

130 FERC ¶ 61,025
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Jon Wellinghoff, Chairman;
Marc Spitzer and Philip D. Moeller.

Texas Regional Entity

Docket No. PA09-6-000

ORDER APPROVING AUDIT REPORT, DETERMINING ISSUE OF
SEPARATION OF FUNCTIONS, AND DIRECTING
COMPLIANCE AND OTHER CORRECTIVE ACTIONS

(Issued January 8, 2010)

1. In this order, the Commission approves the attached Audit Report (Report) prepared by the Division of Audits in the Office of Enforcement (OE), with the assistance of staff from the Office of Electric Reliability. The Report contains staff's findings and recommendations with respect to Texas Regional Entity (Texas RE), a division of the Electric Reliability Council of Texas, Inc. (ERCOT), whose other division is an independent system operator (ERCOT ISO). The audit evaluated Texas RE's compliance with: (1) the Regional Delegation Agreement between the North American Electric Reliability Corporation (NERC) and Texas RE, a division of ERCOT; (2) the Texas RE bylaws; and (3) other obligations and responsibilities as approved by the Commission.
2. This audit was intended to help the Commission determine whether Texas RE is (1) sufficiently independent from its parent, ERCOT, and (2) capable of evaluating compliance with Reliability Standards by ERCOT ISO and other registered entities in an unbiased manner, consistent with requirements of Order No. 672.¹
3. Staff informed Texas RE of the audit findings and recommendations in a draft audit report on September 25, 2009, as revised on November 13, 2009, to

¹ *Rules Concerning Certification of the Electric Reliability Organization; and Procedures for the Establishment, Approval, and Enforcement of Electric Reliability Standards*, Order No. 672, FERC Stats. & Regs. ¶ 31,204, *order on reh'g*, Order No. 672-A, FERC Stats. & Regs. ¶ 31,212 (2006).

reflect comments made by Texas RE. The Report found that Texas RE has taken significant measures to ensure that a sufficient separation exists between the functions of Texas RE and ERCOT ISO. However, the Report identified some areas of concern that Texas RE must address to eliminate remaining independence concerns and foster a “very strong” separation of Texas RE and ERCOT ISO, as contemplated by Order No. 672.²

4. Texas RE has agreed to, or has already begun to, undertake all of the recommended corrective actions in the December 10, 2009 final report. In addition, of particular note, Texas RE is in the process of forming a new and separate legal entity to serve as the Regional Entity.

5. Based on the results of the audit and Texas RE’s agreement to implement the Report’s recommendations, we conclude that upon implementation of the recommendations, Texas RE prospectively will satisfy the requirement that its governance structure creates a “very strong” separation between Texas RE and ERCOT ISO, as Order No. 672 specifies for Regional Entities that include or that are affiliated with an ISO or an Regional Transmission Organization (RTO). We condition this conclusion on Texas RE’s timely and effective implementation of the Report’s recommendations, including the filing of an implementation plan as specified below.

Background

6. In Order No. 672, the Commission discussed the generic issue whether an RTO or ISO may have an inherent conflict of interest if it is also a Regional Entity. The Commission pointed out that such an entity would operate the Bulk-Power System and be responsible for overseeing its own compliance with Reliability Standards. The Commission found that “such self-enforcement is extremely difficult to carry out satisfactorily” and that a “system operator/Regional Entity in a single corporation -- absent a very strong separation between the oversight and operations functions – should not oversee its own compliance with Reliability Standards.”³ Accordingly, while not prohibiting such an entity seeking to be a Regional Entity from “making its case” for adequate separation of its compliance oversight and operational functions, the Commission stated: “[A]n RTO or ISO that lies in whole or in part within the United States and applies to become a Regional Entity will have a heavy burden to show that it

² Order No. 672 at P 698.

³ *Id.*

meets the statutory criterion that it be independent of the operators of the Bulk-Power System in its region.”⁴

7. In the Delegation Agreements Order, the Commission, *inter alia*, approved Texas RE’s RDA and Compliance Monitoring and Enforcement Program (CMEP). In that order, this Commission stated:

The board will be sufficiently independent because it will be responsible for managing its own budget, hiring and managing its own staff and consultants, and investigating compliance with, and enforcement of, reliability standards in the ERCOT region. The Texas Commission, moreover, will conduct all hearings on complaints, allegations of violations, and noncompliance reports and will make recommendations as to the appropriate disposition of these matters. The chairman of the Texas Commission will also occupy a seat on the ERCOT Board. As such, we find that there will be a sufficient separation of functions between Texas RE and the ISO function of ERCOT.⁵

8. The Commission emphasized the involvement of the Public Utility Commission of Texas (PUCT) as a distinguishing factor from other ISO/RTO-RE relationships.⁶ The Commission has also clarified that the ERCOT bylaws are “rules,” under Commission regulations, and are subject to NERC and Commission approval as they relate to Texas RE’s Regional Entity functions.⁷

⁴ *Id.* at P 699 (footnote omitted).

⁵ *North American Electric Reliability Council, et al.*, 119 FERC ¶ 61,060 at P 243 (footnotes omitted) (2007) (Delegation Agreements Order), *order on reh’g*, 120 FERC ¶ 61,260 (2007), *order on compliance filing*, 122 FERC ¶ 61,245 (2008) (Second Delegation Agreements Order), *order on compliance filings*, 125 FERC ¶ 61,330 (2008) (Third Delegation Agreements Order).

⁶ In light of the PUCT’s involvement with Texas RE’s enforcement process, Texas RE’s CMEP differs substantially from the *pro forma* CMEP. Delegation Agreements Order at P 250-253.

⁷ *Id.* P 245; Second Delegation Agreements Order at P 156.

The Audit

9. On November 13, 2008, OE staff issued a public letter to Texas RE in this docket announcing the commencement of an audit to determine whether Texas RE was in compliance with: (1) Texas RE's Bylaws, (2) the Delegation Agreement between NERC and Texas RE and the conditions included in the relevant Commission orders, and (3) other obligations and responsibilities, as approved by the Commission. In particular, in the ensuing audit, OE staff examined the relationship between Texas RE and ERCOT ISO. In this regard, staff took into account that Texas RE had registered the ERCOT ISO as conducting numerous functions relating to the Reliability Standards, including Reliability Coordinator, the highest level of authority with responsibility for the reliable operation of the Bulk-Power System. NERC had also delegated to Texas RE the following major program functions:⁸

1. Develop regional and national Reliability Standards;
2. Administer the compliance enforcement program and organization registration and certification;
3. Conduct reliability readiness evaluations;
4. Provide training, education and operator certification;
5. Conduct reliability assessment and performance analysis;
6. Conduct situational awareness and infrastructure security; and
7. Provide administrative services.

10. In the course of the audit, OE staff issued data requests, conducted analytical work, performed site visits, examined emails, and held many meetings and interviews with Texas RE's officials and staff. Subsequently, on September 25, 2009, OE staff sent Texas RE a draft audit report and gave Texas RE until October 13, 2009, to respond to the audit findings and recommendations. After a November 6, 2009 teleconference discussing the draft audit report, OE staff sent Texas RE a revised draft audit report on November 13, 2009, with a November 27, 2009 deadline for Texas RE's response. Texas RE's response to the draft audit report is attached to this order.

The Audit Report

11. In the Report, staff determines that Texas RE has taken significant measures to ensure that a sufficient separation exists between the functions of

⁸ *North American Electric Reliability Corporation*, 117 FERC ¶ 61,091, at P 20 (2006) (Business Plan and Budget Order), *order on reh'g*, 119 FERC ¶ 61,059 (2007).

Texas RE and ERCOT ISO. However, the Report identifies the following areas of concerns: (1) the operations of Texas RE and ERCOT under a shared board of directors and the ERCOT ISO CEO's membership on both the ERCOT board and the Texas RE board; (2) Texas RE's role in compliance monitoring of ERCOT ISO; (3) Texas RE's role with respect to preparation of reliability assessments for the ERCOT region; and (4) Texas RE's controls over access to confidential information.

12. First, Texas RE and ERCOT ISO operations under a shared board of directors and the ERCOT ISO CEO serving as a member on the Texas RE board raise potential conflict of interest and independence concerns. For example, the audit found that there are potential conflicts as to the fiduciary duties that the board has to both Texas RE and ERCOT ISO, and as to the oversight of the board for the CMEP activities that the Texas RE exercises in relation to the ERCOT ISO.⁹

13. Second, Texas RE's role in compliance monitoring of ERCOT ISO is frustrated by the lack of a demonstration of very strong separation. As long as there are conflict of interest concerns related to Texas RE because of its affiliation with the ERCOT ISO, the Texas RE should not perform CMEP activities involving the ERCOT ISO. As such, the audit found that Texas RE is unable to perform the CMEP functions delegated to it under the RDA. Furthermore, until such time as Texas RE is able to establish its independence from the ERCOT ISO, the Texas RE needs to enter into a formal agreement whereby its duties under the RDA are delegated to an approved third party.¹⁰

14. Third, Texas RE should expand its role with respect to preparation of reliability assessments for the ERCOT region by providing a thorough and independent review of the reliability assessment. The audit concluded that employing sufficient staff to provide at least a robust examination of, and thorough comments on, the assessment was the recommended action.¹¹

15. Finally, Texas RE should increase controls over access to confidential information. Pursuant to an agreement by which ERCOT ISO provided all computer equipment and IT services to Texas RE, Texas RE's computers and

⁹ Report at p. 20-23.

¹⁰ Report at p. 24-26.

¹¹ Report at p. 26-29.

servers were accessible to about a half-dozen ERCOT ISO employees who maintained IT systems. While these employees signed agreements to maintain the confidentiality of ERCOT data, audit staff found that they did not execute agreements to explicitly maintain the confidentiality of Texas RE's CMEP data.¹²

Texas RE Response

16. In its response, Texas RE states that it accepts all the findings in the Report as recommendations for improvements in Texas RE's operations and agrees to implement the recommendations.¹³ Texas RE further states that it has already begun to implement many of the recommendations.¹⁴

Discussion

17. The Commission accepts the audit findings. However, we note that, as stated in the Report, some of the concerns raised above would not exist if Texas RE goes forth with its plans to structurally separate from ERCOT. In that regard, the Commission commends Texas RE for proposing to proactively address independence concerns identified through the audit in the most effective manner, i.e., structural separation.

18. Regarding reliability assessments, the Commission believes that the Regional Entities should increase their efforts to verify, analyze and integrate information they receive from registered entities and provide in regional assessment reports to NERC. Therefore, the Commission encourages Texas RE to continue to increase its role in reliability assessments beyond its agreed upon expanded review.

19. Texas RE has agreed to implement the Report's recommendations. Under these circumstances, we expect Texas RE to comply with the recommended actions in the Report. Accordingly, upon implementation of the recommendations, Texas RE will prospectively satisfy the requirement that its governance structure creates a "very strong" separation between its RTO and RE functions, as Order No. 672 specifies for Regional Entities that include or that are affiliated with an RTO or an ISO. This conclusion is conditioned on Texas RE's

¹² Report at p. 30-32.

¹³ Texas RE Response at p. 1.

¹⁴ *Id.*

timely and effective implementation of the Report's recommendations, including the submission of an implementation plan as specified below.

20. The Report requires Texas RE to design an implementation plan that includes procedures to implement the recommendations that are described in the audit report. The plan is to be submitted to OE staff for review and approval within 60 days from the date of issuance of this order. Thereafter, Texas RE must make non-public quarterly submissions in Docket No. PA09-6-000 to OE staff detailing Texas RE's progress in implementing the actions set forth in the Report until all the actions are completed. The submissions are to be made not later than 30 days after the end of each calendar quarter, beginning with the first quarter after the submission of the implementation plan and continuing until Texas RE completes all the recommended actions. We direct OE staff to conduct a post-audit site visit when Texas RE states 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.

The Commission orders:

- (A) The attached Report is approved in its entirety without modification.
- (B) Texas RE is directed to implement the actions recommended in the Report.
- (C) Texas RE is directed to submit an implementation plan outlining the steps it will take to implement the recommendations in the Report within 60 days from the date of issuance of the final report in this docket.
- (D) Texas RE must make non-public quarterly submissions in Docket No. PA09-6-000 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 calendar quarter, beginning with the first quarter after the submission of the implementation plan and continuing until Texas RE completes all the recommended corrective actions.

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.

Attachment A



Federal Energy Regulatory Commission

Audit of Regional Entity Independence of Texas Regional Entity

Docket No. PA09-6-000
Date: December 10, 2009

Office of Enforcement
Division of Audits

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I. Executive Summary

A. Overview

The Office of Enforcement's (OE) Division of Audits, with the assistance of the Office of Electric Reliability's Division of Compliance, has completed an audit of the Texas Regional Entity (Texas RE), a division of the Electric Reliability Council of Texas, Inc. (ERCOT), whose other division is an independent system operator (ERCOT ISO). The audit evaluated Texas RE's compliance with: (1) the Regional Delegation Agreement between the North American Electric Reliability Corporation (NERC) and Texas RE, a division of ERCOT; (2) the Texas RE bylaws; and (3) other obligations and responsibilities as approved by the Commission. The audit covered the period from May 18, 2007 through the present.

This audit is intended to help the Commission determine whether Texas RE is sufficiently independent from its parent company, ERCOT ISO, and is capable of evaluating ERCOT ISO and other registered entities in an unbiased manner, consistent with requirements of Order No. 672.¹

As described in greater detail below, audit staff found that Texas RE has taken significant measures to ensure that a sufficient separation exists between the functions of Texas RE and ERCOT ISO. However, audit staff identified some areas of concern that Texas RE should address to eliminate remaining independence concerns and foster a "very strong" separation of Texas RE and ERCOT ISO, as contemplated by Order No. 672.

¹ *Rules Concerning Certification of the Electric Reliability Organization; and Procedures for the Establishment, Approval, and Enforcement of Electric Reliability Standards*, Order No. 672, FERC Stats. & Regs. ¶ 31,204, *order on reh'g*, Order No. 672-A, FERC Stats. & Regs. ¶ 31,212 (2006).

B. Texas Regional Entity (Texas RE)

Under its Regional Delegation Agreement (RDA) with NERC, approved by the Commission on April 19, 2007,² Texas RE oversees 212 registered entities responsible for 326 NERC functions within the ERCOT region. NERC has delegated to Texas RE the following major program elements:³

1. Develop regional and national reliability standards;
2. Administer the compliance monitoring and enforcement program and organization registration and certification;
3. Conduct reliability readiness evaluations;
4. Provide training, education, and operator certification;
5. Conduct reliability assessment and performance analysis;
6. Conduct situational awareness and infrastructure security; and
7. Provide administrative services.

In addition to its responsibilities under the RDA, Texas RE is responsible for oversight of compliance with ERCOT regional protocols.⁴ The Texas RE only

² *North American Electric Reliability Council, et al.*, 119 FERC ¶ 61,060 (2007) (Delegation Agreements Order), *order on reh'g*, 120 FERC ¶ 61,260 (2007), *order on compliance filing*, 122 FERC ¶ 61,245 (2008) (Second Delegation Agreements Order), *order on compliance filings*, 125 FERC ¶ 61,330 (2008) (Third Delegation Agreements Order) (collectively Delegation Agreement Orders).

³ *North American Electric Reliability Corporation*, 117 FERC ¶ 61,091, at P 20 (2006) (Business Plan and Budget Order), *order on reh'g*, 119 FERC ¶ 61,059 (2007).

⁴ The ERCOT protocols are a collection of policies, rules, guidelines, procedures, standards, and criteria intended to implement ERCOT ISO's functions as the entity responsible for ensuring access to the transmission and distribution systems for all buyers and sellers of electricity on nondiscriminatory terms; the reliability and adequacy of the ERCOT transmission grid; the conveyance of information relating to customer's choice of Retail Electric Provider in the state of Texas to all end-users; and accurate accounting of electricity production and delivery among generation resources and wholesale buyers and sellers, and transmission and/or distribution service providers.

oversees those protocols that relate to reliability of the grid – not market information. This latter oversight falls outside of the Commission’s jurisdiction over reliability pursuant to section 215 of the Federal Power Act (FPA).⁵

Texas RE has performed most of the “statutory” RDA functions that fall within FPA section 215. However, its role in conducting reliability assessments, a key element of the fifth major program element, is limited. As the report will discuss in more detail below, both Texas RE and audit staff believe that Texas RE’s role in conducting reliability assessments should be increased such that Texas RE provides substantive review and corroboration of the ERCOT ISO’s assessments.

Texas RE staff includes nine full-time employees (FTEs) in the compliance audit function and five FTEs in the compliance enforcement function. Texas RE’s anticipated 2010 budget will be nearly \$7.6 million, of which \$6.5 million will be for its statutory duties under the RDA.⁶

As explained in detail below, Texas RE is governed by a board of directors whose members also serve as the governing board for the ERCOT ISO. Shared ERCOT employees provide Texas RE with support services, including IT support, human resources, payroll, and accounting.

The Commission approved Texas RE as a Regional Entity on April 19, 2007 in the Delegation Agreements Order. In that order, the Commission, *inter alia*, approved NERC’s *pro forma* Compliance Monitoring and Enforcement Program (CMEP). The Commission approved NERC’s 2008 budget, including Texas RE’s budget and business plan, on October 18, 2007.⁷

⁵ 16 U.S.C. § 824o (2006).

⁶ Texas RE 2010 Draft Business Plan and Budget, June 15, 2009.

⁷ *North American Electric Reliability Corp.*, 121 FERC ¶ 61,057 (2007) (2008 Budget Order).

C. Commission Orders on Regional Entity Independence

Pursuant to FPA section 215, the Commission issued an order on July 20, 2006 certifying NERC as the Electric Reliability Organization (ERO).⁸ Pursuant to FPA section 215(e)(4), the ERO is authorized to delegate authority to a Regional Entity (RE) for the purpose of proposing Reliability Standards to the ERO and enforcing mandatory, Commission-approved Reliability Standards. NERC's *pro forma* Delegation Agreement, including the *pro forma* CMEP to be used by NERC and the Regional Entities to monitor, assess, and enforce compliance with NERC's Reliability Standards, was approved by the Commission in April 19, 2007 in the Delegation Agreements Order.

The Commission approved the *pro forma* Delegation Agreement in accordance with FPA section 215, which authorizes the Commission to approve delegation of the ERO's responsibilities if: (i) the RE is governed by an independent board, a balanced stakeholder board, or a combination of the two; (ii) the RE otherwise satisfies the criteria required for certification of the ERO; and (iii) the proposed agreement promotes effective and efficient management of the Bulk-Power System. As to Texas RE, the Commission found that "TRE will be governed by a combination independent and balanced stakeholder board (ERCOT Board) and will otherwise satisfy the criteria applicable to NERC's certification to serve as the ERO."⁹

The ERCOT ISO manages transmission for three quarters of Texas (excluding the Panhandle and sections of East and West Texas), representing 85 percent of the state's electric load. As such, ERCOT is an operator of the Bulk-Power System in addition to serving as an RE. In Order No. 672, the Commission found that serving as both an RE and as an ISO in a region may create a conflict of interest because the entity would be responsible for enforcing its own compliance with NERC's Reliability Standards:

⁸ *North American Electric Reliability Corp.*, 116 FERC ¶ 61,062, *order on reh'g and compliance*, 117 FERC ¶ 61,126 (2006), *order on compliance*, 118 FERC ¶ 61,030, *order on compliance*, 118 FERC ¶ 61,190, *order on reh'g*, 119 FERC ¶ 61,046 (2007).

⁹ Delegation Agreements Order at P 231.

An RTO or ISO may have an inherent conflict of interest if it is also a Regional Entity itself. The same institution would operate the Bulk-Power System and be responsible for overseeing its own compliance with Reliability Standards. The comments received reinforce the Commission's opinion that such self-enforcement is extremely difficult to carry out satisfactorily. A system operator/Regional Entity in a single corporation – absent *a very strong separation* between the oversight and operations functions – should not oversee its own compliance with Reliability Standards.¹⁰ [Emphasis added.]

As a result, the Commission stated, an ISO/RTO seeking to become an RE “will have a heavy burden to show that it meets the statutory criterion that it be independent of the operators of the Bulk-Power System in its region.”¹¹

In the Delegation Agreements Order approving Texas RE's RDA and its CMEP, the Commission stated:

The board will be sufficiently independent because it will be responsible for managing its own budget, hiring and managing its own staff and consultants, and investigating compliance with, and enforcement of, reliability standards in the ERCOT region. The Texas Commission, moreover, will conduct all hearings on complaints, allegations of violations, and noncompliance reports and will make recommendations as to the appropriate disposition of these matters. The chairman of the Texas Commission will also occupy a seat on the ERCOT Board. As such, we find that there will be a sufficient separation of functions between Texas RE and the ISO function of ERCOT.¹²

The Commission emphasized the involvement of the Public Utility Commission of Texas (PUCT), as a distinguishing factor from other ISO/RTO-RE

¹⁰ Order No. 672 at P 698.

¹¹ Order No. 672 at P 699.

¹² Delegation Agreements Order at P 243 (footnotes omitted).

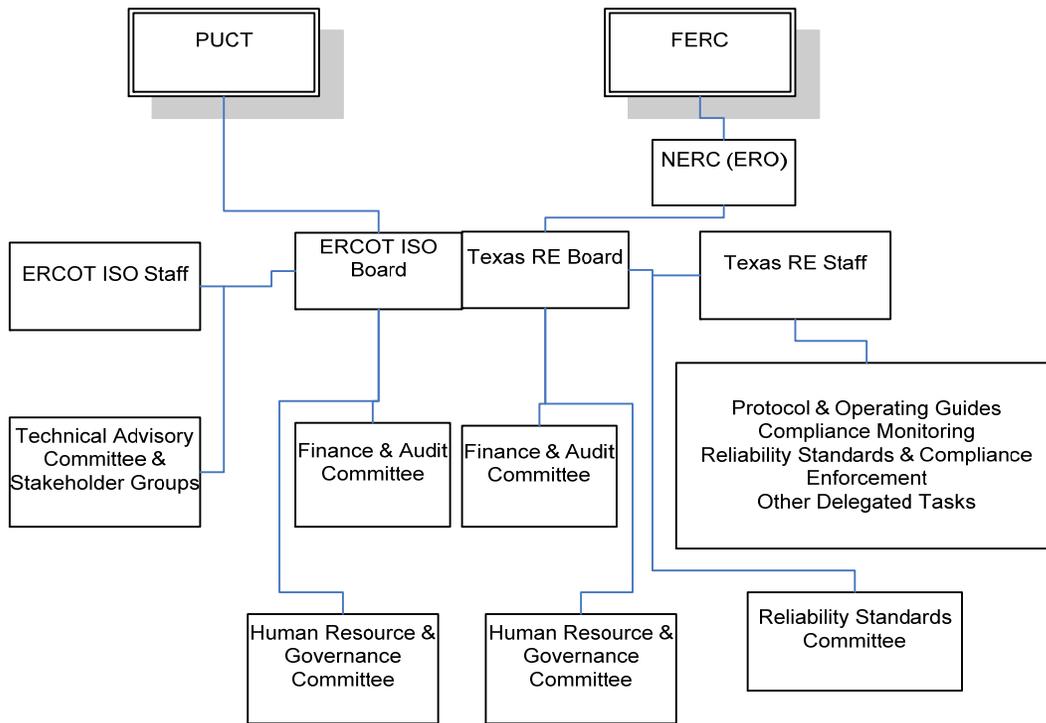
relationships.¹³ The Commission also clarified that the ERCOT bylaws, as they relate to Texas RE's Regional Entity functions, are "rules," under Commission regulations, and are subject to NERC and Commission approval.

D. Texas RE and ERCOT Organizational Structure

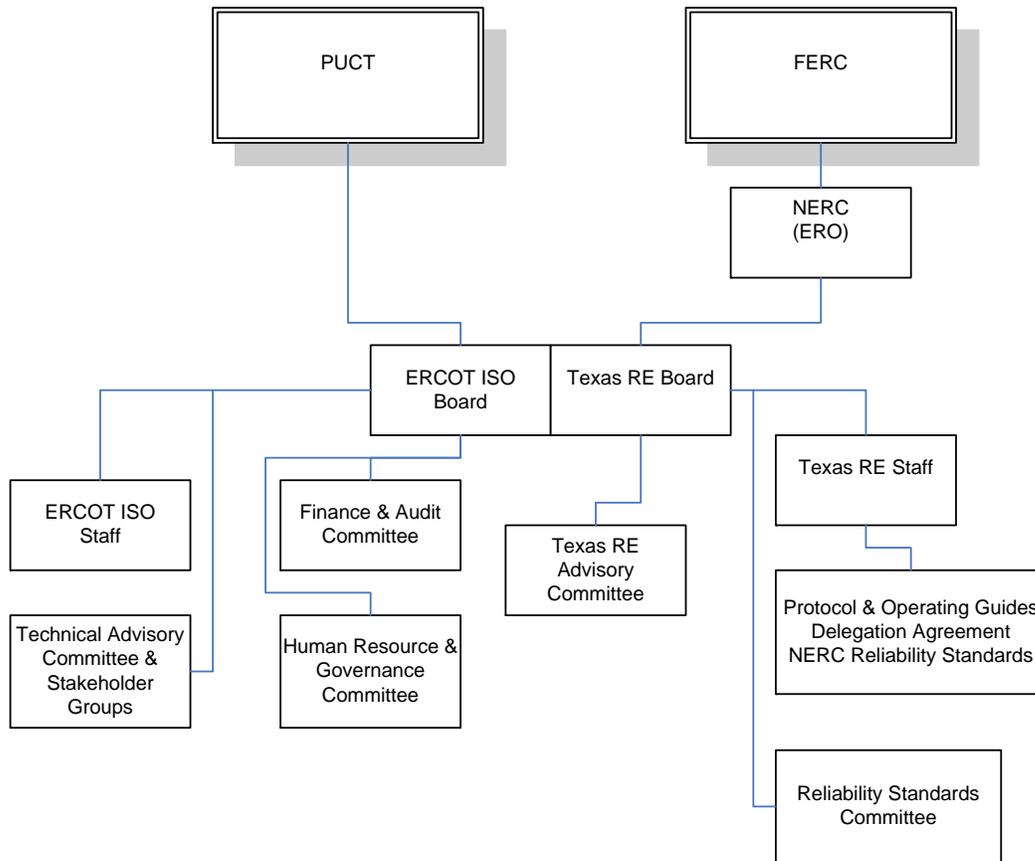
The ERCOT ISO and Texas RE operate under a shared board of directors. The board consists of sixteen members representing consumers and representatives from each of ERCOT's electric-market segments, the chairman of the PUCT (nonvoting), the CEO of the ERCOT ISO, and five members not affiliated with owners, users or operators of the Bulk-Power System. The board of directors appoints the CEO for both the ERCOT ISO and Texas RE. The organizational structure approved by the Commission in April 2007 consisted of the single shared board and the previously established committees that provided administrative oversight (e.g., the Human Resources and Governance Committee, and the Finance and Audits Committee).

As there is only one board, the potential for conflicts exists. Recognizing this, Texas RE has taken significant steps to distinguish itself as functionally independent from ERCOT ISO. For example, when Texas RE was initially established, the board deliberated over Texas RE and ERCOT ISO issues during the same meeting. Over time, this practice created confusion among the board members and in June 2007, they met as the Texas RE Board in a late afternoon session and the ERCOT ISO board in a morning session on the same day. This schedule was again modified in July 2008, when the directors began meeting on Mondays to discuss Texas RE issues and on Tuesdays to discuss ISO issues. An effort was also made to distinguish the meetings of various key board committees that provided oversight to both Texas RE and ERCOT ISO by meeting at different times and by referring to themselves during such differentiated meetings by different titles. The organizational structure in place in July 2008 is depicted by the following organizational chart:

¹³ In light of the PUCT's involvement with Texas RE's enforcement process, Texas RE's CMEP differs substantially from the *pro forma* CMEP. *Id.* P 250-253.



To further increase Texas RE’s functional independence from the ERCOT ISO, the Texas RE Advisory Committee (TAC) was formed in August 2008. The purpose of TAC is to provide assistance to the Texas RE board in fulfilling its oversight responsibility relating to Texas RE’s employment, compensation, financial, financial audit, and other administrative matters. The TAC is comprised of the five unaffiliated ERCOT directors, the chairman (or his or her designee) of the PUCT, and the Public Counsel from the Texas Office of Public Utility Counsel. The TAC’s recommendations are passed to the full Texas RE board of directors for approval. The following organizational chart depicts the current Texas RE organizational structure.



At the August 2009 Texas RE board meeting, the board discussed proposed changes to the bylaws that will create structural independence for the Texas RE. The proposed changes were posted for comment on Texas RE's Web site. Under the terms of the proposed revised bylaws, a new board will be created for the Texas RE which will be separate from the ERCOT ISO Board, i.e., the two boards will not share members. This proposed board would consist of:

- Four independent board members;
- The CEO of the Texas RE;
- Two stakeholder representatives (the chair and vice chair of the Members Representatives Committee);
- A nonvoting PUCT representative, and
- A nonvoting representative of the Office of Public Utility Council

The proposed bylaw changes also provide that a Texas RE board quorum requires three independent members as well as a majority of the voting directors. This structure would remove the ERCOT ISO CEO from the Texas RE board, would greatly reduce the direct involvement of other stakeholders in the oversight of the Texas RE operations, and would provide a strong separation between ERCOT ISO and the Texas RE.

E. Summary of Compliance Findings

Audit staff found that Texas RE has instituted numerous actions to ensure that an adequate separation exists between its and ERCOT ISO functions. These actions were undertaken to strengthen Texas RE independence from ERCOT ISO and eliminate any real or perceived concerns as to its independence. Based on information gathered through interviews, email, and other records, audit staff believes that independence concerns continue to exist, despite Texas RE efforts to create more independence between its and ERCOT ISO's functions. However, these concerns would not exist if Texas RE goes forth with its plans to structurally separate from ERCOT.

- **The organizational structure of the Texas RE raises conflict of interest concerns**

Texas RE and ERCOT ISO operate under a shared board of directors and the ERCOT ISO CEO serves as a member on the Texas RE and ERCOT board. In audit staff's view, the organizational structure raises potential conflict of interest concerns and gives the appearance of a lack of independence between the operations of Texas RE and ERCOT ISO.

The ERCOT ISO CEO is responsible for the success or failure of the ERCOT ISO. As such, he is responsible for, among other items, ERCOT ISO's compliance with NERC Reliability Standards. The ERCOT ISO CEO's membership on the Texas RE board of directors, the board that oversees the RE responsible for determining ERCOT ISO's compliance with the NERC Reliability Standards, creates a potential conflict of interest. Moreover, officials at the PUCT and the Texas RE expressed concerns as to the participation of the ERCOT ISO CEO as a member of the Texas RE board.

The ERCOT board of directors serves as the board for both Texas RE and ERCOT ISO. Initially, the board deliberated over Texas RE and ERCOT ISO matters at the same meeting, confusing board members. To alleviate the confusion, the board decided to meet at different times, and ultimately on different days, to discuss Texas RE matters independently of ERCOT matters; the board referred to itself as the Texas RE board when discussing Texas RE issues and the ERCOT board when discussing ERCOT ISO issues.

To further address independence concerns, in July 2008, the Texas RE Board approved the formation of the TAC to provide assistance to the Texas RE Board in fulfilling its oversight responsibility as to Texas RE's employment, compensation, financial, financial audit, and other administrative matters. As noted above, the TAC is comprised of the five unaffiliated ERCOT directors, the chairman (or his or her designee) of the PUCT, and the Public Counsel from the Texas Office of Public Utility Counsel. TAC typically makes recommendations on these matters to the full Texas RE board of directors.

On June 15, 2009, the Texas RE board of directors passed a resolution approving legal separation in concept and authorizing Texas RE staff to take the steps necessary to create a new legal entity for Texas RE, including seeking all regulatory approvals. At the August 2009 Texas RE board meeting, the board approved proposed changes to the bylaws and directed further changes, which, if passed, will create structural independence for the Texas RE. On October 19, 2009, the Texas RE board approved draft bylaws for a legally separate entity, allowing Texas RE staff to commence discussions with Commission and NERC staff regarding an amended RDA.

- **Texas RE's role in compliance monitoring of ERCOT ISO is frustrated by a lack of a demonstration of very strong separation:**

Texas RE is responsible under the RDA to determine ERCOT ISO's compliance with NERC standards and take any necessary enforcement actions against ERCOT ISO. However, based on the potential conflict of interest, NERC has been actively participating in the CMEP activities involving the ERCOT ISO. Unless the Texas RE continues to expeditiously move to a structural separation from the ERCOT ISO, NERC and Texas RE should execute a formal agreement addressing NERC, or an entity approved by NERC, in performing such activities.

- **Texas RE should do more under the RDA regarding reliability assessment:**

Pursuant to the RDA, Texas RE receives funding to perform duties related to reliability assessment and performance analysis as required by the NERC Rules of Procedure. Texas RE should perform a more thorough review of ERCOT ISO's work product. Texas RE should hire more staff or train current staff to perform this function.

- **Texas RE's controls over access to confidential information should be strengthened:**

Pursuant to a memorandum of understanding (MOU) between Texas RE and ERCOT ISO, ERCOT ISO provides all computer equipment and information technology (IT) services to Texas RE. Texas RE's computers and servers are inaccessible to any ERCOT ISO employee, except for about a half-dozen IT employees who maintain IT systems, all of whom have signed confidentiality agreements to protect ERCOT data, which does not explicitly include CMEP data. Further, there is no written agreement in effect in which these ERCOT ISO employees agree to comply with section 1500 of the NERC Rules of Procedure on protection of confidential information. Also, Texas RE should improve its controls over access to confidential information to prevent this information from potentially being compromised.

F. Recommendations

The audit staff is encouraged by the efforts of Texas RE to increase Texas RE's independence from ERCOT ISO, including the establishment of Texas RE as a separate legal entity that the ERCOT ISO board will not oversee. To ensure Texas RE's independence and adequate separation of ERCOT ISO and reliability functions while those efforts proceed and, as appropriate, after Texas RE should become a separate legal entity, audit staff recommends that Texas RE take the following actions:

- Continue in its efforts to eliminate any independence concerns or the appearance of a lack of independence;
- Strengthen procedures to ensure that discussions as to Texas RE employment, compensation, financial, financial audit, and other administrative matters remain within TAC and the Texas RE Board;
- Submit a plan detailing its efforts to eliminate independence concerns or the appearance of a lack of independence to the Office of Enforcement, Division of Audits;
- Arrange a formal contract to have NERC, or an entity approved by NERC, conduct audits and perform other compliance activities related to ERCOT ISO while Texas RE remains a division of ERCOT ISO. While Texas RE pursues independence from ERCOT ISO, it does not need to commence this arrangement unless a compliance audit of the ERCOT ISO is conducted;
- Confine its participation on ERCOT ISO audits and investigations to providing technical assistance while Texas RE remains a division of ERCOT ISO;
- Develop a plan to review staffing needs to perform reliability assessments pursuant to the RDA;
- Consider increasing staff or training existing staff to include expertise sufficient to perform its duties under the RDA as to reliability assessment;

- Appoint an RE staff member to represent Texas RE on NERC's Reliability Assessment Subcommittee and any other committee or subcommittee whose authority includes RE statutory functions;
- Obtain executed agreements (or a written confirmation from ERCOT ISO's general counsel that such agreements have been accepted) to comply with section 1500 of the NERC Rules of Procedure with all ERCOT ISO employees who are granted access to Texas RE's IT, until such time as Texas RE eliminates its reliance on ERCOT ISO for IT services;
- Ensure that any third-party vendor agrees to comply with section 1500 of the NERC Rules of Procedure concerning confidential information;
- Instruct the ERCOT ISO IT department to deactivate the Texas RE website hosted by ERCOT and redirect all inquires to this site to the new independently hosted website; and
- Provide audit staff with updates on the status of Texas RE's efforts to eliminate its reliance on ERCOT ISO for IT services.

G. Compliance and Implementation of Recommendations

Texas RE should design an implementation plan that includes procedures to implement the exception-specific recommendations described in this report. The plan should be submitted to audit staff for review within sixty days from the date of issuance of the final report in this docket. Thereafter, Texas RE must make nonpublic quarterly filings in Docket No. PA09-6-000 to audit staff, detailing its progress in implementing the corrective actions in this report until all the corrective actions are completed. The filings should be made not later than thirty days after the end of each calendar quarter, beginning with the first quarter after the filing of the implementation plan, and continuing until Texas RE completes all the recommended corrective actions.

II. Introduction

A. Objectives

The Division of Audits of the Office of Enforcement of the Federal Energy Regulatory Commission commenced an audit of Texas RE to examine Texas RE's performance as a Regional Entity and its independence from ERCOT ISO. The audit was designed to determine whether during the audit period Texas RE has complied with (1) the RDA between NERC and Texas RE,¹⁴ (2) the Texas RE bylaws,¹⁵ and (3) other obligations and responsibilities as approved by the Commission.

B. Scope and Methodology

To determine the separation between ERCOT ISO's and Texas RE's operations, audit staff:

- Reviewed publicly available materials, FERC's eLibrary for company filings, Commission orders and formal complaints, the Enforcement Hotline for complaints made against Texas RE or ERCOT ISO, and local newspapers, trade and academic press to identify significant developments and occurrences that arose during the audit period, to familiarize itself with Texas RE and ERCOT ISO's operations.
- Conducted a site visit to Texas RE's offices on January 6-9, 2009 during which its members interviewed Texas RE management and staff to understand their job functions. Those interviewed included:
 - Chief Executive Officer and Chief Compliance Officer;
 - Director of Legal Affairs;

¹⁴ *North American Electric Reliability Council, et al.*, 119 FERC ¶ 61,060 (2007), 122 FERC ¶ 61,245 (2008), and *order on reh'g*, 123 FERC ¶ 61,276 (2008).

¹⁵ *Id.*

- Director of Compliance;
 - Manager of Reliability Standards;
 - Manager of Compliance and Enforcement;
 - Senior Financial Analyst;
 - Manager of Compliance Audits;
 - Manager of Information Technology; and
 - Manager of Compliance Stakeholder Management.
- Conducted a second site visit to Texas RE's offices on August 26-27, 2009, during which it interviewed Texas RE senior management as well as executive staff of the PUCT.

In addition, the audit staff:

- Issued five sets of data requests, encompassing more than 100 separate data request items, many of which included multiple elements;
- Reviewed thousands of emails sent and received by Texas RE compliance staff employees over the audit period;
- Conducted numerous phone conferences to clarify data responses and seek additional information;
- Interviewed the current and former chairs of the Texas RE board of directors;
- Reviewed meeting minutes (including executive session and other closed-session minutes) for the Texas RE board of directors, Texas RE Reliability Standards Committee, Texas RE Human Resources and Governance Committee, Texas RE Advisory Committee, ERCOT ISO board of directors, ERCOT ISO Technical Advisory Committee, ERCOT ISO Finance and Audit Committee, and ERCOT ISO Human Resources and Governance Committee;
- Sampled audits, spot checks, investigations and other compliance actions Texas RE has undertaken;
- Reviewed electronic timesheet data;
- Reviewed the periodic reports of Texas RE to NERC, presentations made by Texas RE staff and management to the Texas RE board, presentations to the PUCT, presentation made at ERCOT meetings and to the NERC, Texas RE self-assessments and other materials that summarized Texas RE compliance efforts.

Prior to this audit, FERC staff participated in a NERC-led audit of ERCOT ISO (September 9-12, 2008) to assess its compliance with NERC Reliability Standards. Members of the audit staff gained valuable insight from observing the NERC-led audit.

ERCOT ISO cooperated fully with audit staff in providing ERCOT minutes and other materials requested during the audit. To maintain confidentiality, ERCOT ISO responses were submitted directly to audit staff rather than being conveyed through Texas RE.

Specifically, audit staff did the following:

Accounting for shared costs

- Interviewed the Senior Financial Analyst of the Texas RE;
- Reviewed the MOU between the Texas RE and the ERCOT ISO for the provision of administrative and IT services;
- Reviewed separation studies to determine the costs to Texas RE for alternative sources of services provided by ERCOT ISO under the MOU;
- Reviewed time-sheet data for allocation of staff costs between statutory and nonstatutory duties; and
- Interviewed the Manager of IT Services.

Structural and operational separation of ERCOT ISO and the Texas RE

- Reviewed organizational charts for the audit period;
- Interviewed Texas RE administration and staff, on site and via telephone;
- Reviewed minutes of all Texas RE Board and committee meetings since the formation of the RE;
- Reviewed minutes of the ERCOT ISO board and committee meetings for the audit period;

- Conducted telephone interviews with Texas RE Board members;
- Reviewed the emails of Texas RE compliance staff;
- Reviewed voluminous materials related to Texas RE involvement in the 2008 NERC-led compliance audit of ERCOT ISO and the subsequent Texas RE enforcement efforts; and
- Toured Texas RE offices, both the former facility shared with ERCOT ISO and the new, physically separate office.

RE compliance with CMEP

- Conducted an on-site review of select compliance audits and spot checks the Texas RE performed to understand file layout and data retention policies and procedures;
- Reviewed a sample of the CMEP activities for each of the tasks enumerated in the Texas RE CMEP program, including compliance audits, spot checks, mitigation plan reviews, mitigation plan certifications, and evaluations of self-reported violations by the registered entities;
- Reviewed Texas RE records for submission of conflict of interest and ethics declarations;
- Reviewed assignment of Texas RE staff for participation in CMEP compliance and enforcement activities to ensure no conflicts of interest;
- Reviewed resumés of compliance staff for technical and audit qualifications;
- Reviewed emails for inappropriate contacts;
- Reviewed timesheet data to determine the time and effort expended on specific RDA tasks; and
- Conducted interviews on-site and via telephone to examine staffing levels and qualifications to perform RDA tasks.

III. Findings and Recommendations

1. Independence Concerns Related to Texas RE

Audit staff had the following concerns about Texas RE independence that resulted in, at a minimum, the appearance of a lack of independence:

- The Texas RE board members also serve as board members of ERCOT ISO; and
- The ERCOT ISO CEO serves as a board member of both ERCOT ISO and Texas RE.

Pertinent Guidance

In Order No. 672, the Commission found that an organization serving as both an RE and as an ISO in a region may have a potential conflict of interest because the entity would be responsible for enforcing its own compliance with NERC's Reliability Standards:

A system operator/Regional Entity in a single corporation – absent *a very strong separation* between the oversight and operations functions – should not oversee its own compliance with Reliability Standards.¹⁶ [Emphasis added.]

Section 6.3 of Texas RE's bylaws states in part:

Texas RE “will be managed directly by the ERCOT board to ensure independence from ERCOT ISO's functions.” Relying on this and other representations, in the Delegation Agreements Order, the Commission found that the Texas RE “board will be sufficiently independent.”¹⁷

¹⁶ Order No. 672 at P 698.

¹⁷ Delegation Agreements Order at P 243.

Background

Shared Board of Directors

As mentioned earlier, ERCOT ISO and Texas RE operate under a shared board of directors. Consistent with section 4.2 of the ERCOT bylaws, the board consists of sixteen members representing consumers and representatives from each of ERCOT's electric market segments, the chairman of the PUCT (nonvoting), the CEO of ERCOT ISO, and five members not affiliated with owners, users or operators of the Bulk-Power System. The board of directors appoints the CEO for both ERCOT ISO and the Texas RE.

Since only one board deliberates over matters involving both Texas RE and ERCOT ISO, there is a potential conflict of interest that creates an appearance of a lack of independence. There are also potential conflicts as to the fiduciary duties that the board has to both Texas RE and ERCOT ISO. Finally, there are potential conflicts as to the oversight of the board for the CMEP activities that the Texas RE exercises in relation to the ERCOT ISO and any objections by the ERCOT ISO to either the findings or the proposed penalties and sanctions arising from CMEP enforcement activities. Recognizing this, Texas RE has taken significant steps to distinguish itself as functionally independent from ERCOT ISO. For example, when Texas RE was initially established, the board deliberated over Texas RE and ERCOT ISO issues during the same meeting. Over time, this practice created confusion among the board members. In June 2007, they determined to meet as the ERCOT ISO board in the morning and as the Texas RE Board in an afternoon session on the same day. This schedule was again modified in July 2008. Since that time, the directors meet on Mondays to discuss Texas RE issues and on Tuesdays to discuss ERCOT ISO issues.

On July 14, 2008, the five unaffiliated directors, the PUCT chairman, Texas RE CEO and other Texas RE staff met to discuss actions that could be taken to increase Texas RE's functional independence from ERCOT ISO. To further increase Texas RE's functional independence from ERCOT ISO, the Texas RE Advisory Committee (TAC) was formed in August 2008. The purpose of TAC is to provide assistance to the Texas RE Board in fulfilling its oversight responsibility relating to Texas RE's employment, compensation, financial, financial audit, and other administrative matters. The TAC is comprised of the five unaffiliated ERCOT directors, the chairman (or his or her designee) of the PUCT, and the Public Counsel from the Texas Office of Public Utility Counsel.

TAC's recommendations are passed to the full Texas RE board of directors for approval.

At the August 2009 Texas RE board meeting, the board discussed new bylaws for the Texas RE, which will create structural independence for the Texas RE. The proposed changes were posted for comment on Texas RE's Web site. Under the terms of the proposed revised bylaws, there will be a new board for the Texas RE which will be separate from the ERCOT ISO board, i.e., the two boards will share no members. This proposed board would consist of:

- Four independent board members;
- The CEO of the Texas RE;
- Two stakeholder representatives (the chair and vice chair of the Members Representatives Committee);
- A nonvoting PUCT representative; and
- A nonvoting representative of the Office of Public Utility Council.

The new Texas RE bylaws also provide that a board quorum require three independent directors as well as a majority of the directors. This structure would remove the ERCOT ISO CEO from the Texas RE Board, greatly reduce the direct involvement of other stakeholders in the oversight of the Texas RE operations, and strongly separate ERCOT ISO and the Texas RE.

Audit staff believes an independent board would strengthen Texas RE's independence and credibility and be an important step toward ensuring the establishment of a very strong separation as required by Order No. 672.

Shared Board Member

Although legally section 4.2 of the ERCOT bylaws provides that the ERCOT ISO CEO is a member of the Texas RE and ERCOT ISO board of directors, in practice, he or she may have a conflict of interest. For example, Texas RE is responsible for determining ERCOT ISO's compliance with NERC standards and for taking any necessary enforcement actions against ERCOT ISO. Audit staff observed the following from the executive session board committee minutes as to ERCOT ISO CEO's involvement in Texas RE matters:

- In August 2007, the ERCOT board of directors ordered that media inquiries related to the creation of Texas RE be answered by the ERCOT ISO CEO rather than Texas RE.
- From Texas RE's inception to the present, the ERCOT ISO CEO has attended many open and closed meetings of the ERCOT board's Human Resources and Governance Committee meetings, both meetings for ERCOT ISO as well as meetings identified as pertaining exclusively to Texas RE. For example, from August through November 2007, the ERCOT ISO CEO attended every meeting of the Texas RE Human Resources and Governance Committee. During these meetings, the selection of Texas RE CEO was discussed as well as the manner in which the Texas RE would perform its duties and how performance should be measured.
- The minutes of the April 22, 2009 ERCOT ISO Human Resource and Governance Committee Executive Session record a discussion of personnel issues. During this discussion, the compensation for the Texas RE CEO was deliberated. According to the July 2008 measures to have the TAC review, among other things, Texas RE's compensation matters, this discussion should not have occurred in this forum. Rather, per Texas RE documents and organizational chart, these discussions should have been limited to meetings of the TAC and the Texas RE board.
- The ERCOT ISO CEO routinely attended meetings when the Texas RE board discussed compliance efforts involving specific registered entities. Texas RE has randomly assigned alphabetic identifiers to entities that have been the subject of compliance matters in an attempt to hide the identity of the registered entities being discussed during board meetings. However, such a procedure affords relatively little protection from disclosure of the entity's identity given the public schedule of Texas RE compliance audits. In the case of the ERCOT ISO, since it is the only Registered Entity for numerous reliability functions, hiding its identity during Board meetings in which the ERCOT ISO CEO is present would be impossible. Moreover, the audit team did not find any indication that the ERCOT ISO CEO left these meetings or took other steps to ensure that he was not present during discussion of compliance issues relating to ERCOT ISO.

Texas RE officials indicated that they observed that the Texas RE board members were finding it increasingly difficult not to have conflicts of interest arise in their dual function as representing the interests of the ERCOT ISO as well as the Texas RE. They indicated that difficulty had intensified over the past year. The conflicts had advanced beyond mere appearance of conflicts to actual conflicts, as a result of the possibility of significant monetary penalties being imposed. Texas RE officials stated that these conflicts involved not only the CEO of the ISO and other stakeholders, but even the shared independent board members.

Representatives of the PUCT also expressed their concerns as to the need to expand independence of the Texas RE from the ERCOT ISO and other stakeholders via a separate board for the Texas RE that could provide effective guidance to the Texas RE in the performance of its duties under the RDA. The PUCT representatives indicated their full support for a structurally independent Texas RE as being the most effective means of assuring that the Texas RE can fulfill its duties under the RDA.

Audit staff is concerned that the ERCOT ISO CEO participation on the shared board that oversees the compliance functions of Texas RE and presence at various meetings cited above involving activities of Texas RE raises independence concerns. Although there is no evidence to date of any partiality, the current structure allows a real or perceived conflict of interest. Based on the above, one would reasonably question the ability of the ERCOT ISO CEO to be strongly independent in representing the interests of both Texas RE and ERCOT ISO, when faced with an issue that may present conflicting interests between the two divisions of ERCOT.

Recommendations

We recommend that Texas RE:

1. Continue its efforts to eliminate any independence concerns or the appearance of a lack of independence; and
2. Submit a plan detailing its efforts to eliminate independence concerns to the Office of Enforcement, Division of Audits.

2. Texas RE Role in Compliance Monitoring of ERCOT ISO

As explained above, Texas RE is an independent division of ERCOT, as is ERCOT ISO. Texas RE thus has a potential conflict of interest in regulating ERCOT ISO. For example, Texas RE is responsible under the RDA to determine ERCOT ISO's compliance with NERC standards and take any necessary enforcement actions against ERCOT ISO. To address this potential conflict, NERC has been actively participating in the CMEP activities involving ERCOT ISO.

Pertinent Guidance

NERC has delegated to Texas RE responsibility for implementing the CMEP for registered entities within its region, including ERCOT ISO. However, in Order No. 672, the Commission found that serving as both an RE and as an ISO in a region may create a conflict of interest because the entity would be responsible for enforcing its own compliance with NERC's reliability standards:

An RTO or ISO may have an inherent conflict of interest if it is also a Regional Entity itself. The same institution would operate the Bulk-Power System and be responsible for overseeing its own compliance with Reliability Standards. The comments received reinforce the Commission's opinion that such self-enforcement is extremely difficult to carry out satisfactorily. A system operator/Regional Entity in a single corporation – absent a very strong separation between the oversight and operations functions – should not oversee its own compliance with Reliability Standards.¹⁸

Background

ERCOT ISO is registered with NERC as the sole entity within the ERCOT region to perform the following reliability functions: Balancing Authority, Interchange Authority, Planning Authority, Reliability Coordinator, Reliability Planner, Transmission Operator, and Transmission Service Provider. NERC has been actively participating in the CMEP activities involving ERCOT ISO. However, NERC's role and relationship to the Texas RE as to such activities are

¹⁸ Order No. 672 at P 698.

not formally defined in the RDA or in any other documents that audit staff reviewed. Texas RE confirmed that no such formal agreement exists.

In September 2008, a NERC team was assigned to lead an audit of ERCOT ISO with Texas RE assigned to provide technical assistance. FERC staff also participated as a part of the 2008 Regional Entity Observation Audit program. FERC staff noted several instances in which the Texas RE staff's participation varied significantly from the role that NERC had established for its NERC-led audits. The NERC guidelines called for a role limited to providing technical assistance. The audit team believes that the Texas RE staff did not knowingly violate any audit procedures. Nevertheless, the audit team believes that the lack of an approved written agreement specifying the appropriate involvement of the Texas RE staff lead to audit difficulties.¹⁹

Upon the completion of the 2008 compliance audit, authority for the CMEP process involving ERCOT ISO became more confusing. NERC staff who participated in the audit improperly informed Texas RE staff that Texas RE would have CMEP authority for any subsequent actions relating to the audit findings. The audit staff believes that such conflicts in authority for the CMEP effort could and should be resolved under a formal contract between Texas RE and NERC or an entity approved by NERC and the Commission.

Recommendations

We recommend that, while remaining a division of ERCOT ISO, Texas RE:

3. Arrange a formal contract to have NERC, or any entity approved by NERC and the Commission, conduct audits and perform other

¹⁹ Although not published at the time of the September 2008 audit, the Commission provided guidance on this issue in its January 15, 2009 Guidance Order on Compliance Audits Conducted by the Electric Reliability Organization and Regional Entities: "to resolve possible perceptions that a Regional Entity's compliance staff is not sufficiently independent from the audited entity, such as the Regional Entity itself or its affiliate . . . Regional Entity staff should serve as subject matter experts, rather than lead the audit or advise on its conduct or scope." *Guidance Order on Compliance Audits Conducted by the Electric Reliability Organization and Regional Entities*, 126 FERC ¶ 61,038, at P 5 (2009).

compliance activities related to ERCOT ISO. While Texas RE pursues independence from ERCOT ISO, it does not need to commence this arrangement unless a compliance audit or investigation of the ERCOT ISO is conducted.

4. Confine its participation on ERCOT ISO audits and investigations to providing technical assistance.

3. Texas RE Reliability Assessment Responsibilities

Texas RE should perform more thorough reviews of the ERCOT ISO's work product.

Pertinent Guidance

Section 804 of the NERC Rules of Procedure states:

To carry out the reviews and assessments of the overall reliability of the Interconnected bulk power systems, the regional entities and other entities shall provide sufficient data and other information requested by NERC in support of the annual long-term and seasonal assessments and any special reliability assessments. . . . In connection with the reliability assessment reports, requests shall be submitted to each of the regional entities for required reliability assessment data and other information, and for each region's self-assessment report.

Section 805.4 of the NERC Rules of Procedure further provides:

The teams of reliability and technical experts shall provide an independent assessment of the reliability of the regional entities and the North American interconnected bulk power system for the period of the assessment. While the regional entities are relied upon to provide the information to perform such assessments, the review team is not required to accept the conclusions provided by the regional entities. . . . Upon completion of the assessment, the team shall share the results with the regional entities. The regional entities shall be given the opportunity to review and comment on the

conclusions in the assessment and to provide additional information as appropriate.

Background

Under the reliability assessment process, a Regional Entity is responsible for collecting information necessary for its region's self-assessment report and for ensuring that NERC receives the report. After NERC's team of experts reviews the information from the Regional Entities, it will share the results with the Regional Entities, which have an opportunity to comment on the draft assessment's conclusions and to provide additional information.

When audit staff initially asked about Texas RE's role in reliability assessment reporting, Texas RE's Director of Compliance termed it "at best [a] sanity check." However, when audit staff asked for written confirmation of Texas RE's reliability assessment activities in a data request, Texas RE's CEO outlined a more expansive role:

ERCOT ISO submits completed assessment reports to Texas RE staff for review and comment prior to submitting to NERC. Texas RE staff reviews the reports (including the data and other information provided) for completeness, adequacy, reliability concerns and issues, and potential impacts on the reliability of the ERCOT Bulk Power System. Texas RE staff is not required to accept the conclusions provided by ERCOT ISO staff, and Texas RE collaborates with ERCOT ISO staff to resolve any concerns or questions. ERCOT ISO submits the completed reports to NERC.

In Texas RE's self-assessment, filed with NERC in April 2009,²⁰ Texas RE reverted to a more modest description, stating that it "reviews the [reliability assessment] reports for completeness prior to forwarding to NERC."

Audit staff attempted to reconcile these conflicting answers through data requests and concluded that Texas RE staff, at best, did little more than a

²⁰ *Texas Regional Entity Statement of Activities and Accomplishments in Carrying Out Its Delegated Responsibilities for the Period January 1, 2007 – February 28, 2009*, April 1, 2009, at page 14.

perfunctory review of ERCOT ISO's periodic assessments. Audit staff discovered that in at least one instance, ERCOT ISO forwarded the regional assessment directly to NERC without any review by Texas RE.

To support performance in this area, Texas RE, in both its response to an audit staff data request, as well as its self-assessment, listed its involvement in other ERCOT ISO-related activities as constituting performance under this function. In response to a data request, Texas RE cited at length its nonstatutory duties in response to ERCOT protocol events. In the self-assessment, Texas RE alluded to staff attendance at ERCOT committee meetings. While audit staff does not denigrate Texas RE's involvement in these activities, audit staff does not believe that these activities constitute performance under the NERC Rules of Procedure.

Texas RE provided audit staff with dates it received reliability assessments from ERCOT ISO for review and dates that ERCOT ISO filed the assessments with NERC. At least once, ERCOT ISO sent the reports to Texas RE on the same day that ERCOT ISO sent them to NERC, thereby providing Texas RE no opportunity for even a cursory review.

Audit staff also asked Texas RE to identify Texas RE staff members with sufficient knowledge to perform the functions that Texas RE had identified as required. Texas RE responded with the names and a brief description of the qualifications of four of its staff members who could perform the necessary functions. The employees identified were the CEO, Manager of Compliance Stakeholder Management, Director of Compliance, and Manager of Compliance Audits. For the time periods indentified, audit staff requested and reviewed time-sheet data for these individuals and concluded that none of them who were responsible for reviewing these assessments recorded any hours for reliability assessments (time code: Texas RE0800) in their time sheets.

Audit staff is aware that ERCOT ISO and its members historically played the lead role in the formulation of the periodic reliability assessments. This may have been initially appropriate after the creation of Texas RE, but the Commission desires movement towards a greater role for the RE in fulfilling responsibilities under the NERC Rules.²¹

²¹ Order No. 693 at P 157-160.

When audit staff presented its conclusions to Texas RE in a phone conference, Texas RE staff acknowledged it could do more with respect to scrutinizing the ERCOT regional reliability assessments before submission to NERC. Texas RE indicated that it is considering hiring additional staff with the skills required to perform these duties. At the most recent site visit, the CEO of Texas RE indicated his desire to hire the required staff within 60 days if a suitable candidate can be identified. Audit staff believes that Texas RE should increase its staff or training as necessary to perform this function.

Audit staff also notes that Texas RE did not have any employee representing it on NERC's Reliability Assessment Subcommittee, unlike the practice of most other Regional Entities, which include RE employees among their representatives.

Recommendations

We recommend that Texas RE:

5. Develop a plan to review staffing needs to perform reliability assessments;
6. Consider increasing staff or training existing staff to include expertise sufficient to perform its duties as to reliability assessment; and
7. Appoint an RE staff member to represent Texas RE on NERC's Reliability Assessment Subcommittee and any other committee or subcommittee whose authority includes RE statutory functions.

4. Controls over Confidential Information

Pursuant to an MOU between Texas RE and ERCOT ISO, ERCOT ISO provides all computer equipment and IT services to Texas RE. Texas RE's computers and servers are accessible to about a half-dozen ERCOT ISO employees who maintain IT systems, all of whom have signed agreements promising to maintain the confidentiality of ERCOT data, which does not explicitly include CMEP data. Further, there is no written agreement in which these ERCOT ISO employees agree to comply with section 1500 of the NERC

Rules of Procedure, Protection of Confidential Information. Also, Texas RE needs to improve its controls over access to confidential information to prevent this information from potentially being compromised or disclosed improperly to ERCOT ISO personnel.

Pertinent Guidance

As approved by the Commission in the Delegation Agreement Orders, section 9.3.3 of the Compliance Monitoring and Enforcement Program provides that: “The Compliance Enforcement Authority personnel (including any contractors, consultants and industry volunteers) and committee members, and participants in Compliance Program activities shall be informed of, and agree to comply with, Section 1500 of the NERC Rules of Procedure concerning Confidential Information.” Section 1500 of the NERC Rules of Procedure provides the rules for, among other items, the Texas RE’s treatment of confidential information.

Background

Pursuant to an MOU between ERCOT ISO and Texas RE, ERCOT ISO owns and services the computers and servers Texas RE uses, and provides the corporate and Internet connectivity, secure remote access and email, file storage, and backup services. Texas RE staff verbally informed audit staff that ERCOT ISO employees are prohibited from accessing Texas RE files and services without an explicit request by Texas RE.

Texas RE’s computers and servers are inaccessible to any ERCOT ISO employee except for about a half-dozen IT employees who maintain IT systems, all of whom have signed agreements promising to maintain the confidentiality of ERCOT data. Specifically, the ERCOT ISO employees sign an Employee Ethics Agreement, which requires maintaining the confidentiality of ERCOT information; only Texas RE employees sign the Texas Regional Entity Employee Ethics Agreement, which contains specific reference to the need to maintain the confidentiality of Texas RE’s CMEP data. In the amended MOU dated February 16, 2009, there is a statement that “ERCOT employees and contractors who provide any services to Texas RE under this MOU or who have access to Texas RE confidential information must also agree to maintain confidentiality of all Texas RE confidential information.” (MOU at section II, B,6.) However, to date there is no written agreement, signed by ERCOT ISO employees, in which the ERCOT ISO IT employees agree to comply with section 1500 of the NERC Rules

of Procedure on protection of confidential information. On August 18, 2009, ERCOT amended its Code of Conduct and Ethics Corporate Standard, to include NERC section 1500 language, but Texas RE has not yet received confirmation that all ERCOT ISO employees providing services under the MOU have complied with this standard.

Texas RE's offices, located in a separate building from the ERCOT ISO since February 27, 2009, are restricted by physical security. Non Texas RE employees, including ERCOT ISO employees providing IT and other services to the Texas RE, are required to register and have access approved. Nonetheless, confidential information may be accessed by these employees. To date, there have been no recorded incidents that this has occurred. Audit staff's examination of email between Texas RE and ERCOT employees indicated no communications that compromised confidential Texas RE information.

Texas RE has indicated that it plans to move all its IT services, including email servers, onto third-party vendor equipment with no links to ERCOT ISO. A third-party vendor already hosts the confidential portal Texas RE uses to allow the registered entities to convey confidential documents to Texas RE, and for NERC and Texas RE to pass confidential information in a secure fashion.

Texas RE's vendor also hosts Texas RE's primary public Web site (www.texasre.org). Texas RE's previous primary Web site was embedded within the ERCOT ISO Web site (www.ercot.com/mktrules/compliance/TRE), leading users to view the two entities as integrated. However, during the audit period, both Web sites were active, which may result in confusion and the potential for errors if the content of each site is not updated. On August 3, 2009, Texas RE notified audit staff of the activation of the new Web site and its intention to terminate the ERCOT ISO-hosted Web site. The rapid implementation of this policy is anticipated to eliminate the concerns of dual Web sites. However, the initial review of the new Texas RE Web site indicated errors in its postings. The audit team asked employees at the Texas RE about its efforts to ensure the accuracy and continuity of the information posted. The audit team reviewed the Texas RE procedure for moving critical information to its new Web host and is satisfied with the new program.

Recommendations

We recommend that Texas RE:

8. Obtain executed confidentiality agreements (or a written confirmation from ERCOT ISO's general counsel that such agreements have been accepted) covering Section 1500 of the NERC Rules of Procedure concerning confidential information with all ERCOT ISO employees who are granted access to Texas RE's IT until such time as Texas RE eliminates its reliance on ERCOT ISO for IT services;
9. Ensure that any third-party vendor agrees to comply with section 1500 of the NERC Rules of Procedure about confidential information;
10. Instruct the ERCOT ISO IT department to deactivate the Texas RE Web site hosted by ERCOT and redirect all inquires to this site to the new independently hosted Web site; and
11. Update audit staff on the status of its efforts to eliminate its reliance on ERCOT ISO for IT services.

Attachment B



November 27, 2009

Bryan K. Craig
Director, Division of Audits
Office of Enforcement
Federal Energy Regulatory Commission
888 First Street N.E.
Washington, D.C. 20426

Via Electronic Delivery

Re: Docket No. PA09-06-000 – Response to September 24, 2009 Draft Audit Report

Dear Mr. Craig:

Texas Regional Entity, an independent division of Electric Reliability Council of Texas, Inc. (Texas RE) provides the following response to revised report by the Federal Energy Regulatory Commission (the Commission) Office of Enforcement's Division of Audit's "Audit of Regional Entity Independence of Texas Regional Entity," dated September 24, 2009 and sent to Texas RE on November 13, 2009 (Report).

Texas RE accepts the findings in the Report as recommendations for improvements in Texas RE's operations, many of which are already being implemented. Texas RE asserts that it is fully compliant with: (1) the Regional Delegation Agreement between North American Electric Reliability Corporation (NERC) and Texas RE, (2) the Texas RE bylaws, and (3) other obligations and responsibilities as approved by the Commission. As noted in the Report, Texas RE has voluntarily taken steps to increase the independence of Texas RE from Electric Reliability Council of Texas, Inc. (ERCOT ISO) over the past eighteen months, including moving toward a corporate separation from ERCOT ISO.

Texas RE agrees to continue to implement the recommendations in section III. 1 ("Independence Concerns Related to Texas RE") of the Report, by forming a new and separate legal entity to serve as the Regional Entity. Texas RE expects to form the new corporation in January 2010 and to request approval of the NERC Board of Trustees for an amended Regional Delegation Agreement and amended 2010 Business Plan and Budget for the new corporation by February 2010. Texas RE estimates that NERC will file the amended Regional Delegation Agreement and 2010 Business Plan and Budget with the Commission for approval by the end of February 2010, and Texas RE anticipates that the Commission will take action on the requested amended documents by June 2010. Texas RE agrees to submit a formal separation transition plan to Commission staff.

Texas RE agrees to continue to implement the recommendations in section III. 2 ("Texas RE Role in Compliance Monitoring of ERCOT ISO") by having NERC lead all compliance and enforcement activities of ERCOT ISO until a legally separate Texas RE is authorized as a Regional Entity. If any compliance audit of ERCOT ISO is performed in 2010, prior to approval by the Commission of an amended Regional Delegation Agreement for a legally separate Texas RE, Texas RE will arrange a formal contract with NERC to conduct audits and perform compliance activities relating to ERCOT ISO.

Texas RE submits that it has complied with its reliability assessment obligations under NERC Rules of Procedure Section 800 while avoiding duplication of the reliability assessment activities traditionally performed by ERCOT ISO. Texas RE's historically more limited role¹ (in terms of both time and resources expended) in coordinating, reviewing, and commenting on the regional reliability assessments was approved by the Commission in its approval of the Texas RE 2009² and 2010³ Business Plans and Budgets. Texas RE agrees to implement the recommendations in section III. 3 ("Texas RE Reliability Assessment Responsibilities") of the Report by adding an additional employee with experience in planning or reliability assessments to its staff who will (1) participate in regional planning meetings and NERC's Reliability Assessment Subcommittee and other related committees and subcommittees, and (2) review and provide thorough comments to the draft regional reliability assessments prepared by ERCOT ISO. Texas RE anticipates hiring the additional employee by February 1, 2009. Texas RE has already improved its internal procedures for documenting reliability assessment comments and tracking time spent by employees in the reliability assessments area.

Texas RE agrees to implement the recommendations in section III. 4 ("Controls over Confidential Information") of the Report.

1. Texas RE has received an affidavit from ERCOT ISO General Counsel, dated October 30, 2009, confirming that all ERCOT ISO employees have taken annual Antitrust and Ethics training and agreed to comply (by electronic or inked signature) with the requirements of the ERCOT Ethics Agreement, which specifically includes an obligation to maintain the confidentiality of information as required by section 1500 of NERC Rules of Procedure.
2. Texas RE requires all contracts for its vendors who may access confidential information to require the vendor and its personnel to comply with section 1500 of the NERC Rules of Procedure, and Texas RE requires all consultants performing services for it to sign an Ethics Agreement agreeing to comply with section 1500 of the NERC Rules of Procedure.
3. As requested by Texas RE, on August 14, 2009, the ERCOT ISO information technology department deactivated the Texas RE content from the ERCOT ISO Web site, except for links on the ERCOT ISO Web site to the Texas RE Web site content.
4. Texas RE has retained a consultant to oversee the competitive selection of new information technology suppliers for Texas RE and the implementation of the removal of

¹ See *NERC 2009 Long-Term Reliability Assessment*, page i, footnote 3, noting that "ERCOT and SPP are tasked with performing reliability self-assessments as they are Regional planning and operating organizations. SPP-RE (SPP-Regional Entity) and TRE (Texas Regional Entity) are functional entities to who NERC delegates certain compliance and enforcement authorities."

² See Attachment 9 to *Request of the North American Electric Reliability Corporation for Acceptance of its 2009 Business Plan and Budget and the 2009 Business Plans and Budgets of Regional Entities and for Approval of Proposed Assessments to Fund Budgets*, filed August 22, 2008 in Docket RR08-6-000; and *Order Conditionally Accepting 2009 Business Plan and Budget of the North American Electric Reliability Corporation and Ordering Compliance Filings*, 125 FERC ¶ 61,056 (October 16, 2008).

³ See, *Request of the North American Electric Reliability Corporation for Acceptance of its 2010 Business Plan and Budget and the 2010 Business Plans and Budgets of Regional Entities and for Approval of Proposed Assessments to Fund Budgets*, filed August 24, 2009 in Docket RR09-9-000; and *Order Conditionally Accepting 2010 Business Plan And Budget of the North American Electric Reliability Corporation and Ordering Compliance Filings*, 129 FERC ¶ 61,040 (October 15, 2009).



Brian K. Craig
November 27, 2009

information technology services from ERCOT ISO. Texas RE will update Commission staff on the progress of the services transition, until the administrative services by ERCOT ISO are terminated.

Please notify me if you have additional questions.

Sincerely,

*Larry D. Grimm, by Susan [unclear]
with permission*

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