 61,026 (2006).

[12] On March 5, 2009, NYISO filed proposed tariff revisions and a request for a waiver in Docket No. ER09-803-000, based on some of the tariff-related issues revealed in the audit. The Commission accepted the revisions for filing, effective May 4, 2009, by a delegated letter order issued on April 7, 2009.

a. Consider organizational structure changes for its internal market monitoring function, in light of the findings in the audit report and the requirements of Order No. 719;

b. Conduct and submit to the Commission within six months of the issuance of the Report a review of the adequacy of resources that have flowed into its MMU over the last two years to determine whether any market monitoring efforts have been hindered;

c. Conduct a formal review of the processes used to: (1) identify formal tariff compliance problems; (2) conduct internal evaluations of such problems; (3) vet such problems with stakeholders; and (4) seek waivers or tariff revisions at the Commission, as appropriate. The goal of such review should be to ensure that there are strong controls in place in the future. Audit staff specifically recommends that NYISO consider: (1) explicitly identifying the person responsible for, and the team assembled to work on, each piece of tariff compliance; (2) establishing a completion date for each task; (3) documenting deviations from completion dates; (4) developing an explicit process for stakeholder notification; and (5) developing explicit procedures and timetables for informing the Commission of possible tariff problems and making timely filings at the Commission; and,

d. Develop written procedures consistent with the process review to ensure that NYISO takes timely actions when it identifies tariff problems. NYISO should conduct audits of how effective these new procedures are, and the extent to which they are being followed by NYISO personnel. These audits should be conducted annually for at least two years after NYISO implements the new procedures.

11. Notwithstanding that NYISO agreed with the audit findings, recommendations, and conclusions in the Report, the Commission is concerned with NYISO's failure to formally notify the Commission and inform market participants of its tariff-related problems in a timely manner. The Commission is especially troubled by NYISO's failure in this regard because, as noted above, this is not the first time that the Commission has addressed this issue with NYISO.

12. The Commission is encouraged that NYISO has agreed to conduct a formal review of processes used to identify potential tariff compliance problems, conduct internal evaluations of such problems, vet such problems with stakeholders, and seek timely waivers or tariff revisions at the Commission as appropriate. The goal of such review should be to ensure that there are strong controls in place on a going-forward basis. We expect NYISO to comply with the recommended actions in the Report. Also, we direct the Office of Enforcement to report to the Commission any failure of NYISO to comply.

<u>The Commission orders</u>:

(A) The attached Report is approved in its entirety without modification.

(B) NYISO is directed to implement the corrective actions recommended in the Report.

(C) NYISO is directed to submit a compliance plan outlining the steps it will take to implement the Report recommendations within 30 days from the issuance of the final report in this docket.

(D) NYISO must make non-public quarterly submissions in Docket PA08-3-000 detailing its progress in implementing the corrective actions until all the corrective actions are completed. The submissions must be made not later than 30 days after the end of each quarter, beginning with the first quarter after the submission of the compliance plan and continuing until NYISO completes al the recommended corrective actions.

By direction of the Commission.

Nathaniel J. Davis, Sr.,
Deputy Secretary.

Federal Energy Regulatory Commission

Audit of Compliance with Tariffs and Agreements of the New York Independent System Operator, Inc.

Docket No. PA08-3-000
April 17, 2009

Office of Enforcement
Division of Audits

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I. Executive Summary

A. Overview

The Division of Audits (DA) in the Office of Enforcement (OE) of the Federal Energy Regulatory Commission (Commission) has completed an audit of the New York Independent System Operator, Inc. (NYISO). The audit addressed NYISO's responsibilities as an Independent System Operator (ISO) under the requirements of Order No. 888[13] and other Commission directives for ISOs, and its specific responsibilities under Commission requirements for NYISO.

Specific objectives of this audit were to determine whether NYISO operated in compliance with a select set of its responsibilities under its tariffs and agreements, including: (1) the NYISO Agreement, [14] (2) the Membership Agreement,[15] (3) the Market Services Tariff,[16] and (4) the Open Access Transmission Tariff.[17] This audit covered the period from January 2006 through the end of January 2009.

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[13] *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, Order No. 888, 61 Fed. Reg. 21,540 (May 10, 1996), FERC Stats. & Regs. ¶ 31,036 (1996), *order on reh'g*, Order No. 888-A, 62 Fed. Reg. 12,274 (Mar. 14, 1997), FERC Stats. & Regs. ¶ 31,048 (1997), *order on reh'g*, Order No. 888-B, 81 FERC ¶ 61,248 (1997), *order on reh'g*, Order No. 888-C, 82 FERC ¶ 61,046 (1998), aff'd in relevant part sub Nom. Transmission Access Policy Study Group v. FERC 225 F.3d 667 CD.C.Cir. 2001, Aff'd Sub Nom. New York v. FERC, 535 U.S.1(2002).

[14] *Central Hudson Gas & Electric Corporation et al.*, 88 FERC ¶ 61,229 (1999) (order accepting NYISO agreement on governance).

[15] *New York Independent System Operator, Inc.*, 90 FERC ¶ 61,015 (2000) (order accepting, among other things, revised NYISO Services Tariff.

[16] New York Independent System Operator, Inc., FERC Electric Tariff Original Volume No. 2.

[17] New York Independent System Operator, Inc., FERC Electric Tariff Original Volume No. 1.

B. NYISO's Organizational Structure Relevant to this Audit

NYISO is a not-for-profit corporation that operates as an ISO under Commission rules and regulations.[18] NYISO manages the electric transmission grid and oversees and administers wholesale electric markets within its footprint. NYISO was formed in 1997 and commenced operations as an ISO in 1999. NYISO currently has over 400 employees.

Governance

NYISO is governed by a 10-member Board of Directors whose members come from the power industry, environmental organizations, and the fields of finance, academia, technology and communications. The NYISO Agreement requires that the members of the Board, as well as all employees, must be independent of any business, financial, operating or other direct relationship to any market participant or stakeholder.

The NYISO Agreement calls for three standing committees comprised of representatives from each party to the NYISO Agreement to report to the Board of Directors. These committees (Management, Operating, and Business Issues) are supported by several subcommittees, which are made up of individuals from five major stakeholder sectors: Transmission Owners, Generation Owners, Other Suppliers, End-Use Consumers, and Public Power and Environmental Parties. The standing committees are tasked with meeting on a monthly basis to discuss, debate, and vote on issues directly affecting NYISO's operations, reliability, and markets.

In addition to the three standing committees, the Board of Directors has voluntarily established four "Board Committees" to assist in governance of the NYISO. As of April 2008, these committees include the Governance Committee, the Audit and Compliance Committee, the Reliability and Markets Committee, and the Commerce and Compensation Committee. The four Board Committees cannot act on behalf of the

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[18] *Central Hudson Gas & Electric Corp. et al.*, 83 FERC ¶ 61,352 (1998) (order conditionally authorizing establishment of Independent System Operator). The NYISO later applied to the Commission for approval as a Regional Transmission Organization under Order No. 2000, in Docket No. RT01-95-000. The application was rejected by the Commission (*New York Independent System Operator, Inc.*, 96 FERC ¶ 61,059 (2001) (order on RTO compliance filing)). Docket No. RT01-95-000 and various related dockets, *e.g.*, RT01-99-000 and RT02-3-000, were later terminated by the Commission. *E.g.*, *RTO Informational Filings*, 104 FERC ¶ 61,296 (2003) (order terminating RTO proceedings).

Board, but they review issues that are set to come before the Board and then make recommendations to the full Board.

Market Monitoring

NYISO employs a hybrid structure for market monitoring, including an external, independent Market Advisor,[19] and an internal Market Monitoring unit (MMU). The Market Advisor reports directly to the Board of Directors. The MMU is part of a business unit termed Market Structures. The head of this business unit reports to the President and CEO, who then reports directly to the Board of Directors.

Compliance

NYISO's compliance program includes annual employee training and annual attestation, as well as various other controls such as outside independent assessments and regular reporting to the Board of Director's Audit and Compliance Committee. There is a Chief Compliance Officer and an Assistant Compliance Officer. The Chief Compliance Officer also served as Vice President and General Counsel during the audit period.[20] The Assistant Compliance Officer also served as Director of a NYISO business unit during the audit period, but after a recent promotion, now serves as Vice President of Enterprise and Customer Service as well as Assistant Compliance Officer.

NYISO characterizes the NYISO Compliance Office as an enterprise level resource that provides compliance guidance and oversight via a team approach. In interviews, audit staff learned that the compliance function is highly decentralized. The primary responsibility for ensuring NYISO compliance with its tariffs and agreements rests with each business unit or function that is affected by a tariff or agreement provision. The direct responsibilities of the NYISO Compliance Office for ensuring compliance are limited, and are mostly confined to coordination of the overall compliance program.

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[19] The Market Advisor is Potomac Economics Ltd.

[20] The General Counsel assumed the role of Chief Compliance Officer in January 2007. The Chief Compliance Officer role had been served by another company officer prior to that point. The General Counsel also held the title of Corporate Secretary until January 15, 2008 at which time that duty was reassigned.

C. Summary of Compliance Findings

Below is a summary of audit staff's compliance findings. A more detailed discussion of audit staff's findings is included in Section III. Audit staff found two areas of concern related to NYISO's Independent System Operator Agreement, Market Administration and Control Area Services Tariff and Open Access Transmission Tariff requirements:

- NYISO employs a hybrid market monitoring structure. An external Market Advisor reports directly to NYISO Board of Directors. An internal MMU reports directly to the Vice President of Market Structures, a business unit that also includes a number of functions related to market design and product development. The reporting arrangement for the MMU raises concerns whether the MMU is sufficiently independent of the market design function. Audit staff recommends NYISO change its organizational structure so that it is consistent with the requirements and timetable of Order No. 719.[21]

- NYISO has made a significant commitment in time and resources to ensure compliance with its tariffs and agreements, and has made a large number of filings at the Commission to ensure compliance with its tariffs. However, NYISO has not always informed market participants on a timely basis or notified the Commission on a timely basis when it has uncovered tariff-related problems. Audit staff recommends that NYISO review its tariff compliance processes and develop stronger processes, as necessary, to ensure timely consideration and action.

D. Summary of Recommendations

Below is a summary of audit staff's recommendations to remedy the findings in this report. Detailed recommendations are included in Section III.

- NYISO should begin consideration of organizational structure changes for its internal market monitoring function, in light of the findings of this audit report, and the requirements of Order No. 719. Further, NYISO should conduct a review of the adequacy of resources that have flowed to its MMU over the last two years, to evaluate whether the resources allocated to the market monitoring function are sufficient on a going-forward basis.

[21] *Wholesale Competition in Regions with Organized Electric Markets*, Order No. 719, 73 Fed. Reg. 61,400 (October 28, 2008), FERC Stats. & Regs. 31,281 (2008).

- NYISO should conduct a formal review of the processes it uses to remedy potential tariff compliance problems, particularly the processes employed to ensure timely involvement of stakeholders, and timely notification of and filings to the Commission.

E. Compliance and Implementation of Recommendations

Audit staff further recommends that NYISO:

- Submit for audit staff's review a plan for implementing audit staff's recommendations. NYISO should provide this plan to audit staff within 30 days of the issuance of the final audit report in this docket.

- Submit non-public quarterly reports to OE describing progress in completing each corrective action recommended in the final audit report in this docket. NYISO should make the quarterly submissions no later than 30 days after the end of each calendar quarter, beginning with the first quarter after the final audit report in this docket is issued, and continuing until NYISO completes all the recommended corrective actions.

- Submit copies of any written policies and procedures developed in response to the recommendations in the final audit report. These policies and procedures should be submitted for audit staff's review in the first quarterly filing after these products are completed by NYISO.

II. Introduction

A. Objectives

This audit addressed NYISO's responsibilities as an ISO. Specific objectives of this audit were to determine whether NYISO operated in compliance with a select set of its responsibilities under Commission-sanctioned tariffs and agreements, including (1) the NYISO Agreement, (2) the Membership Agreement, (3) the Market Services Tariff, and (4) the Open Access Transmission Tariff. The audit covered the period from January 2006 through January 2009. Actions taken by NYISO during the audit period and subsequent to the close of the audit period are noted in this Audit Report.

B. Scope and Methodology

OE's audit staff employed the following basic steps in conducting this audit:

- Reviewed the Commission's criteria for an ISO, and specific requirements for NYISO.
- Reviewed publicly-available information about NYISO, including Commission orders and rulemakings, filings made to the Commission, NYISO annual reports, market monitoring reports, etc., and information on NYISO's website.
- Reviewed confidential data provided by NYISO in briefings to audit staff and in response to audit staff's data requests.
- Reviewed follow-up materials provided by NYISO in response to questions raised by audit staff.
- Interviewed key NYISO employees on issues related to the scope of this audit.
- Conducted two site visits to NYISO headquarters and one site visit to the NYISO Power Control Center.
- Conducted audit field testing and spot verification of select data and audit findings.

At a more granular level, audit staff tested NYISO conformance with key requirements in the NYISO agreements and tariffs. For example, during the course of this audit, audit staff performed the following:

Governance and Independence

- Reviewed NYISO's Board of Directors' selection requirements, voting procedures, and votes taken.

- Reviewed NYISO's Committee membership requirements, agenda process, voting procedures, and appeals process.

- Interviewed key NYISO staff, including legal and regulatory affairs staff, on the actual performance of the Board of Directors and Committees.

Market Monitoring

- Reviewed NYISO's market monitoring reports, documentation of reference levels, investigation reports, and routine monitoring reports, to evaluate whether adequate controls and procedures were in place.

- Interviewed managers and staff of the MMU to clarify specific tasks performed by the group, and the manner in which MMU staff interacted with the external Market Advisor, other NYISO staff, NYISO Board of Directors, NYISO Committees, and the Commission.

- Evaluated the organizational structure of NYISO's MMU to evaluate staff adequacy, access to market data, independence to effectively monitor the performance of NYISO markets, and efficacy of market design.

Compliance Controls

- Interviewed managers and key staff in legal and compliance business units to evaluate the scope of NYISO's compliance program, specifically including procedures employed to identify market design flaws, inconsistencies between market operations and tariff provisions, and processes used to evaluate tariff revisions when necessary.

- Interviewed NYISO's manager of internal audits to evaluate the role of auditing in the compliance program.

- Evaluated NYISO training programs, including review of select training materials used.

- Reviewed the procedures used by NYISO to determine whether to assess, and the amount of sanctions imposed on market participants. Reviewed the documentation for sanctions imposed for violations of NYISO's rules for its installed capacity market, to evaluate, e.g., whether sanctions were imposed consistently for all market participants.

Market Structures

- Interviewed managers and key staff in NYISO's Operations and Market Structures business units to evaluate their responsibilities for market monitoring, market design, and product development.

- Reviewed and analyzed price validation procedures employed in NYISO day-ahead and real-time markets.

- Reviewed NYISO's billing processes for compliance with tariff provisions.

III. Findings and Recommendations

A. NYISO's Internal Market Monitoring Function Is Not Sufficiently Independent of Its Market Design Function

NYISO employs a hybrid market monitoring structure. An external Market Advisor reports directly to NYISO Board of Directors. An internal market monitoring function (MMU) reports directly to the Vice President of Market Structures, a business unit that also includes a number of functions related to market design and product development. The reporting arrangement for the MMU raises concerns whether the MMU is sufficiently independent of the market design function.

Pertinent Guidance

The NYISO Market Monitoring Plan[22] requires the MMU to be responsive to NYISO's Chief Executive Officer (CEO). For example:

- Section 3.3 on Accountability. "The Market Monitoring Unit shall act at the direction of the Chief Executive Officer, who shall be accountable for implementation of this Plan."

- Section 3.2 on Staffing. The MMU "may retain such consultants and other experts as it deems appropriate to the effective implementation of this Plan, subject to the management oversight of the Chief Executive Officer."

- Section 5.1.1 on Monitoring Methods, Procedures and Resources Adequacy. "Subject to management oversight by the Chief Executive Officer, the Market Monitoring Unit shall develop and implement methods, procedures, staffing and other resources for achieving the purpose and objectives of this Plan. Such methods, procedures, staffing and other resources shall be appropriate to realizing the purposes and objectives and effective implementation of this Plan, and shall be

[22] *New York Independent System Operator Market Monitoring Plan: Composite Agreement Reflecting Commission Orders and Filings Through June 27, 2008, Rev. 506* (NYISO Market Monitoring Plan), http://www.nyiso.com/public/webdocs/documents/regulatory/agreements/mmp/mmp.pdf (last visited on Feb. 20, 2009).

subject to review, modification and approval by the Chief Executive Officer, in consultation with the New York ISO Market Advisor."

The Market Monitoring Plan also requires NYISO to ensure that the MMU has adequate employees, funding and other resources, access to required information, and the cooperation of NYISO staff, as necessary to function effectively and provide for the independent, impartial and effective monitoring of and reporting on the New York electric markets.

Audit staff's concerns about the independence of NYISO's MMU pre-date issuance of Order No. 719. When Order No. 719 was issued on October 17, 2008, it provided guidance on a going-forward basis for the Commission's preferred reporting structure for an internal market monitoring function: "We adopt the NOPR proposal requiring MMUs to report to the RTO or ISO board of directors."… "Removing the MMU from reporting to management will give it the separation needed to foster independence." [23] Further, Order No. 719 clarifies that "if the internal market monitor is responsible for carrying out any or all of the above-cited core MMU functions, it must report to the board (as must the external market monitor). This solution allows the RTO or ISO to structure its MMU function in the way it deems most suitable while also ensuring that the market monitor that performs the core MMU functions enjoys the independence from management that reporting to the board accomplishes."[24]

Background

The NYISO Market Monitoring Plan calls for the MMU to be responsible to NYISO's CEO. Current organizational charts show that the head of the MMU reports directly to the Vice President of Market Structures, who in turn reports to the CEO, who in turn reports to the NYISO Board of Directors. Thus, while the MMU does report to the CEO, it is indirect reporting through the VP of Market Structures. Because the VP of Market Structures has responsibilities for market design as well as market monitoring, any conflicts between these two functions are resolved in the first instance by the VP of Market Structures. In audit staff's view, this organizational structure is not consistent with what audit staff presumes to be the intent of section 3.3 of the NYISO Market Monitoring Plan, i.e., for the MMU to report directly to the CEO.

[23] Order No. 719 at P 339.

[24] *Id.* P 341.

With respect to the adequacy of resources available to the MMU, audit staff did not find any significant evidence that the MMU was denied access to any type of necessary resources, or that the market design function (or any other business unit in NYISO) otherwise impeded in any way the efforts of the MMU. However, audit staff's concern remains that the existing organizational structure that NYISO has adopted, effectively intertwining the management of the market monitoring and market design functions, does not sufficiently foster independence of the market monitoring function. For example:

- *Hiring*. The MMU makes requests for additional staffing through the VP of Market Structures. Audit staff learned that at least once during the audit period, the MMU's request for new staff was denied. The explanation offered was that the MMU could pursue less costly alternatives, including: hire a contractor, hire a part time employee, or request that an employee from another NYISO business unit be detailed to the MMU. Audit staff raises this to illustrate that the MMU function competes with market design functions with respect to staffing decisions.

- *Performance Evaluations and Bonuses.* Performance evaluations of MMU staff are done by the head of the MMU, but the performance evaluation of the head of the MMU is done by the VP of Market Structures. Since the VP of Market Structures is responsible for market design as well as market monitoring, this creates the possibility of biasing the head of MMU towards actions requested by the VP of Market Structures, actions that could be disadvantageous to the market monitoring function's capabilities. And the same concern that applies to performance evaluations applies to awarding of bonuses for individual performance— since the VP of Market Structures is responsible for determining the bonus of the head of the MMU, this may impede the independence of the market monitoring function vis-à-vis the market design function.

Based on extensive review of market monitoring activities, and interviews with key staff, it is audit staff's view that NYISO's MMU does carry out the core market monitoring functions listed in Order No. 719. For example, the MMU, in conjunction with the Market Advisor, performs a large number of tasks related to market monitoring, including, e.g.: identifying undue market concentration, collusive or anticompetitive behavior; evaluating bids; identifying causes of transmission congestion; evaluating market power mitigation; evaluating appropriate sanctions for rules violations; and engaging in such other conditions, function or actions as may be approved by the CEO or the Board.[25]

[25] NYISO Market Monitoring Plan at Section 5.1.2.

The functions carried out by NYISO's MMU appear wholly consistent with the Commission's identification of core market monitoring functions. For example, in the Policy Statement on market monitoring units, the Commission said that MMUs monitor organized wholesale markets to identify ineffective market rules and tariff provisions, identify potential anticompetitive behavior by market participants, and provide the comprehensive market analysis critical for informed policy decision making.[26]

Order No. 719, which supercedes the Policy Statement, describes three core functions as: (1) evaluating existing and proposed market rules, tariff provisions and market design elements; (2) reviewing and reporting on the performance of the wholesale markets to the RTO or ISO, the Commission, and other interested entities such as state commission and market participants; and (3) identifying and notifying the Commission's Office of Enforcement staff of instances in which a market participant's behavior, or that of the RTO or ISO, may require investigation.[27]

For all of these reasons, audit staff believes that the current organizational structure for NYISO's MMU does not result in a sufficiently independent market monitoring function. Moreover, Order No. 719 requires (among other things) that all RTOs and ISOs (such as NYISO) make compliance filings demonstrating that they are in compliance with the new Commission requirements on MMU independence and oversight. NYISO is required to demonstrate in its compliance filing, due to the Commission in April 2009, that it is in compliance with the requirement that an internal market monitor that is responsible for carrying out any or all core MMU functions must report to the Board of Directors.

Recommendations

Audit staff recommends:

1. NYISO should consider organizational structure changes for its internal market monitoring function, in light of the findings of this audit report, and the requirements of Order No. 719.

2. In light of the insufficient independence of the internal market monitoring function, NYISO should conduct a review of the adequacy of resources that

[26] *Market Monitoring Units in Regional Transmission Organizations, Independent System Operators*, 111 FERC ¶ 61,267 (2005). This Policy Statement on market monitoring units was effective during the audit period.

[27] Order No. 719 at P 354.

> have flowed to its MMU over the last two years, to determine whether any market monitoring efforts have been hindered. The results of this review should be submitted to OE within six months of issuance of this audit report.

B. NYISO is Sometimes Slow to Inform Market Participants and Notify the Commission About Tariff-Related Problems

NYISO has not always informed market participants on a timely basis and notified the Commission on a timely basis when it has uncovered tariff-related problems.

Pertinent Guidance

Audit staff did not find any specific requirements in NYISO tariffs or agreements, or any general Commission requirements for ISOs such as NYISO, with respect to the timeliness of tariff review, or subsequent notification of stakeholders and notification of the Commission. However, in a past order, the Commission said that it expected NYISO to act proactively about tariff-related problems, particularly with respect to NYISO's procedures to identify problems as they occur and to report to the Commission appropriately on these problems, and to inform market participants of such problems.

In a 2006 order granting a tariff waiver to NYISO to allow it to correct errors it made in its computation of bid production cost guarantees, the Commission stated:

> We are pleased that NYISO is acknowledging that its current methods of assuring that it properly computes prices under its tariff needs improvement and that, among other matters, it needs to better train its employees to perform these important tasks competently. We expect NYISO to closely monitor its progress in perfecting its software, in properly training its employees, and in devising any other steps needed to stem the continuing epidemic of billing and computation errors that have plagued NYISO since the inception of its real-time system. If these steps prove insufficient, NYISO must act proactively to identify any remaining or new problems, to devise effective solutions, and to report to the Commission realistically about the scope of its problems and its efforts to resolve them.[[28]]

[28] *New York Independent System Operator, Inc.*, 115 FERC ¶ 61,026, at P 60 (2006).

Since the completion by audit staff of its audit field work, the Commission issued an order deferring action on NYISO's request for a waiver for a tariff error, pending submission of further information by NYISO to the Commission.[29] A number of market participants had expressed concern about the length of time it took NYISO to inform them of the tariff error, the absence of stakeholder involvement in the analysis of the error and the development of corrective action. As a result, the Commission directed NYISO to develop procedures for early notification of stakeholders, timely follow-up and detailed explanations regarding errors, and greater transparency and heightened responsiveness to stakeholders. In addition, the Commission ordered NYISO to:

- "…file a report within 30 days of the date of this order, explaining when and how the error was discovered; why NYISO did not self-report the error to the Commission's Office of Enforcement; whether NYISO notified its market monitor of the tariff violation (and when), or if the market monitor was otherwise aware of it; and the steps NYISO took in informing its market participants, stakeholder committees, and this Commission of the error."

- "…file a report with the Commission within 180 days of the date of this order either proposing tariff changes, or updating the Commission on the development of procedures for stakeholder involvement in the analysis of errors and the development of corrective action."

- "…provide market participants with its full analysis of the impact of the error, including the data requested by the protestors and whether any course of restitution is feasible, within 30 days of the date of this order, and to report the results of its stakeholder discussions concerning the error that is the subject of this filing to the Commission within 90 days of the date of this order."[30]

Background

NYISO has a number of on-going efforts to verify that its operating procedures are consistent with its tariffs and agreements. The main effort, the Strategic Tariff Review Project (STR), was initiated in 2007. Its purpose is to identify potential improvements to the NYISO tariffs and confirm that procedures in place are consistent with, and are adequately addressed in the NYISO tariffs. In addition, NYISO described for audit staff other processes and procedures to ensure compliance with its tariffs, including: on-going

[29] *New York Independent System Operator, Inc.*, 126 FERC ¶ 61,100, at P 18 (2009).

[30] *Id.* at Ordering Paragraphs A-C.

internal audits; a review by the Market Advisor; a review of its Accounting and Billing Manual and Day-Ahead Scheduling Manual; and a requirement for NYISO officers to conduct due diligence to confirm whether they are aware of any tariff non-compliance issues in their area of responsibility.

Audit staff and NYISO personnel discussed these processes at length, in order for audit staff to evaluate how well they have worked. Audit staff focused on ten filings made by NYISO to the Commission that NYISO personnel identified. Audit staff reviewed these compliance filings, and reviewed additional information requested by audit staff involving the circumstances of each of the filings. Specifically, audit staff's review focused on how each issue was identified by NYISO personnel, brought to the attention of NYISO management, and NYISO's actions after the issue had been identified.

Our review of these filings suggests NYISO has not always acted in a timely manner. In some cases it appears that NYISO was relatively quick to inform market participants of problems with market design, and relatively quick to inform the Commission and to make requests for waivers and tariff modifications. However, in other cases, the actions of NYISO were particularly slow. For example:

- In 2006, NYISO discovered that the tariff language which established the allocation methodology for Operating Costs was inconsistent with NYISO's and its stakeholders' intent. Having identified this issue, NYISO informed market participants of the problem and began a stakeholder process to correct the deficiencies. However, it was not until March 2007 that NYISO filed with the Commission a request to amend NYISO's tariffs to correct the identified errors.

- Also in 2006, NYISO discovered a discrepancy between how the costs of blackstart service costs were allocated and relevant tariff language. NYISO decided to incorporate this issue into a larger effort to overhaul its billing and accounting system software. It was not until March 2007 that NYISO made a filing with the Commission to request a waiver of existing tariff provisions and request tariff changes.

In addition to the tariff issues identified by NYISO personnel, audit staff also tested whether there were other circumstances, not yet identified by NYISO, where tariff provisions were not being followed. Audit staff found one such example, involving the use of load forecast data provided by Load Serving Entities (LSE) to NYISO.

Sections 4.2.5 and 4.2.4 of the NYISO Market Services Tariff describe the use of LSE load forecasts in the process of NYISO developing its security constrained unit commitment schedules. For some period of time since inception of the NYISO market,

LSE forecasts were used by NYISO in developing ISO-wide load forecasts for use in the scheduling process. Over time, LSE forecast data were used less, and by sometime in 2006, LSE forecast data stopped being used.

NYISO personnel explained to audit staff that NYISO determined, through extensive testing of its load forecasting models, the load forecast data provided by LSEs was less accurate than the load forecast data that NYISO developed from its own analyses and other sources.[31] The upshot is that since 2006, the load forecast data provided by LSEs is still used by NYISO to compute initial bills, but is no longer used for load forecasting purposes.

NYISO personnel told audit staff that they have had discussions about the LSE load forecast data internally, and with market participants, as early as 2000. Audit staff asked whether market participants, specifically LSEs, had been formally notified that LSE load forecast data were no longer used in NYISO's load forecasting process. NYISO personnel told audit staff that the issue was discussed with market participants at the September 2000 Business Issues Committee meeting and that NYISO did issue a Technical Bulletin (#065) on the subject on August 30, 2002. Audit staff reviewed this Technical Bulletin—it describes the method used to develop state-wide load forecasts, and the use of LSE load forecast data is not mentioned. Audit staff's concern is whether these steps constitute adequate notice to market participants that NYISO has changed the method it uses to develop state-wide load forecasts, and that the new method may not be wholly consistent with tariff provisions.

NYISO personnel informed audit staff that NYISO personnel would review whether there is an inconsistency between the tariff provisions and the actual use made of LSE load forecast data. The NYISO has since developed conforming tariff revisions through the stakeholder process with unanimous approval. On February 10, 2009, NYISO's Board of Directors approved a motion directing the NYISO to file the proposed changes and a request for any necessary waivers with the Commission. On March 5, 2009, the proposed changes and request for waiver were filed at the Commission in Docket No. ER09-803-000. On April 7, 2009, in a delegated letter order, NYISO's revised tariff sheets were accepted for filing, effective May 4, 2009, as proposed by NYISO.

One additional observation audit staff made on this issue concerns the on-going STR process which NYISO is using to identify inconsistencies between NYISO operations and NYISO tariffs. In February 2008, NYISO provided to audit staff a list of

[31] Audit staff performed a spot check and found that a sample of load forecast data supplied by the LSEs was less reliable than the load forecast data relied on by the NYISO in performing its scheduling functions.

eight provisions of NYISO tariffs that were ripe for review. Audit staff monitored progress on these eight issues, and as of the end of November 2008, half of the reviews were finished, but half were still pending. NYISO personnel indicated that with respect to all relevant tariff provisions, only about one-third of such provisions had been reviewed as of the end of 2008, and that the review of all such provisions would not be finished until late 2009.

Audit staff believes that NYISO has made a significant commitment in time and resources to review its operations, keep its stakeholders informed, and to make necessary changes to its tariffs. However, audit staff's observations suggest that NYISO's commitment does not necessarily result in timely action.

Recommendations

Audit staff has the following recommendations to make the NYISO tariff review processes more proactive:

3. Consistent with the Commission's directive in the February 9th order, NYISO should conduct a formal review of processes used to: identify potential tariff compliance problems, conduct internal evaluations of such problems, vet such problems with stakeholders, and seek waivers or tariff revisions at the Commission as appropriate. The goal of such review should be to ensure that there are strong controls in place on a going-forward basis. Audit staff specifically recommends that NYISO consider:

    i. explicitly identifying the person responsible, and the team assembled, to work on each piece of tariff compliance
    ii. establishing a completion date for each task
    iii. documenting deviations from completion dates
    iv. developing an explicit process for stakeholder notification
    v. and developing explicit procedures and timetables for informing the Commission of possible tariff problems and making timely filings at the Commission.

4. NYISO should develop written procedures consistent with the process review to ensure timely actions are taken by NYISO when tariff problems are identified. NYISO should conduct audits of how effective these new procedures are, and the extent to which they are being followed by NYISO personnel. These audits should be conducted on an annual basis, for at least a two year period after implementation of the new procedures.

NEW YORK INDEPENDENT SYSTEM OPERATOR
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March 18, 2009

Brian K. Craig, Director
Division of Audits
Federal Energy Regulatory Commission
888 First Street, NE, RM 51-37
Washington, DC 20426

RE: New York Independent System Operator, Inc.;
Docket No. PA08-3-000

Dear Mr. Craig,

This letter sets forth the response of the New York Independent System Operator, Inc. ("NYISO") to the draft audit report issued by the Federal Energy Regulatory Commission's ("Commission's") Office of Enforcement, Division of Audits ("Audit Staff") on February 20, 2009, in the above-referenced docket ("Draft Audit Report").[1] The NYISO agrees with the findings and recommendations set forth in the Draft Audit Report and will take action within the time periods established in the report to comply with Audit Staff's recommendations.

The NYISO appreciated the opportunity to work with Audit Staff in a constructive and collaborative process in their audit of the NYISO's compliance with its NYISO Agreement, Membership Agreement, Market Administration and Control Area Services Tariff, Open Access Transmission Tariff, and other applicable Commission-directed regulatory requirements ("Governing Documents and Commission Requirements"). The NYISO found the audit process to be beneficial as it identified several areas in which the NYISO can make additional improvements to its processes and methods. The NYISO remains committed to ensuring its on-going compliance with the Governing Documents and Commission Requirements. This on-going commitment to compliance has the full support of the NYISO Board and senior management, who have made the NYISO's compliance program one of their highest priorities.

As specified in the Draft Audit Report, the NYISO will submit within thirty days of the issuance of the final audit report its plan for implementing Audit Staff's recommendations. This implementation plan will set forth the specific steps that the NYISO has already taken, and will take, to fully comply with Audit Staff's recommendations. In the interim, the NYISO provides the following status report on its implementation of Audit Staff's recommendations.

Recommendation #1 - Market Monitoring Structural Changes

The NYISO is actively engaged in reviewing and preparing revisions to its internal market monitoring unit's organizational structure to provide for an appropriate reporting

[1] As agreed upon with Audit Staff on February 24, 2008, the NYISO is providing its response on March 18, 2008 to the Draft Audit Report.

relationship to the Board of Directors that will comply with Audit Staff's findings and the requirements of the Commission's Order No. 719.[2] The NYISO will timely file its revisions with the Commission in compliance with Order No. 719.

Recommendation #2 - Review of Adequacy of Market Monitoring Resources

The NYISO will conduct a review of the adequacy of resources that have flowed to its market monitoring unit over the last two years to determine whether any market monitoring efforts have been hindered and will report the results of its review to the Office of Enforcement within six months of the issuance of the final audit report.

Recommendation #3 - Timely Action Regarding Tariff Problems

The NYISO is actively engaged in preparing new procedures to ensure that the NYISO takes timely action in response to tariff problems to comply with Audit Staff's findings and a related Commission order.[3] The NYISO will make such filings as are necessary to comply with Audit Staff's findings and the Commission's related order in a timely manner.

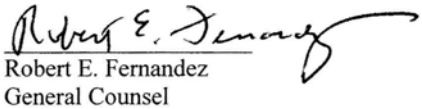
Recommendation #4 - Effectiveness of Procedures Regarding Timely Action

The NYISO will audit the effectiveness of the new procedures created to ensure that the NYISO takes timely action in response to tariff problems and will report the results to Audit Staff as required by the final audit report.

Finally, the NYISO will submit quarterly reports to the Office of Enforcement describing its progress in implementing each of Audit Staff's recommendations until the NYISO completes all of the recommended corrective actions and will provide copies of any written policies and procedures developed in response to these recommendations.

On behalf of the NYISO, I would like to thank Audit Staff for their professionalism, courtesy, and constructive input during the audit process.

Sincerely,



Robert E. Fernandez
General Counsel
New York Independent System Operator, Inc.

cc: Eliot Wessler
Gerald Williams
Stephen Somma
Aaron Bloom

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[2] *Wholesale Competition in Regions with Organized Electric Markets* (Order No. 719), 125 FERC ¶ 61,071, Docket Nos. RM07-19-000 and AD07-7-000 (October 17, 2008).

[3] *New York Independent System Operator, Inc.*, 126 FERC ¶ 61,100, Docket No. ER09-405-000 (February 9, 2009).