FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D.C. 20426

In Reply Refer To:
Office of Enforcement
Docket No. FA12-6-000
June 11, 2013

R. Scott Henry, President and CEO
SERC Reliability Corporation
2815 Coliseum Centre Drive
Suite 500
Charlotte, NC 28217

Dear Mr. Henry:

1. The Division of Audits (DA) within the Office of Enforcement (OE) of the Federal Energy Regulatory Commission (Commission) has completed the audit of the SERC Reliability Corporation (SERC), for the period from August 23, 2006 through February 19, 2013. The enclosed audit report explains our audit conclusions and recommendations.

2. The audit evaluated SERC's budget formulation, administration, and execution. Also DA focused on the costs and resources used to achieve program objectives in fulfilling the duties delegated to SERC by the North American Electric Reliability Corporation as the Electric Reliability Organization under section 215 of the Federal Power Act.[1]

3. In its June 6, 2013 response, SERC stated it accepts the audit report and has already taken actions to address the recommendations. A copy of your verbatim response is included as an appendix to this report. I hereby approve the audit report.

4. Within 30 days of this letter order, SERC should submit a plan to comply with the recommendations. SERC should make quarterly submissions describing how and when it plans to comply with the recommendations, including the completion date for each recommendation. The submissions should be made no later than 30 days after the end of

[1] 16 U.S.C. § 824o (2012).

each calendar quarter, beginning with the first quarter after this audit report is issued, and continuing until all the recommendations are completed.

5. The Commission delegated the authority to act on this matter to the Director of OE under 18 C.F.R. § 375.311 (2012). This letter order constitutes final agency action. SERC may file a request for rehearing with the Commission within 30 days of the date of this order under 18 C.F.R. § 385.713 (2012).

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

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

Sincerely,

Norman C. Bay
Director
Office of Enforcement

Enclosure

Federal Energy Regulatory Commission

Audit of the SERC Reliability Corporation for Budget Formulation, Administration, and Execution

Docket No. FA12-6-000
June 11, 2013

Office of Enforcement
Division of Audits

Table of Contents

I. Executive Summary

A. Overview

On November 2, 2011, the Division of Audits (DA) commenced an audit of SERC Reliability Corporation (SERC). The audit evaluated SERC's budget formulation, administration, and execution and addressed SERC's responsibilities as a Regional Entity (RE). In addition, the audit focused on the costs and resources used to achieve program objectives. The audit covered the period from August 23, 2006 to February 5, 2013.

B. SERC Reliability Corporation

Under section 215(e)(4) of the Federal Power Act (FPA), the Commission may approve delegation by the North American Electric Reliability Corporation (NERC), the Commission's certified Electric Reliability Organization, of authority to propose and enforce reliability standards to REs. SERC is one of eight REs in North America delegated such authority under FPA section 215. SERC, headquartered in Charlotte, NC, is a nonprofit corporation responsible for promoting and improving the reliability of the bulk power systems in all or portions of 16 central and southeastern states. SERC's service area covers approximately 560,000 square miles, and electric systems in the region serve approximately 26.8 percent of the net energy for load (NEL) in North America and 31.9 percent of the NEL in the Eastern Interconnection. SERC, initially called the Southeastern Electric Reliability Council, was formed in 1970 as a voluntary association of members comprising electric industry reliability stakeholders in the southeast.

SERC executed an agreement with NERC on May 2, 2007 to delegate to SERC certain responsibilities and authorities of an RE as defined by FPA section 215.[2] At that time, SERC oversaw 125 registered entities in eight states in the south and southeastern United States. The number of registered entities for which SERC was responsible at the end of the audit period was approximately 245. Within SERC's footprint, NERC has delegated to SERC the following statutory functions:[3]

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[2] 16 U.S.C. § 824o (2012).

[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).

- Active participation in the development of North American reliability standards for the Bulk-Power System, and, as needed, development of reliability standards applicable within the SERC region.

- Monitoring and enforcement of approved reliability standards, including the registration of registered entities, and, as needed, certification of such entities.

- Assessment of the present and future reliability, adequacy, and security of the Bulk-Power System.

- Promotion of situational awareness.

- Conducting event analysis to identify and distribute lessons learned to improve reliability.

- Promotion of effective training and education of reliability personnel, and assisting in the certification of operating personnel.

- Promotion of the protection of critical infrastructure.

Additionally, in July 2010 the Commission approved the contract that established SERC as the Compliance Enforcement Authority (CEA) to perform compliance monitoring and enforcement activities for the reliability functions that two other Regional Entities, the Southwest Power Pool, Inc. and the Florida Reliability Coordinating Council, Inc., had registered to perform subject to Commission approval. Costs associated with any such activities SERC performed were to be funded by payments from each RE contracting with SERC for such services under the Commission-approved contract between SERC and the other RE[4].

Within each annual SERC business plan and budget during the audit period, SERC affirmed that it did not engage in any non-statutory functions that would be ineligible for funding pursuant to FPA section 215.

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[4] North American Electric Reliability Corp., 132 FERC ¶ 61,024, Order Conditionally Accepting Compliance Monitoring and Enforcement Program Agreements and Revised Delegation Agreements and Ordering Compliance Filing, Docket No. RR10-7, July 12, 2010.

C. Summary of Conclusions

Below is a summary of audit staff's conclusions. Detailed conclusions are in section IV of this report. Audit staff has documented our conclusions in six areas:

- *Expenditure Policies and Control* – While SERC demonstrated strong oversight when evaluating expenditures, it should strengthen its written expense guidelines within its Employee Handbook to ensure consistency in applying its guidelines to all employee expenses. Also, SERC did not adequately document an instance when there was an exception to one of its written expense policies governing travel expenses during the audit period.

- *Employee Events* – SERC should enhance its current policies and processes for budgeting company-sponsored employee events. SERC's existing policies and processes did not have the necessary transparency to permit effective approval and tracking of these expenses. Instead, SERC treated these expenses as discretionary, funded by unused funding without appropriate budgeting policies and procedures in place.

- *Retirement Benefits* –SERC should enhance its existing procedures to adequately justify increases in its retirement contribution. Moreover, SERC did not have adequate written policies and procedures to support the disbursement of its discretionary contribution. In addition, SERC included bonuses in the compensation used in the retirement benefit obligation calculations for its employees without adequate justification.

- *Tracking Time and Expenses by Program Areas* – SERC's method for accounting for its activities by each of its organizational departments may not always promote sufficient transparency of activities in specific program areas as reflected in its budgeting process. Therefore, SERC should enhance its procedures for recording and tracking employee time and related expenses to accurately allocate resources and expenses to each program area in its budget.

Other Matters:

- *Industry Subject Matter Experts* – SERC did not have sufficient documented procedures and processes to efficiently and effectively use audit feedback forms to: (1) address the use of Industry Subject Matter

Experts (ISMEs) on audit engagements and (2) assess SERC's educational and training needs.

- *Audit Scope Reductions for Planned Audits* – Although SERC believed it had valid reasons to reduce the scope of planned audits, it should not have done so without written authorization from NERC in accord with the current NERC annual CMEP Implementation Plan.

D. Summary of Recommendations

This Section summarizes audit staff's recommendations to remedy this report's conclusions. Detailed recommendations are in Section IV. Audit staff recommends that SERC:

1. Strengthen standard written policies and procedures regarding expense reimbursements for travel, meals, home offices, and other business-related expenditures to provide SERC employees with a clear, consistent, and specific set of rules that can be regularly implemented at the managerial level;

2. Establish written procedures to specify when exceptions to expense policies are appropriate and ensure documentation of such instances;

3. Continue to review its expenses and identify all unbudgeted expense items, including employee events that are recurring in nature, so it can plan, budget, and account for such expenses in the budget for each year;

4. Revise its current accounting and budgeting recordkeeping policies to ensure consistency and transparency in accounting and budgeting for employee events, and other similar expenses, to ensure it properly budgets and accounts for them;

5. Consider the justification for, and impacts of, inclusion of discretionary compensation (e.g., bonuses) in the calculation of retirement contributions and submit this analysis to its Board of Directors for approval;

6. Develop clear written guidelines to inform the Board of the appropriate metric to use to assess corporate performance in order to justify the discretionary component of the retirement benefit contribution;

7. Continue to develop and implement functional codes at the appropriate level of granularity, but at least at the program area level, to allow effective and efficient project management and oversight, including the tracking of each employee's time and expenses;

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

9. Train SERC employees on the proper use of the time-reporting practices;

10. Revise its processes, procedures, and controls regarding ISME participation in compliance activities and ensure SERC has an adequate and detailed set of policies governing ISMEs' participation in compliance activities;

11. Ensure greater awareness of SERC's ongoing training and education programs and use the feedback from ISME participation in compliance activities to better focus these outreach programs;

12. Establish written processes and procedures to ensure that when it reduces the scope of a compliance audit, SERC receives written approval from NERC in the manner required by the current NERC CMEP implementation plan filed with the Commission;

13. Establish written processes and procedures to ensure that when compliance auditing is conducted on a registered entity already subject to on-going enforcement activities, there are no gaps in determining compliance for the complete audit period;

E. Implementation of Recommendations

Audit staff further recommends that SERC:

- Submit to audit staff for review the company's plans for implementing audit staff's recommendations. SERC should provide these plans to audit staff within 30 days of the final audit report's issuance;

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

- Submit copies of any written policies and procedures developed in response to recommendations in the final audit report. These policies and procedures should be submitted for audit staff review in the first nonpublic quarterly filing after SERC completes these documents.

II. Background

A. Overview

Under section 215(e)(4) of the Federal Power Act (FPA),[5] the Commission approved NERC's delegation of certain statutory functions to the REs. Effective January 1, 2011, SERC executed an Amended and Restated Regional Delegation Agreement with NERC that delegated to SERC certain responsibilities and authorities pursuant to FPA section 215. The duties NERC delegated, according to the agreement, include: Compliance Monitoring, Organization Registration and Certification, Enforcement, Reliability Standard Development, Event Analysis and Reliability Improvement, Training and Education, Situational Awareness, Infrastructure Security, and Reliability Assessment and Performance Analysis.

B. Statutory Activities

SERC carried out its statutory functions and responsibilities through four functional units: Compliance, Enforcement and Mitigation, Reliability Services, and Reliability Assessments. To support those functional units, SERC maintained employees in two other functional units: Information Technology and General and Administrative.

Compliance

The SERC Compliance functional unit is responsible for auditing compliance with NERC standards, registering and certifying organizations, and conducting compliance investigations. The delegated duties assigned to Compliance include:

- Compliance Monitoring
- Organization Registration and Certification

Enforcement and Mitigation

The SERC Enforcement and Mitigation functional unit is responsible for the disposition of potential violations of NERC standards and for the review and approval of mitigation plans. The delegated duty assigned to Enforcement is enforcement.

[5] 16 U.S.C. § 824o (2012).

Reliability Services

The SERC Reliability Services functional unit is responsible for reliability standards, event analysis, situational awareness, infrastructure security, training and education, and committees and member forums. The delegated duties assigned to Reliability Services include:

- Reliability Standard Development
- Event Analysis and Reliability Improvement
- Training and Education
- Situational Awareness
- Infrastructure Security

Reliability Assessments

The SERC Reliability Assessments functional unit is responsible for supporting NERC reliability assessments and producing SERC reliability assessments. The delegated duty assigned to Reliability Assessments is Reliability Assessment and Performance Analysis (RAPA).

Information Technology

The SERC Information Technology functional unit is responsible for supporting staff and registered entities with the portal system and core technology infrastructure, project support, and IT vendor management.

General and Administrative

The SERC General and Administrative functional unit is responsible for performing administrative services for the corporation, including legal, accounting/finance, and interaction with stakeholders.

C. Organizational Structure and Staffing

SERC underwent several organizational restructurings during the audit period. Two major organizational changes are particularly important for the purpose of this report:

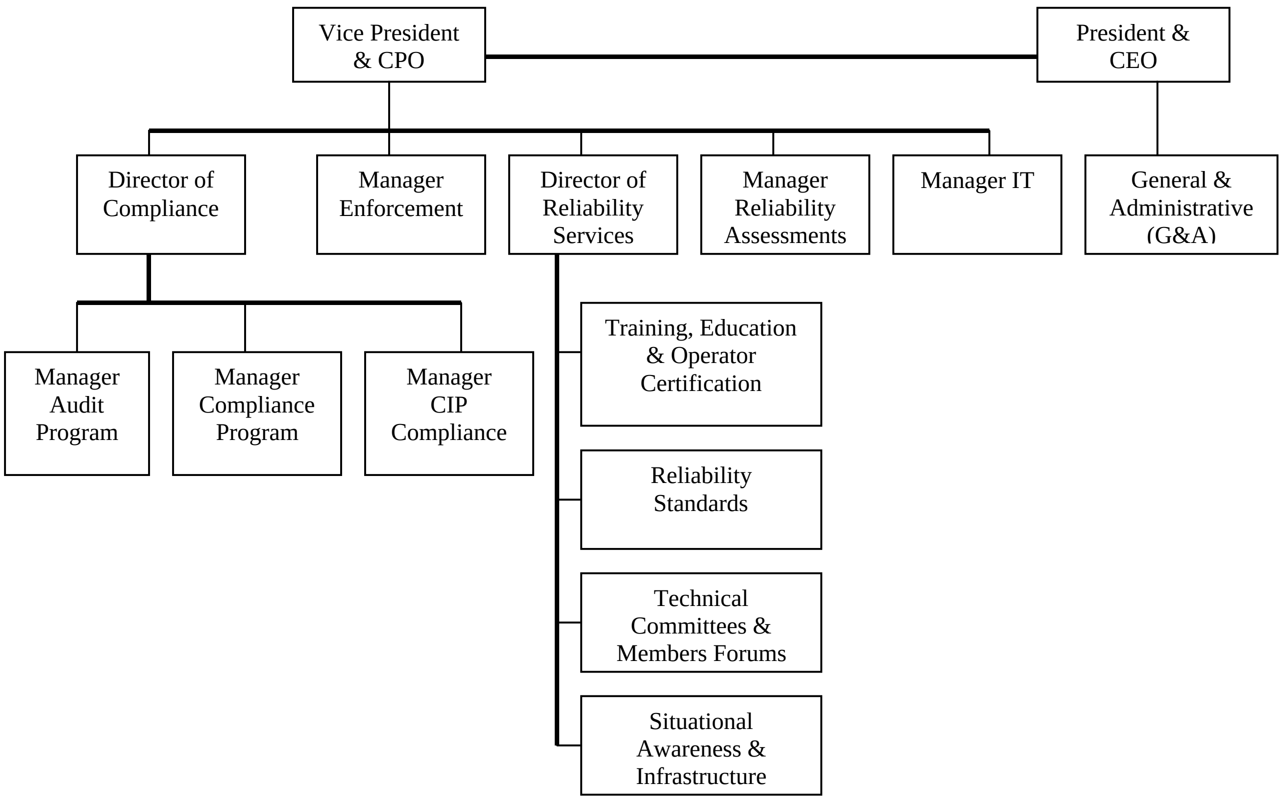
- SERC added a Chief Program Officer (CPO) effective March 28, 2011. This position was established at a Vice Presidential level within the organization and reported directly to the President. SERC created the CPO position and staffed it in 2012 to enable greater day-to-day oversight of Compliance, Reliability Services, Reliability Assessments, and IT (Organizational chart dated May 31, 2011).

- SERC separated the reporting relationship for the Enforcement group so it would report directly to the Vice President-CPO. Prior to this, the group reported directly to the Director of Compliance. SERC believed this change would increase organizational efficiency and emphasize the disposition of possible violations (Organizational chart dated January 3, 2012).

SERC designed its organizational structure by broad program areas identified within its business plan and budget. For example, SERC separated its Compliance Monitoring and Enforcement Program (CMEP) activities from its other activities and further divided its CMEP into two groups. One group supported compliance audits and spot checks, and another processed the results of such activities, including violation assessments, settlements, and violation mitigation. Additionally, SERC's Reliability Services group supported multiple program areas, including its delegated responsibilities for Reliability Standards; Technical Committees and Members' Forums; Situational Awareness and Infrastructure Security; and Training, Education, and Operator Certification.

Although SERC built its organization primarily around specific delegated program areas, employees within some program areas often assisted the efforts of other program areas, particularly when additional resources or expertise were needed. Figure 1 illustrates SERC's organizational structure as of April 2012.

Figure 1: SERC Organizational Chart[6]



For budgeting and reporting purposes, each employee had a default, or "home" department, in which his or her position resided. Since employees sometimes assisted other program areas outside their default department, SERC's organizational charts during the audit period did not fully reflect its functional operations or staff support for the various program activities in its business plan and budget. Some examples include:

- Legal counsel resources resided within the General and Administrative (G&A) department, but directly supported some enforcement activities, such as settlements or mitigation plan processing.

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[6] For purposes of this report, audit staff created this simplified, organizational chart based on others SERC provided (dated April 30, 2012). Refer to Appendix A for the complete SERC organizational chart.

- Resources within both the Reliability Assessments department and the Reliability Services department conducted activities related to Performance Analysis.

Since 2007, SERC has increased its initial 30.3 full-time equivalent employees (FTEs) by about 43 FTEs. In its 2012 Business Plan and Budget, SERC budgeted for 73.7 (FTEs), an increase of 20.2 FTEs from its 2011 budget.

While FTEs added in 2012 included compliance and CIP auditor positions within the Compliance group, SERC also utilized ISMEs to augment its compliance audit teams for large audits. ISMEs were volunteers from the registered entities within the SERC region with expertise in operations, engineering, communication systems, computerized control systems, network security, protection and/or control systems, and/or compliance programs. SERC believed its use of ISMEs allowed it to continue to strengthen the RE's compliance auditing program and minimize costs.

D. Budget, Accounting, and Recordkeeping

Budget Formation

During the audit period, SERC coordinated with both NERC and the Commission to form its budget. SERC, with the other REs, developed a shared business plan and budget assumptions by participating in the ERO's Executive Management Group. This group, consisting of the NERC CEO, the CEO of each RE, and NERC and RE staff working in specialized subgroups, collaborated in developing budget assumptions, annual goals, and key deliverables for the budget – the ERO Strategic Plan.

SERC used the ERO Strategic Plan to form its corporate and individual performance goals. In addition to the Strategic Plan, each year the SERC CEO and management team identified focus areas that were important to SERC to further its core values and principles. After developing key elements and yearly objectives, SERC then created corporate and individual goals to support its budget formation.

In March of the preceding budget year, SERC began drafting its business plan and budget using the NERC template.[7] Each program area manager reviewed his or her program area's key assumptions, goals, and deliverables for the budget

[7] NERC and the REs operate on a calendar-year budget year.

year. Based on this assessment, the program area managers provided input on labor needs, contracts and consultants, new projects, and projected meetings SERC would host or attend. At the same time, program area managers also considered travel-related costs and associated expenses, such as employee training.

The Director of Finance and Human Resources (DFHR) coordinated budget development among the program areas. The DFHR estimated travel and meeting costs by obtaining actual costs from the previous year from SERC's general ledger and adjusting the estimates for any known and measurable changes for the current budget year. The DFHR also assessed unbudgeted items from the previous fiscal year to determine if they should be included in the current year's budget. The DFHR relied on compensation studies to assess and determine salary ranges for staffing positions and budgeting for labor costs.

For each budget year, SERC submitted its initial draft to the Board of Directors for approval in April of the proceeding budget year. The Board obtained and reviewed the completed budget, paying particular attention to budget variances from the prior year. Once the Board approved and/or modified the initial draft, SERC posted its business plan and budget for public comment for 30 days on its web site. SERC responded to all comments received during the posting period at the Board Executive Committee meeting held in July of each year.

SERC's Board Executive Committee consisted of 12 members from the Board who were responsible for making decisions between meetings of the Board, such as reviewing and approving the SERC budget. During each year's July Executive Committee meeting, the Committee members reviewed and approved the final business plan and budget. SERC then submitted them to NERC for approval in July in order to make the final submittal to the Commission by late August of the preceding budget year.

Accounting and Recordkeeping

SERC used the NERC System of Accounts (NSOA) to classify income and expenses. The NSOA segregated income and expenses based on the functional categories within the NERC ROP.

To track and account for employee time, SERC used both direct and indirect cost centers. Direct cost centers were mainly direct programs in the business plan and budget. In SERC's time-tracking software, each employee's labor hours were set to default to their respective department within SERC, even for employees whose work spanned functional activity areas. Indirect cost centers were used to record the costs of enterprise-wide activities that SERC could not directly assign to a functional program area as a direct cost center. SERC allocated costs accumulated within indirect cost centers to functional categories based on FTEs within each program.

III. Introduction

A. Objective

The objective of this financial audit was to evaluate SERC's budget formulation, administration, and execution. This audit focused on the costs and resources used to achieve program objectives and determine whether SERC, as an RE, had adequate funding to carry out its delegated responsibilities.[8]

B. Scope and Methodology

The procedures audit staff performed to evaluate SERC and its budget formulation, administration, and execution required audit staff to review Commission-related orders and criteria, NERC's and SERC's business plans and budgets, NERC and SERC's Delegation Agreement, and SERC's Bylaws. Audit staff gathered and reviewed information through data requests, interviews, teleconferences, and a site visit. To address audit objectives, audit staff:

- Reviewed Public Information – To familiarize itself with SERC'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 the company, and local newspapers, and trade and academic press to identify significant developments and occurrences that arose during the audit period.

- Conducted a Site Visit – Audit staff conducted a site visit to SERC in March 2012. During the site visit, audit staff obtained a thorough understanding of SERC's processes, procedures, and controls. Audit staff conducted several interviews with SERC management and staff to understand their job functions and learn about SERC operations and activities related to its delegated functional responsibilities. On-site discussions included SERC's management team and other employees, including the President and Chief Executive Officer (CEO), Vice President and CPO, DFHR, and other program managers.

- Interviewed the Board of Directors – Audit staff interviewed two SERC Board members to understand their roles and responsibilities as SERC

[8] Order No. 672, 114 FERC ¶ 61,104 at P 227.

Board members, the Board of Directors' involvement in the SERC budget development process, and the various activities and responsibilities among Board of Directors subcommittees.

- Issued Data Requests – Audit staff gathered information through more than 100 formal and supplemental data requests. Information obtained included copies of SERC's organizational and functional structure, internal policies and controls, budget development procedures, accounting policies, and other key documents.

To facilitate audit staff's evaluation of SERC as an RE and its budgeting for its delegated responsibilities, audit staff conducted extensive reviews and testing relating to SERC's processes, policies, procedures, and controls. Specifically, audit staff conducted the following activities relating to the major subject areas of the audit:

Objectives of SERC, its Delegated Responsibilities, and Functional Organization

- Reviewed SERC's organizational goals, business objectives, and key deliverables to facilitate discussions on how SERC determines resources needed to achieve objectives;

- Reviewed SERC's organizational charts to understand its structure and the responsibilities of its various functional groups;

- Examined how program managers responsible for delegated responsibilities assessed and aligned resources to achieve program goals;

- Assessed coordination between SERC, NERC, and the SERC Board to achieve ERO goals and objectives; and

- Interviewed the President and CEO, with other senior management, to understand SERC's processes for setting organizational and individual goals, tracking progress toward goal achievement, and compensating for goal achievement.

Budget Development, Administration, and Execution

- Examined processes and procedures SERC used to develop its annual budget and how it identified resources to adequately achieve program goals and objectives;
- Ensured sufficient detail existed within SERC's business plan and budget as presented to ensure the Commission is able to conclude delegated responsibilities are adequately funded;
- Examined how SERC used its budget throughout the budget year to support day-to-day operations and contingencies, as well as examined how it met organizational and program goals;
- Examined and tested controls used to help ensure adherence to SERC's business plan and budget;
- Reviewed SERC's procedures for monitoring its budget and conducting budget variance analysis throughout the budget year; and
- Sampled and tested representations made within SERC's business plans and budgets to determine whether SERC adhered to key deliverables presented within its budget, and achieved program goals and objectives.

SERC's Use of Industry Subject Matter Experts (ISMEs)

- Examined the way SERC utilized ISMEs on audits of registered entities to supplement the expertise of the audit team, including the level of involvement of ISMEs in the audit;
- Evaluated SERC's policies and procedures on identifying the need for ISMEs, selecting and evaluating the skills of ISMEs, and assessing the need for specific ISMEs to use on audits of registered entities;
- Reviewed SERC's process for examining the benefits SERC derived from the use of ISMEs, including a cost analysis of using ISMEs; and discussed with SERC management SERC's expectations of ISMEs' contributions and participation during audits; and
- Reviewed a sample of feedback forms completed by ISMEs who participated on SERC audits of registered entities to determine the function and role of ISMEs from their perspective.

SERC's Compliance with NERC's Compliance Monitoring and Enforcement Program (CMEP) Implementation Plan

- Examined SERC's procedures for ensuring compliance with NERC's CMEP Implementation Plan;

- Evaluated SERC's enforcement processes and how they changed after reducing the scope of audits involving open violations;

- Discussed with SERC management SERC's understanding of the process to notify NERC of changes in the scope of audit activities; and

- Reviewed SERC's policies and procedures regarding the coordination between enforcement and audit functions when conducting a compliance audit.

Accounting and Recordkeeping

- Reviewed policies and procedures for SERC's accounting for income and expenses;

- Examined processes for employee time tracking and accounting for labor associated with functional categories;

- Sampled and tested expenditures to determine the proper accounting of expenses for each functional category within NERC's ROP;

- Tested SERC's processes of allocating general and administrative and other support activities among program areas; and

- Tested expenditures and supporting documentation to assess the effectiveness of SERC's internal controls over accounting and reporting.

Staffing and Organizational Responsibilities

- Reviewed SERC's Bylaws, evaluated their policies and procedures, and held discussions with SERC management to determine the process for evaluating and assessing employee performance, compensation, benefits, and incentives;

- Reviewed job descriptions and compensation studies, and conducted interviews, to evaluate SERC's processes for employee placement within program areas; and

- Reviewed SERC's employee performance evaluation process and examined how it tied to SERC's incentive compensation allocation process.

IV. Conclusions and Recommendations

1. Expenditure Policies and Controls

While SERC demonstrated strong oversight when evaluating expenditures, it should strengthen its written expense guidelines within its Employee Handbook to ensure consistency in applying its guidelines to all employee expenses. Also, SERC did not adequately document an instance when there was an exception to one of its written expense policies governing travel expenses during the audit period.

Pertinent Guidance

The FPA, as amended by the Energy Policy Act of 2005, added section 215 on Electric Reliability. Section 215(c)(2) states the Commission may certify an entity as an ERO if, among other considerations, the Commission determines that the ERO " ... has established rules that allocate equitably reasonable dues, fees, and other charges among end users for all activities under this section." Section 215(e)(4) empowers the Commission to authorize the ERO to enter into an agreement to delegate authority to a regional entity if, among other things, the regional entity satisfies the provisions of section 215(c)(2).

The SERC Reliability Corporation Employee Handbook states the following:

"Spouse or family travel expenses are not reimbursable, unless specifically authorized by the SERC President."

Background

Audit staff obtained and reviewed policies, processes, and controls over SERC's expenditures. SERC explained its expense-approval process and provided copies of its Employee Handbook and internal control procedures used by SERC management and employees for approving expense reimbursements. While audit staff believes SERC has used adequate standards in its expenditure practices, many of these practices were not documented or consistently defined. For example, a review of SERC's expenditure policies identified an area of concern related to the reimbursement of travel, meals, home offices, and other business expenses. SERC's Employee Handbook only referenced and limited employee expenditures to "reasonable" expenses. Although the handbook specified some restrictions, it did not define reasonableness associated with most travel, meals, home offices, or other business expenditures. During the audit period, after expense reports were approved by employees' immediate supervisors, the DFHR also reviewed and approved each report. SERC's reliance upon the DFHR to review all of the expenses reporting led to operational inefficiencies when, in the absence of the DFHR, the time and attention of senior management, particularly the CEO, was diverted to perform key administrative tasks.

Specifically for travel-related expenses, the Employee Handbook stated that SERC staff should "strive to make travel arrangements through the most cost effective service." The handbook neither thoroughly specified the method by which the employee incurring the cost should determine the most cost-effective service, nor did it explain how the employee should demonstrate compliance with the policy. For example, while the handbook stated that employees should reserve coach/economy class for airline travel, the handbook did not provide further details on how employees should select the lowest fare available or demonstrate cost effectiveness (e.g., comparing alternate airlines). Despite this lack of specificity, audit staff did not find significant instances of excessive costs for air travel.

Of importance to audit staff's concern regarding the adequacy of SERC's written policies was SERC's stated intention to modify its review and approval process as a result of the growth of the organization. During the audit, SERC declared its intention to increase the rigor of the expense review at the program manager level and decrease the level of oversight from the DFHR. SERC managers would continue to approve expenditures of their subordinates, but they will receive more training to ensure that they are doing a thorough and consistent review. This practice would allow the DFHR to simply conduct spot-checks instead of reviewing all employees expenses. SERC saw this as a critical step to permit the DFHR to focus on more strategic tasks as the amount of employees in the organization continued to grow. Audit staff commended SERC for its efforts to improve its expenditure review and approval process and believes this practice will lead to enhanced efficiency at SERC. Indeed, enhancements in this area will ensure that SERC managers can approve expenditures without as much reliance upon the DFHR to review and approve all expenditures. At the same time, clear and specific guidelines on reasonable expenditures would establish sustainability of SERC's past rigorous review practices and ensure that all managers apply a consistent set of policies.

It is important to note that, absent written guidelines, audit staff believes that managers along with the DFHR thoroughly reviewed expenses, rejecting any expense claims found questionable. A review of SERC's general ledger and sample of employee expense reports did not indicate that employees received improper or inflated reimbursements. SERC also demonstrated that during the audit period both the managers and the DFHR had routinely rejected expenditures that were not considered reimbursable. These rejections were for travel, meals, home office, and other business-related expenses. Audit staff commends the diligence of the reviews but believes that these examples indicate that a greater awareness of allowable expenses would promote higher levels of compliance at the staff level. Therefore, while SERC's informal guidelines for expense approvals did prevent noncompliance with the rigorous involvement of the DFHR in the review process, audit staff feels that formal processes will help promote increased cost awareness and enhance SERC's ability to ensure reasonable costs going forward.

Audit staff identified an instance where staff did not believe that SERC had adequate documentation with regards to one expense policy during the audit period. SERC held annual employee events twice a year (e.g. summer and fall). SERC paid the travel expenses for employees' spouses attending the employee events. The SERC Employee Handbook stated that such expenses were not reimbursable, unless the SERC President explicitly authorized them. SERC stated that the President orally authorized these exceptions. However, during the audit period SERC's procedures did not require written evidence that the President authorize such expenses nor the basis upon which such exceptions were granted. Audit staff is concerned that the existing company policy did not provide sufficient guidance on the criteria upon which the President should base his decision to approve such expenses, particularly since such expenses had not been specifically budgeted for and approved, although routinely incurred. Audit staff believes that, to the extent that SERC wants to allow such expenses, it needs to have: (1) a separate policy in place to determine whether such expenses are reasonable; (2) procedures by which to control such a policy; and (3) specifically approved and budgeted funds to spend on these activities.

Recommendations:

Audit staff recommends that SERC:

1. Strengthen standard written policies and procedures regarding expense reimbursements for items such as travel, meals, home offices, and other business-related expenditures to provide SERC employees with a clear, consistent and specific set of rules that can be regularly implemented at the managerial level; and

2. Establish written procedures to specify when exceptions to expense policies are appropriate and ensure documentation of such instances.

2. Employee Events

SERC should enhance its current policies and processes for budgeting company-sponsored employee events. SERC's existing policies and processes did not have the necessary transparency to permit effective approval and tracking of these expenses. Instead, SERC treated these expenses as discretionary, funded by unutilized funding without appropriate budgeting policies and procedures in place.

Pertinent Guidance

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

18 C.F.R. § 39.4 sets out the requirements for funding an ERO. Specifically, section 39.4(b) addresses annual budget requirements and the requirement for the ERO and REs to file a complete business plan and organization chart explaining the proposed collection of all dues, fees, and charges and the proposed expenditure of funds collected in sufficient detail to justify the requested funding collection and budget expenditures.

Background

Audit staff obtained and reviewed policies, processes, and controls on SERC's expenditures, both budgeted and unbudgeted. As a rule, SERC's policies, processes, and controls appear to have functioned well during the audit period for its budgeted expenses. However, a review of SERC records identified a single area of concern related to the use and accounting of SERC funds for unbudgeted expenses. Audit staff identified expenses associated with hosting company-sponsored employee events that SERC did not separately identify and include in its business plan and budget in a transparent manner.

Audit staff's review of expenses during the audit period showed that SERC held annual events for its employees twice a year (e.g. summer and fall). Expenses relating to SERC employee events were about $21,000; $19,000; and $19,000 in 2009, 2010, and 2011 respectively.[9] Audit staff believes that SERC

[9] The precise amount of funds SERC expended was difficult to determine. SERC had inconsistent processes for labeling costs relating to employee events. SERC described most of the expense items as "employee celebrations" within its

should have identified them as a budgeted item to have effective transparency and accountability in its budget process.

SERC did not identify funding for employee event expenses in its business plan and budget since these expenditures were considered “discretionary.” By using that term, SERC explained that it planned to hold such events only if the organization as a whole operated within budget and unexpended budgeted funds were available. Audit staff agrees with SERC that it should not spend money on unbudgeted employee events if doing so would incur costs over budget or divert funds from higher priority budgeted activities that SERC could undertake. Audit staff believes that if SERC decides to host such employee events routinely that, at a minimum, SERC should specifically identify and budget for them in its annual operating budget to ensure transparency and accountability.[10]

Recommendations:

Audit staff recommends that SERC:

3. Continue to review its expenses and identify all unbudgeted expense items, including employee events that are recurring in nature, so it can plan, budget, and account for such expenses in the budget for each year; and

4. Revise its current accounting and budgeting recordkeeping policies to ensure consistency and transparency in accounting and budgeting for employee events, and other similar expenses, to ensure it properly budgets and accounts for them.

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general ledger. However, not all expenses related to employee events were classified as such, which did not allow for audit staff or SERC staff to readily identify and determine all costs related to employee events.

[10] Audit staff did not make a determination of the appropriateness of such costs but believes that if the costs are clearly budgeted, such a determination should be made within SERC’s budget review and approval process.

3. Retirement Benefits

SERC should enhance its existing procedures to adequately justify increases in its retirement contribution. Moreover, SERC did not have adequate written policies and procedures to support the disbursement of its discretionary contribution. In addition, SERC included bonuses in the compensation used in the retirement benefit obligation calculations for its employees without adequate justification.

Pertinent Guidance

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

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

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

Background

SERC contracted for compensation studies during the audit period that analyzed SERC's base salary and bonuses in comparison to similar companies. However, a significant part of SERC's total employee compensation was tied to its 401(k) benefits. These studies did not analyze how these benefits, along with base salary and bonuses, compared to similar companies. SERC completed a compensation study in December 2012, while the fieldwork was drawing to a close, and that was therefore not included in audit staff's fieldwork. The impact that this study may have upon addressing the audit's concerns will be treated in the implementation phase of the audit.

By the end of the audit period, SERC had a defined contribution retirement plan for all employees, with a maximum company contribution of 14 percent of compensation. The 14 percent was composed of three elements: a base contribution ("Safe Harbor" 401(k) Plan) automatic contribution of 3 percent of compensation regardless of any employee contribution; an additional contribution to match employee contributions (capped at 6 percent of compensation); and a discretionary contribution component of up to five percent. These percentages were applied to SERC's definition of "compensation" as "base salary plus bonus." As part of its annual budget, SERC fully budgeted for its anticipated retirement benefits plan contribution obligations.

Discretionary Contribution

SERC's discretionary contribution, which was termed a "profit sharing contribution" in its 401k plan document, has been included to provide a means of competing for qualified staff with organizations that can include performance incentives that are lacking in non-profit organizations such as REs. However, in the case of SERC, this contribution is not as strongly linked to any corporate wide performance measures, as would be the case in "for-profit" firms, which look to their bottom-line for a corporate wide performance measure. There did not appear to be any such yardstick available to SERC or its Board by which to exercise appropriate discretion during the audit period. For this reason, audit staff believes that the current up to five percent discretionary contribution needs more stringent written guidelines and procedures as part of the Board approval process. SERC stated that, typically, the SERC Board Treasurer, on behalf of the HRCC, had made a motion at the Board Executive Committee meeting to approve the discretionary contribution. This decision was based on the availability of funds and the performance of the corporation over the past year, yet no objective measure of performance was requested by, or provided to, the Committee.

Essentially, HRCC's approval of the discretionary contribution depended on both the availability of funds and SERC's performance. Audit staff noted that funds should be expected to be available, since each year SERC budgeted for, and received from assessments to the regional loads, full funding for the anticipated retirement contribution, including the discretionary amount at full funding levels. However, SERC could not produce any written guidelines or procedures governing how it would meet the necessary criteria to receive the discretionary contribution. Nor did SERC have any guidelines as to how these criteria being filled should be correlated to any particular discretionary percentage. Hence, audit staff is concerned about what criteria the Board used to justify the disbursement of these funds.

Audit staff interviewed the SERC Chairman, who also served as the SERC Treasurer and an HRCC member. The Chairman stated that he believed a denial of the full five percent discretionary contribution would only be made as a punitive measure. Therefore, audit staff believes approval of this level of contribution had more the attributes of an "entitlement," instead of what SERC's official documents stated to be a measure to reward corporate performance. Audit staff believes that SERC should have documented set criteria warranting disbursement to maintain this as a discretionary element in its budgeting process.

401(k) Plan

Audit staff believes SERC should have provided additional documentation in support of raising its 401(k) match from 3 percent to 6 percent, thus establishing a new maximum contribution percentage of 14 percent, up from 11 percent. A similar concern relates to SERC's revision of its retirement benefits plan's definition of "compensation" to include annual bonuses on top of base salary. Both of these changes were approved in March 2011 and implemented between July 1, 2011 and January 1, 2012.

The latest Hay Group compensation study, commissioned by SERC in 2011, did not indicate that changes to the retirement benefits plan were necessary. Rather, audit staff's review of the Hay Group study noted that it was silent on the matter since it did not evaluate the value of SERC's defined contribution plan as a component of an employee's total compensation. The study only examined whether those companies in SERC's peer group offered a 401(k), or similar plan, and did not estimate the equivalent monetary benefit of the specific plan.

SERC asserted that the primary justification for the change from 11 percent to 14 percent and the new definition of "compensation" resulted from SERC's own internal benchmarking of its compensation against that of other REs and NERC (which SERC termed its peer group). SERC asserted that its retirement benefits previously fell below those of its peer group and needed an upward adjustment. However, SERC's presentation to its Board of Directors focused on retirement benefits and did not mention how they compared to this peer group on a total compensation basis.

Audit staff recognizes that SERC could better support these changes if it significantly lagged behind similarly-situated companies on a cost-of-living adjusted total compensation basis, particularly if it had experienced recruitment or retention issues. Moreover, SERC provided no evidence to either the Board, in its March 2011 presentation, or to the audit staff, during this audit that this compensation component had led to any past employee recruitment or retention problems. On the contrary, SERC indicated to audit staff that a review of exit interview responses during the period before SERC increased its 401(k) match demonstrated that no departing employees commented specifically on SERC's retirement benefits plan as a reason for leaving the company. This information led audit staff to believe that SERC's decision to raise the value of employee retirement benefits was not in response to a specific retention or recruiting problem.

In regard to the inclusion of bonuses in the calculation of retirement contributions, audit staff believes relevant industry practices suggest that retirement contributions should be based on compensation to which an employee is entitled. SERC management stated during interviews that incentive compensation has not been an entitlement for any SERC employee or officer. Since all SERC employees are eligible to receive some level of incentive compensation, and officers and senior managers received incentive compensation at significant levels, inclusion of incentive compensation had a significant impact upon SERC's obligation to budget and pay for such contributions.

For these reasons, audit staff believes that SERC should carefully consider and provide strong empirical support for its need to include bonuses in the "compensation" on which retirement contributions are based and, to the extent SERC supports this practice, consider the impact it has upon employees' total compensation and benefits.

Therefore, audit staff believes that SERC needs to improve its existing procedures to ensure the adequacy of the evidence supporting increased retirement benefits. Audit staff believes developing and presenting solid empirical support for decision making ensures transparency of information presented to SERC's Board and assists NERC and the Commission in carrying out oversight responsibilities.

Recommendations:

Audit staff recommends that SERC:

5. Consider the justification for, and impacts of, inclusion of discretionary compensation (e.g., bonuses) in the calculation of retirement contributions and submit this analysis to the Board for its approval; and

6. Develop clear written guidelines to inform the Board of the appropriate metric to use to assess corporate performance in order to justify the discretionary component of the retirement benefit contribution.

4. Tracking Time and Expenses by Program Areas

SERC's method for accounting for its activities by each of its organizational departments may not always promote sufficient transparency of activities in specific program areas as reflected in its budgeting process. Therefore, SERC should enhance its procedures for recording and tracking employee time and related expenses to accurately allocate resources and expenses to each program area in its budget.

Pertinent Guidance

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

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

In its order conditionally accepting the 2007 business plans and budgets of NERC and the Regional Entities, the Commission "direct[ed] NERC to provide further consistency and standardization in the formatting of its budget and the Regional Entities' budgets."[11] The Commission also stated that it "expect[s] Regional Entity proposed budgets to be consistent in the activities that are funded."[12]

NERC and SERC's Delegation Agreement Section 9(g), entitled "Funding," states that, as relevant, "SERC shall follow NERC's prescribed system of accounts [NERC System of Accounts] except to the extent that NERC permits a departure from the prescribed system of accounts. NERC shall make an informational filing with the Commission describing any such waiver it permits and providing an explanation supporting the permitted departure. "

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

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[11] *Order Conditionally Accepting 2007 Business Plan and Budget of the North American Electric Reliability Corporation Approving Assessments to Fund Budgets and Ordering Compliance Filings*, 117 FERC ¶ 61,091 at P 84 (2006).

[12] *Id.* P 39.

> Proper charges of personnel expenses incurred by employees whose activities involve more than one functional category is typically supported by a daily or other periodic time reporting system in which the employee is required to report the number of hours or percentage of his/her time spent during the reporting period on activities in each Functional Category.[13]

Background

SERC routinely budgeted and tracked resources and related expenditures based on the organizational group or department to which a staff member was assigned rather than the functional activity the staff member performed. In many instances, given the way in which SERC structured its organization to its delegated duties, this procedure worked with sufficient granularity to permit both efficient internal management and effective oversight. However, in instances in which several organizational groups worked collaboratively, or when specific individuals worked on different program areas, SERC may not have properly allocated time and expenses in the budget process. As a result, SERC might not have fully identified resources used to support more than one program and might not have accurately budgeted for resources within each program.

During a site visit, audit staff learned that certain SERC employees often worked on multiple activities, including programs outside their assigned department. In these instances, these employees' labor costs and associated expenses continued to default to their home department cost center. This time and expense-tracking method impacted both SERC's internal accounting as well as how SERC presented the resources for these activities in its budgets.

Audit staff found that the Reliability Services group employees' activities related to both the Situational Awareness and Infrastructure Security (SAIS) and Reliability Assessment and Performance Analysis (RAPA) programs. Additionally, the Reliability Assessments group employees also supported RAPA activities. Following its customary practices, SERC accounted for labor and related expenses by employees' assigned groups. Therefore, when tracking labor and related expenses of the Reliability Assessments group, SERC only tracked the time and expense of employees fully dedicated to that group and not those who

[13] North American Electric Reliability Corporation Filing, Docket No. RR07-16-003 at P 7 (filed Apr. 1, 2008) (responding to the Commission's 2008 ERO Budget Order, 121 FERC ¶ 61,057 (2007)).

were dedicated to another group but also worked on reliability assessment activities. Essentially, only employees fully dedicated to the Reliability Assessments group were included as resources used for the RAPA program, even though resources from other groups also supported RAPA activities. Similarly, within the Reliability Services group, SERC did not reallocate the labor and related expenses of the resources that resided in the SAIS group to any other group, even though some resources within the SAIS group worked on RAPA activities.

Since SERC did not track employee time allocation between its program areas, there were inaccurate estimates and resource budgeting for multiple programs. SERC's overall budget accounted for all employees at SERC, but did not accurately allocate the employees in the RAPA and SAIS programs, leading to inconsistent categorization of expenses in the business plan and budget. SERC asserted that this practice was unnecessary for its internal management and that having a more granular breakdown based upon actual time spent would have been an inefficient administrative practice. However, audit staff believes that such an allocation was required by the prevailing reporting requirements of the ERO. SERC may assert that it was not efficient to allocate resources based on actual reporting of hours and expenses used for different activities versus allocation based on a study period. However, as it is, making no time allocation for staff who worked on different activities is inconsistent with proper reporting practices as described by NERC in its 2008 filing.

SERC's 2012 Business Plan and Budget included 5.75 full time equivalents (FTEs) for the SAIS program and 5.70 FTEs for the RAPA program. SERC confirmed that some of the 5.75 FTEs budgeted for the SAIS program spent part of their time working on performance analysis activities that are part of the RAPA program of the NERC ROP. Based on this, SERC over-budgeted FTEs within its SAIS program and under-budgeted FTEs in its RAPA program. As a result, SERC inaccurately reflected the activities of 14 employees (10 full-time and 4 part-time) and their related expenses in its 2012 budget. These employees included six budgeted in the RAPA program, one of whom worked part-time, and eight employees budgeted in the SAIS program, three of whom dedicated part of their time to SAIS.

SERC asserted its activities in support of some RAPA objectives most closely aligned with its SAIS program activities. As a result, SERC accounted for some staff that supported RAPA activities under the SAIS program area and did not separate and allocate costs specifically spent on RAPA activities. SERC neither performed any historical time study nor required its employees to track their time by task and, therefore, could not provide supportable estimates of the percentage of time its SAIS staff spent on RAPA.

Audit staff believes that SERC's employee time tracking processes and procedures did not adequately identify resources supporting program-specific activities, which in turn led to inaccuracies in the allocation of resources to support multiple program areas. Such a practice hindered consistency and standardization of the budgets across the REs, a goal the Commission has emphasized in order to facilitate more effective oversight by both NERC and the Commission.

In addition, audit staff believes that recording employee time on a more granular basis may, in some instances, be a cost-effective way to materially improve SERC's ability to assess and improve upon the performance of its delegated duties. Audit staff noted an example of such an instance that SERC had experienced in the past. Prior to the commencement of this audit, SERC Enforcement staff experienced significant backlogs in processing the increasing number of violations reported to, or discovered by, SERC. SERC's backlog grew to such a level that it included 298 enforcement issues in process for longer than 12 months as of January 17, 2012. The backlogs began to adversely impact not only the processing of violations but also future compliance activities. As a result of the backlogs, SERC conducted a closer examination of how key staff engaged in various activities. After the fact, SERC discovered that the amount of time Enforcement staff had been performing on significant duties other than Enforcement work prevented them from fulfilling the demands in the constrained area. A subsequent reallocation of duties among existing SERC staff and the hiring of additional staff enabled SERC to address this issue. Audit staff believes that a proactive managerial approach based upon more granular reporting and analysis of tasks performed may have averted the development of the backlogs.

While SERC's backlog was caused by a confluence of issues including new audit scope areas, the problem was exacerbated because SERC had not been routinely assessing the adequacy of its resources by analyzing the time spent on specific functional activities. In this instance, audit staff believes that had SERC routinely and accurately recorded staff hours by activity performed, SERC would have recognized the problem sooner, and backlogs in SERC Enforcement staff processing might have been avoided or mitigated. Audit staff believes that this instance demonstrates that greater reporting granularity, if properly applied, may have the potential to not only facilitate the Commission's and NERC's oversight efforts by allowing for enhanced budget consistency and standardization, but would also benefit SERC's internal management in its performance of its delegated duties as the RE.

During the audit, audit staff noted that SERC had the ability to track time and expenses with greater granularity using its existing software and procedures. This capability was demonstrated to audit staff by the way SERC tracked its time and costs associated with this audit. When the Commission commenced this audit, SERC created a new Indirect Cost Center, 07-External Audit, in its internal records. This cost center allowed all SERC employees to record and track hours worked on the FERC audit. Similarly, SERC had previously created a similar Direct Cost Center “08-TFE” when it began processing Technical Feasibility Exception (TFE) requests in order to assess the impact of TFE processing on its resources. The creation of these two additional cost centers illustrates SERC’s capability to implement more specific time tracking.

Furthermore, after reviewing a sample of employee time sheets, audit staff found evidence that employees already tracked their time on a day-by-day basis to different cost centers and even differentiated between cost centers within the space of one day. For example, during 2011 the DFHR routinely tracked time to both 06-Accounting and Finance and 05-Human Resources. Therefore, audit staff believes that SERC’s adoption of this practice would not be administratively burdensome.

Audit staff believes that SERC should evaluate its administrative need to increase the granularity of its time and expense-tracking procedures to record data at an appropriate functional level. Audit staff believes that, at a minimum it should be at the program area level, but greater granularity should be used as dictated by cost effective managerial practices. This will ensure budget transparency for the SERC Board of Directors, NERC, and the Commission in their oversight as well as ensuring that SERC’s management makes efficient use of its labor force and resources. Furthermore, because of the fact that SERC has: 1) shown the ability to easily and inexpensively add more cost centers to their time-tracking software and 2) demonstrated that some employees, in fact, already track their time to specific cost centers in which they work, audit staff believes that SERC should establish tracking and reporting employee time procedures to take optimal advantage of its time-tracking capabilities. Oversight authorities, such as the SERC Board, NERC, and the Commission, rely on SERC’s budget for readily accessible, accurate, consistent, and transparent financial information for each program area to conduct effective oversight and ensure accountability, but tracking data at a lower level of granularity can offer improved administrative benefits if properly applied.

Recommendations:

Audit staff recommends that SERC:

7. Continue to develop and implement functional codes at the appropriate level of granularity, but at least at the program area level,

to allow effective and efficient project management and oversight, including the tracking of each employee's time and expenses;

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

9. Train SERC employees on the proper use of the time-reporting practices.

V. Other Matters

1. Industry Subject Matter Experts

SERC did not have sufficient documented procedures and processes to efficiently and effectively use audit feedback forms to: (1) address the use of Industry Subject Matter Experts (ISMEs) on audit engagements and (2) assess SERC's educational and training needs.

Pertinent Guidance

NERC ROP Section 403.7, Use of Subject Matter Experts, states:

> The regional entity shall have procedures defining the allowable involvement of industry subject matter experts and regional entity members. The procedures shall address applicable antitrust laws and conflicts of interest.

The SERC Reliability Corporation Industry Subject Matter Expert (ISME) Audit Team Participation Requirements document states, in part:

> SERC Reliability Corporation's Compliance Audit Program frequently uses industry volunteers employed by registered entities in the SERC Region (Industry Subject Matter Experts or "ISMEs") as supplemental compliance audit team members.
>
> Individuals selected to participate as an ISME audit team member must accept certain responsibilities and meet specific requirements prior to, during, and after accepting an audit team assignment, as detailed in this document.
>
> In order to participate as a volunteer audit team member, ISMEs should meet the following minimum qualifications: Have industry expertise in, and current or recent experience with, Bulk Electric System operations, engineering, communication systems, computerized control systems, network security, and/or compliance programs [and] be very familiar with NERC Reliability Standards, SERC Regional Criteria, and SERC Regional Reliability Standards.

Section 7 of the amended and restated Delegation Agreement between NERC and SERC states:

(e) Training and Education. SERC may provide training and education to registered entities, as it deems necessary, in support of its performance of delegated functions and related activities under this Agreement. NERC may also provide training and education programs to registered entities on topics relating to NERC's responsibilities as the ERO.

In an October 21, 2010 Commission order, addressing approving revisions to Appendix 4C of the ROP – CMEP, the Commission rejected NERC's proposal to add a new section to the CMEP addressing participation in a compliance audit by persons other than the audit team of the RE conducting the audit. The proposed section included allowing representatives of other registered entities to attend the audit for educational purposes, when requested by the audited entity. In the Order, the Commission rejected NERC's proposal, citing concerns over confidentiality and a possible reduction in the overall effectiveness of compliance audits. Instead, the Commission suggested that more appropriate tools to educate registered entities include compliance workshops, seminars, and the dissemination of "lessons learned" information.[14]

Background

SERC generally used ISMEs to augment audit teams on both operations and planning audits and CIP audits of larger registered entities that are registered for multiple functions. However, SERC does use them on audits of smaller, less-complex registered entities, but using fewer in number and less frequently. Each year, after the development of the Regional Audit Schedule for the following year, the Manager of Compliance Audits (MCA) (for audits of operations and planning standards) and the Manager of CIP Compliance Monitoring (MCCM) (for audits of the CIP standards) determined the basic audit team requirements for each scheduled compliance audit, including the needs for ISME participation.

SERC described its selection process for ISMEs as follows:

> After identification of the pool of industry volunteers, the MCA or MCCM sent an email to each of the volunteers detailing the requirements necessary to serve as an ISME. The MCA or MCCM verified that the volunteers had agreed to the terms and

[14] *North American Electric Reliability Corporation*, Order Conditionally Approving Revised Pro Forma Delegation Agreement, Revised Delegation Agreements with Regional Entities, Amendments to Rules of Procedure and Certain Regional Entity Bylaws, at pg. 32-33, 133 FERC ¶ 61,061 (2010).

> conditions of ISME participation, reviewed each volunteer's biography to determine the field(s) in which there was sufficient experience and expertise, and confirmed that they had an active Confidentiality Agreement with SERC. After confirming that the volunteer met all of these conditions, SERC would place them on a list of potential ISME audit team members and would seek to assign them to appropriate audit teams based upon the ISME's knowledge, experience, and the needs of the individual audit teams.

Based upon this selection process, audit staff identified three areas of risk that SERC needed to manage. First, SERC needed to be able to ensure that it was able to identify and assign an ISME with the requisite skills needed by SERC on a particular audit. Second, SERC needed to ensure that any ISME selected by SERC to meet this need would be an effective participant in the audit process. The third and final risk area is whether the use of ISMEs may mask the need for SERC to further expand its own staffing levels.

Managing Risk Areas

Audit staff noted that during the audit period SERC had begun a process by which it could identify and address these risk areas associated with the use of ISMEs on compliance audits. In a data response, SERC described that after each audit, the audited entity and all members of the audit team (including ISMEs and the audit team lead) were expected to complete SERC audit feedback forms. In these forms, the members of each audit team addressed the management and execution of the audit and identified any issues involving standards, performance parameters of the audited entity, and the performance of audit team members, including ISMEs. Audit staff noted that this form was a potentially effective control for the use of ISMEs.

However, SERC did not fully implement this procedure. SERC had not rigorously implemented a process by which the expectation that these forms would be completed and available for use by SERC management in assessing the effectiveness of ISMEs was ensured. On the contrary, SERC did not collect and use this documented feedback mechanism in any systematic fashion. Therefore, SERC could not fully use this feedback to improve the manner in which ISMEs were being used on compliance activities.

In the first risk area – the assignment of appropriate ISMEs to compliance audit activities – the feedback forms demonstrated a need to improve the SERC process. The feedback forms provided evidence that some ISME assignments to audit teams did not always reflect a need for the ISME's expertise to best serve the evaluation of a registered entity's compliance. In reviewing comments by ISMEs who had participated in SERC registered entity audits, audit staff noted one ISME's comment that:

> [I] signed up to be an ISME on the Operations side of the audit but we had two people with Operations experience. I was placed on the planning side because it was felt that I would be more helpful there than the other ISME. I am not as familiar with the Planning Standards as I am the Operations Standards. Probably was not as helpful on some standards as other ISMEs could have been.

This example indicates the need for more rigorous processes and procedures to ensure that ISMEs are chosen to support functions that align with their expertise and the needs of the RE rather than their willingness to participate.

In the second risk area – the ability of SERC to effectively manage ISMEs to be effective audit participants – the feedback forms provided indications that improvements could be made in this area as well. Audit staff found evidence that SERC's use of ISMEs had, on occasion, negatively influenced the effectiveness of past audits. In the SERC audit feedback forms that were provided by SERC in response to data requests, there was evidence indicating that while ISMEs were valuable contributors to audit teams in many instances, some audit teams experienced instances of negative behavior. For example, the evidence indicated that some ISMEs had been disruptive, arguing with the audit team and registered entity. Also, in at least one instance, an ISME tried to convince an audited entity that it did things incorrectly because it had not carried out responsibilities in the same manner as the ISME or the ISME's organization. In addition, the participation of some ISMEs diverted attention to providing auditing guidance to the ISMEs rather than to conducting the audit itself. For example, one SERC audit team lead commented after a particular audit that the use of multiple ISMEs diverted team resources from examining the evidence for compliance to managing ISMEs and keeping them on topic.

Finally, in the third risk area – the adequacy of SERC staffing – audit staff is concerned that SERC make better use of the feedback process in determining the adequacy of its own audit staffing levels. The feedback forms contained comments that reflected this concern. For example, one ISME "recommended that SERC hire more full-time staff or use regular contractors so that the audit teams have more experience working together." On another audit feedback form, the SERC audit team lead noted an understaffed team for that particular audit. There was no evidence on whether SERC used this feedback in its staffing level assessments.

SERC was not able to provide documented evidence of how SERC management systematically used the feedback form comments to inform and improve its conduct of CMEP activities. Essentially, SERC did not have a rigorously implemented, formalized process to assess and evaluate the use of ISMEs or the larger issue of the adequacy of SERC's compliance audit staffing requirements.

Improving SERC's Educational and Training Efforts

A related issue concerns the use of CMEP activities for training of registered entities. In the feedback forms there are ample examples demonstrating that staff from registered entities got a great deal of valuable training and educational benefit from participation in RE compliance activities. For example, one ISME stated, "This was a better training/participation time than anything I have been to. Someone from our group will try to attend at least once per year." Audit staff found multiple examples of ISMEs stating that the experience helped them prepare for their companies' upcoming compliance audits and aided their familiarity with the process and the standards. For example, one ISME stated, "Participating as an ISME allowed me to help my company associates better prepare for our audit. It allowed me to help coach our presenters. It allowed me to ensure our evidence was organized and formatted correctly." The same ISME also said, "SERC provided a workshop this year on CIP-005 and CIP-007 that benefits those who cannot be ISME. I would suggest holding it again next year and adding another workshop for CIP-006."

These comments demonstrated there is a perceived need for expanded training by registered entity personnel and that some registered entities believe that fulfilling these needs by sending staff to participate as ISMEs on compliance audits is the best available option. However, Commission guidance indicates that means other than CMEP participation should be the mechanism by which to provide such training to ensure the effectiveness of the compliance activities. Audit staff believes that increased awareness of the efforts SERC is making in its training workshops and other educational outreach efforts might result in greater registered entity participation in these programs and lessen the perception that participation at CMEP activities is necessary to understand SERC's CMEP process. In addition, strengthening both the awareness, as well as the content of, SERC's training and educational opportunities would also allow a greater number of registered entity staff members access to training and education, and not just those who have personnel available to participate as ISMEs.

Recommendations:

Audit staff recommends that SERC:

10. Revise its processes, procedures, and controls regarding ISME participation in compliance activities and ensure SERC has an adequate and detailed set of policies governing ISMEs' participation in compliance activities; and

11. Ensure greater awareness of SERC's ongoing training and education programs and use the feedback from ISME participation in compliance activities to better focus these outreach programs.

2. Audit Scope Reductions for Planned Audits

Although SERC believed it had valid reasons to reduce the scope of planned audits, it should not have done so without written authorization from NERC in accord with the current NERC annual CMEP Implementation Plan.

Pertinent Guidance

The NERC ERO Compliance Monitoring and Enforcement Program 2012 Implementation Plan states the following:

> Tier 1 Requirements are identified in the 2012 AML [Actively Monitored List] and represent the minimum scope of compliance audits.
>
> Regional Entities are authorized and obligated to implement the annual NERC Implementation Plan. Regional Entity staff may increase the scope of compliance activities related to the NERC program, as described above, but cannot reduce the scope of compliance activities without NERC consent. Where Regional Entities determine that a reduced scope is appropriate, the Regional Entity will submit the *Regional Entity Request to Defer or Reduce the Scope of a Compliance Audit*, which is located in Appendix 3 to the NERC Compliance Operations department at least 90 days prior to the audit for approval.

Background

NERC, as the ERO, has been revising the scope of its actively monitored reliability standards and requirements to reflect a more risk-based approach to compliance monitoring. NERC laid out a three-tiered approach to audit scope determination in the ERO Compliance Monitoring and Enforcement Program 2012 Implementation Plan. As part of this process, NERC annually categorized specific standards and requirements into three tiers, with Tier 1 as the minimal standards and requirements for which compliance should be tested that should, therefore, be included in every audit scope. According to NERC's audit program, any reduction in the scope of compliance activities required filing with NERC 90 days in advance of the audit a form entitled *Regional Entity Request to Defer or Reduce the Scope of a Compliance Audit,* which required NERC to grant an approval for SERC to receive a waiver.

During the audit period, audit staff learned that SERC deviated significantly from NERC's prescribed process in at least one instance. In a CIP compliance audit, SERC, after providing notice to the audited entity that all Tier 1 CIP standard requirements would be covered by the audit, dropped a large percentage of these requirements from the audit scope prior to the site visit. SERC believed it appropriately dropped these requirements for several reasons, including the fact that coverage of the requirements fell within an open enforcement action (OEA) remaining from a spot check conducted on the audited entity 20 months prior. Despite SERC's belief that a legitimate reason to drop these Tier 1 requirements existed, according to NERC's then-effective process, SERC was nevertheless under an obligation to file the approval request to defer or reduce scope with NERC 90 days prior to the audit. Thus, SERC should have obtained NERC's consent to reduce the scope prior to undertaking the audit. SERC did not provide audit staff with any record of having contacted NERC or receiving approval regarding the deletion of requirements from the scope of the compliance audit. Rather, SERC asserted that it had discussed with NERC staff this type of variance in general terms in the past and believed that no notice to NERC of reduction in the compliance audit's scope was necessary.

SERC needed to notify NERC of any reduction in scope of Tier 1 requirements and receive authorization to do so, as required by the 2012 implementation plan. This deviation from the plan denied NERC and the Commission sufficient transparency to permit effective oversight of the ERO's CMEP by means of the ERO-filed CMEP implementation plan. Moreover, the manner in which SERC had ensured coverage of the actively monitored criteria had not been documented in a manner that would permit NERC and the Commission the ability to verify that this had been achieved.

Audit staff believes that SERC should have formalized procedures in place to prevent gaps in its compliance program and to document how this was accomplished. When the scope of a compliance audit that is being conducted for a registered entity already subject to on-going enforcement is reduced, there is a need to coordinate the audit and enforcement activities so no gaps result in determining compliance for the complete audit period. SERC asserts that it has adequate processes to ensure that compliance review gaps did not occur in this instance. Audit staff does not disagree with the outcome in this instance. However, SERC admits that it did not have well-defined and documented procedures in place to either ensure such an outcome would result or to document the treatment of such actions in its registered entity audit reports. SERC stated that it is working to improve its documentation of scoping determination and decision processes. SERC's current policies, procedures, and practices nevertheless were insufficient to address the risk of such potential gaps in coverage.[15] For example, in the specific instance described above, audit staff found that SERC did not adequately describe in the compliance audit report the disposition of the criteria that had been excluded from the audit process.

However, even in the event that SERC had documented processes in place to cover this contingency, it would have still deviated from the approved manner in which SERC should have carried out its delegated duties. Consequently, if SERC wants to continue reducing its compliance audit scope of Tier 1 requirements because of ongoing enforcement activities, it must have protocols to obtain NERC approval. Second, SERC must implement a process so that its coverage of compliance with Tier 1 requirements has no gaps either in performance or in reporting by means of the compliance audit report.

Recommendations:

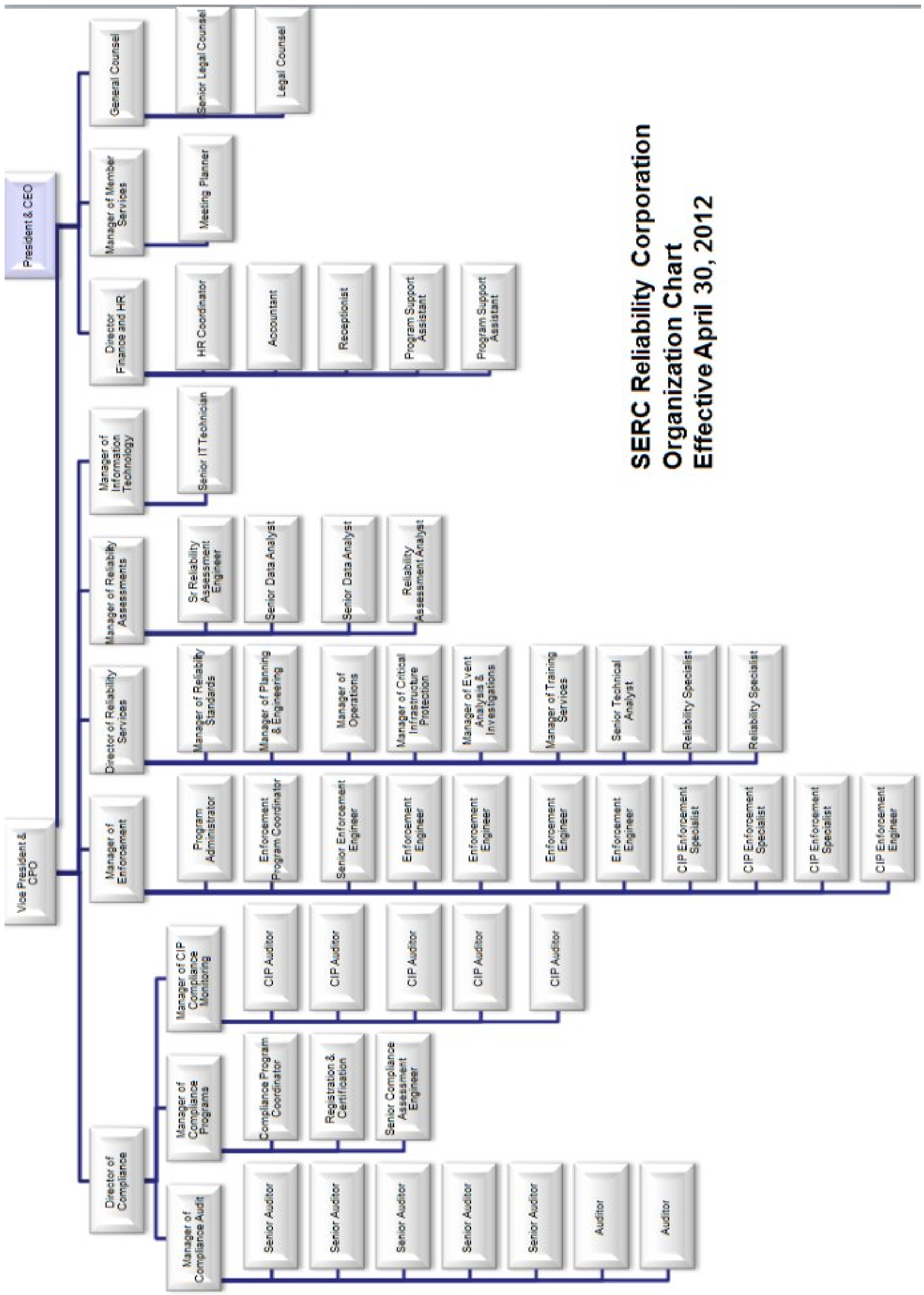
Audit staff recommends that SERC:

12. Establish written processes and procedures to ensure that when it reduces the scope of a compliance audit SERC receives written approval from NERC in the manner required by the current NERC CMEP Implementation Plan filed with the Commission; and

13. Establish written processes and procedures to ensure that when compliance auditing is conducted on a registered entity already subject to on-going enforcement activities, there are no gaps in determining compliance for the complete audit period.

[15] For example, gaps in coverage could result if compliance activities dealing with a specific event (i.e. an investigation) examined evidence for only a limited period of time and ignored evidence for a broader period of time that would have been subject to examination during a compliance audit. Similarly, compliance activities focusing on specific facilities might miss evidence related to other facilities that would have been the subject to consideration in a compliance audit.

Appendix A – SERC Organizational Chart



SERC Reliability Corporation

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June 6, 2013

Mr. Bryan K. Craig
Director and Chief Accountant
Division of Audits
Office of Enforcement
Federal Energy Regulatory Commission
888 First Street NE, RM 5K-13
Washington, DC 20426

Re: Audit of SERC Reliability Corporation, Docket No. FA12-6

Dear Mr. Craig:

In accordance with the letter from Timothy Smith dated May 22, 2013, SERC Reliability Corporation (SERC) hereby responds to the draft audit report issued by the Office of Enforcement, Division of Audits.

As an initial matter, SERC appreciates the time, effort and professionalism of the audit team during its review of SERC's activities surrounding the formation, administration and execution of its budget during the audit period.

In the draft report, the Division of Audits identified four operational enhancements and two other matters which could improve SERC's efficiency and effectiveness as a Regional Entity. SERC has reviewed the draft report and accepts the recommendations proposed by Division of Audits. SERC prides itself on being a learning organization, and as such, has already begun to implement many of the recommendations contained in the report, based on the feedback given by the audit team throughout the audit process. We look forward to sharing with the Division of Audits the enhancements we have already made and the continued work to develop an implementation plan to address any outstanding issues.

If you have any questions, please feel free to contact me.

Sincerely,

Marisa A. Sifontes

Document Content(s)