From: Kimberly Mielcarek
To: Kimberly Mielcarek
Subject: NERC Announcement - FERC Staff Releases Contested Audit Report; NERC Disappointed at Lack of Chance to Resolve Differences
Date: Friday, May 04, 2012 4:06:22 PM

Announcement

FERC Staff Releases Contested Audit Report; NERC Disappointed at Lack of Chance to Resolve Differences

Click for announcement, memo to FERC senior leaders, NERC audit response, NERC redline response and NERC recommendation comparison

WASHINGTON, DC – The North American Electric Corporation (NERC) is disappointed in the unwillingness of the Office of Enforcement of the Federal Energy Regulatory Commission (FERC) to work toward resolution of a recent "economy and efficiency" audit of NERC, choosing instead to litigate many aspects of the audit.

Today the FERC Office of Enforcement released an audit that began in August 2011. On April 23, 2012, NERC responded to a draft of the audit report with constructive changes, factual corrections and a proposal to support, in modified form, 34 of the 43 recommendations. A meeting with FERC's senior staff also was requested to discuss the legal and policy issues raised in the draft report.

The Office of Enforcement has declined to negotiate as is the norm, and instead, opted to initiate litigation on portions of the audit findings and recommendations. NERC is disappointed at this audit process and is dismayed that the Office of Enforcement, acting under delegated authority, declined the request to work toward resolution on these matters.

For more information or assistance, please contact Kimberly Mielcarek.

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MEMORANDUM

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April 23, 2012

To: James A. Pederson
Michael A. Bardee
Norman C. Bay
Joseph H. McClelland

Cc: David Morenoff
Larry D. Gasteiger
Bryan Craig
Martin Kirkwood

From: David N. Cook
John S. Moot

Re: Audit of the North American Electric Reliability Corp.,
Docket No. FA11-21-000

This memorandum requests your assistance in resolving the pending audit of the North American Electric Reliability Corp. ("NERC"). In a draft Audit Report issued March 23, 2012 ("Draft Report"), the Division of Audits has raised several serious legal and policy issues that affect multiple offices within the Commission. The NERC Board of Trustees and senior management are deeply disappointed with the Draft Report and, given the significance of the issues, NERC is hopeful that involving all relevant Commission Staff may help facilitate a reasonable resolution of the issues. NERC is also providing a copy of this memorandum to all the Commissioners because of the importance and time sensitivity of the matter.

Background. On August 22, 2011, the Division of Audits ("DA" or "Audit Staff") opened an "economy and efficiency" audit of NERC. On March 23, 2012, DA released a Draft Report that includes 11 major findings and 42 recommendations. The findings and recommendations raise important legal issues, including the scope of the Commission's authority under section 215 of the Federal Power Act ("FPA"), and also have serious implications for the institutional roles of both the Commission and NERC. In the response submitted today, NERC identifies its concerns with respect to the Draft Report and proposes specific changes to address those concerns. *See* NERC Response to Draft Audit Report; Blackline of Draft Audit Report; List of Recommendations Accepted by NERC. It is our desire to work with Commission Staff to narrow areas of disagreement and, if possible, achieve an uncontested Final Audit Report. Given the nature of the issues, NERC also believes that other Commission offices can play a productive role.

NERC Support for Recommendations. NERC is committed to continually improving its operations and performance as the ERO. The Board of Trustees and NERC's senior management therefore take very seriously the criticisms set forth in the Draft Report. Although we do not agree with many of the criticisms—particularly because they fail to provide an accurate description of NERC's processes and controls—the Board nonetheless shares the Commission's objective, and many of the Draft Report's recommendations, that NERC continually improve its operations, including financial and accounting controls, to ensure a high level of performance. The Board of Trustees and NERC's management have therefore closely reviewed each recommendation and, with certain material modifications, have determined that they can support 34 of the 42 recommendations, including recommendations that would:

- Continue to increase the transparency of budget expenditures and the granularity of NERC's budget filings with the Commission;
- Establish policies and procedures for using information gained and lessons learned from NERC's oversight of Regional Entity operations, business plans, and budgets;
- Develop and implement more comprehensive policies and procedures governing employee time reporting and tracking;
- Establish a comprehensive, single-source accounting manual of accounting policies, procedures, controls, and guidance;
- Devise formalized recruitment and hiring policies, procedures, and strategies that address, among other things, controls over the total compensation packages, salary, retention bonuses, and benefits;
- Continue to conduct periodic updates and review of the Board compensation model and compensation levels; and
- Provide greater transparency and explanation in budget filings regarding functions and activities that can be funded under section 215.

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

Objectivity and Balance. A central problem with the Draft Report is related to the nature of an "economy and efficiency" audit. Most audits concern *compliance* with Commission regulations or orders. 18 C.F.R. § 41.1(a) (audit report under FPA Part II focuses on "findings that the audited person has not complied with a requirement of the Commission"); *Revised Policy Statement on Enforcement*, 123 FERC ¶ 61,156 at P 14 (2008) ("[t]he Divisions of Audits within the Office of Enforcement helps ensure compliance with the Commission's statutes, regulations, and orders by conducting a wide array of audits of jurisdictional entities"). This traditional focus on compliance means that there are *specific criteria*—the Commission's regulations and orders—against which to judge the conduct or practices being audited. Indeed, specific criteria are essential to any government audit. Government Accountability Office

("GAO"), *Government Auditing Standards*, GAO-12-331G (Dec. 2011) ("GAGAS 2011") Section §6.37 (a government audit must "identify . . . the laws, regulations, contracts, grant agreements, standards, specific requirements, measures, expected performance, defined business practices, and benchmarks against which performance is compared or evaluated").

In this case, however, the audit chose not to focus primarily on compliance with Commission regulations or orders, but rather on the "economy and efficiency" of NERC's internal processes. Although NERC does not object to oversight in this area, by divorcing the audit from compliance with specific rules, Audit Staff was essentially left with no objective, Commission-approved standards by which to judge NERC's processes.

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

NERC has multiple concerns with these findings—particularly the fact that they second guess the conclusions of the one of the world's leading compensation consultants—but the most fundamental problem is that the criticisms are simply matters of Audit Staff's *opinion*. *There are no Commission standards or requirements on which to base those criticisms*. Indeed, the *only* "Pertinent Guidance" identified by Staff is the requirement in section 215(c)(2) (and the Commission's own regulations) that NERC "has established rules that allocate equitably reasonable dues, fees, and other charges among end users for all activities under this section." That section does not address how NERC's employees should be compensated and therefore provides no objective, Commission-approved criteria for choosing one compensation method over another.

The same problem underlies Audit Staff's criticism of Board compensation. Audit Staff appears to have great concerns with NERC's decision to shift from a meeting-based compensation method for its Board to a fixed-fee method. Draft Report at 6, 57. Although reasonable minds can perhaps disagree over which method is superior in particular circumstances, it is not clear why Audit Staff should be empowered to pick one or the other or require NERC to "justify" its change from one form of compensation to another, particularly where NERC has provided ample justification for its decision and Audit Staff has no objective criteria by which to criticize that decision.

In the absence of such objective criteria, it is therefore not surprising that Audit Staff would reach its own conclusions regarding how NERC should be managed on a broad range of issues, including compensation. NERC does not object to Audit Staff offering its views on these matters and is willing to agree to many of Audit Staff's recommendations to improve its processes. But we draw the line at recommendations that suggest an effort to micromanage or second-guess NERC's internal operations (and, as noted below, the inaccurate and one-sided nature of the underlying findings).

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

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

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

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

In declining to follow this approach, the Draft Report also displays an unfortunate lack of *balance* in addressing the disputed issues. Rather than providing a fair and complete characterization of NERC's position, the Draft Report provides a one-sided appraisal of the issues and is dismissive of NERC in relatively harsh tones. Perhaps this is the normal course in enforcement matters, but it is not a fair one and it is particularly problematic given the important reliability challenges that the Commission and NERC must address in a cooperative fashion.

NERC therefore respectfully suggests that Commission Staff take a closer look at these findings and consider whether the Draft Report provides a balanced and accurate analysis of the issues the Commission is considering in this audit. The blackline provided herewith attempts to remedy the most glaring problems with specific edits, but does not begin to describe the depth of our concerns regarding the lack of balance and accuracy, as described in NERC's Response to the Draft Audit Report.

The Scope of Section 215. In contrast to these issues concerning management practices, the one audited area that concerns prior Commission orders is the scope of section 215. The Draft Report focuses extensively on whether NERC is performing functions outside the scope of FPA section 215 and finds that Audit Staff is "concerned" that certain NERC activities "exceeded the functions of the ERO explicitly defined in section 215." Draft Report at 75; *see also id.* at 4.

We respectfully suggest that Audit Staff has not fairly characterized prior Commission orders on this issue. As we explain in detail in NERC's Response, the Commission has, on multiple occasions, addressed whether NERC's existing functions fall under section 215 in prior Commission's orders and approved *all* its functions as statutory. *N. Am. Elec. Reliability Corp.*, 116 FERC ¶ 61,062 at P 185 (2006) ("[w]e generally believe that *anything* required of the ERO or a Regional Entity by the statute, Order No. 672 pursuant to the statute, or any subsequent Commission order pursuant to section 215 of the FPA is a statutory activity") (emphasis added); *N. Am. Elec. Reliability Corp.*, 117 FERC ¶ 61,091 at P 28 (2006) (approving budget upon a finding that "NERC . . . has provided an explanation for each of its program areas that relates to a function for which the ERO is responsible pursuant to section 215 of the FPA"). Audit Staff may not agree with the findings in prior orders, but that does not provide a basis for second-guessing them in an audit.

It also should be troubling to the Commission that, by delving into this jurisdictional issue, the Draft Report has implicated the Commission's own jurisdiction. The statutory language at issue in the Draft Report applies equally to both NERC and the Commission. *Compare* 16 U.S.C. § 824o(b)(1) ("The Commission shall have jurisdiction . . . over the ERO . . . for purposes of approving reliability standards established under this section and enforcing compliance with this section.") *with id.* § 824o(d), (e) (providing ERO with jurisdiction over standards and enforcement). Thus, if the Commission finds that NERC cannot engage in certain activities and functions under section 215, the Commission will be tying its own hands in those areas. For example, if NERC cannot use load-serving entity funds to hold a public conference on cyber security (*see* Draft Report at 79), then some may question whether FERC should use public funds to hold conferences on similar issues. Similarly, if NERC cannot function as the Energy Sector—Information Sharing and Analysis Center in connection with section 215 (Draft Report at 82-85), then some may question whether the Commission can require NERC to submit its alerts that are issued in executing that function. *N. Am. Elec. Reliability Corp.*, 120 FERC ¶ 61,239 at P 12 (2007) (requiring NERC to submit ES-ISAC alerts "prior to the issuance of such alerts" because they relate to reliability standards evaluation and development).

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

NERC does not object to providing greater transparency with respect to its statutory activities and is agreeing to certain recommendations in this regard. However, we respectfully suggest that the Draft Report conflicts with the Commission's prior orders on this issue and that this entire area of the Draft Report should either be removed or revisited.

Conclusion. NERC appreciates your attention to this matter and looks forward to working with Commission Staff to resolve the audit in a manner that is agreeable to both the Commission and NERC.

NORTH AMERICAN ELECTRIC RELIABILITY CORPORATION'S

RESPONSE TO

DRAFT AUDIT REPORT DATED MARCH 23, 2012

Docket No. FA11-21-000

APRIL 23, 2012

TABLE OF CONTENTS

I. Introduction……...1

II. Legal Standards and Procedural Matters..……6

A. Auditing Pursuant to Objective Criteria……6

B. Procedures Applicable to a Section 215 Audit……..9

III. As the Commission Has Repeatedly Found, NERC's Activities Are Within the Scope of Section 215……10

IV. Accounting, Budgeting and Cost Reporting…….....21

A. NERC Budget Process…….22

B. Time Reporting and Accounting System…….29

C. NERC Oversight of Regional Entity Budgets……..33

V. NERC's Employee and Board Compensation Levels Are Supported by Appropriate Compensation Studies and the Need to Attract Qualified Personnel in a Timely Manner, and its Method of Board Compensation is Appropriate and Justified……..37

A. Employee Compensation…….39

B. Employee Recruitment and Employee Retention……45

C. Board of Trustees Compensation…….47

D. Pension [Retirement] Plans…….....50

VI. NERC Has Adequately Staffed for and Carried Out its Oversight Responsibilities with Respect to the Regional Entities' CIP CMEP Activities…….51

VII. NERC's Role as the ES-ISAC is an Important Function in Assuring the Reliability And Security of the BPS and Supports NERC's ERO Responsibilities…….....54

VIII. Employee and Board Expenses……56

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

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

I. Introduction

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Second, by delving into this jurisdictional issue, the Draft Report regrettably raises questions regarding the Commission's own jurisdiction. The statutory language at issue in the Draft Report applies equally to both NERC and the Commission. *Compare* 16 U.S.C. § 824o(b)(1) ("The Commission shall have jurisdiction . . . over the ERO . . . for purposes of

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

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

II. Legal Standards and Procedural Matters

A. Auditing Pursuant to Objective Criteria

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

B. Procedures Applicable to a Section 215 Audit

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

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

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

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

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

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

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

NERC rejects any assertion that it has engaged in non-statutory activities or expended Section 215 funds on non-statutory activities, that it has a "philosophy" or operates under an "assumption" that any activity NERC could engage in to promote the reliability and security of the BPS is thereby a statutory activity, and that it does not consider whether an activity is within the scope of its approved statutory program areas before engaging in it. The central problem with the Draft Report's analysis is the mistaken premise that the statutory function of developing reliability standards is limited to the process for *drafting and balloting* such standards. This has

never been the case because such a narrow view would eliminate a broad range of functions that are critical to improving those standards.

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

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

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

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

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

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

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

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

[3] NERC ERO Certification Application at 16.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[10] 2007 ERO Budget Order at P 30.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Aging Workforce. The activity of making presentations and speeches at universities encouraging students to pursue careers in the electric power industry, which has been carried out by NERC's Vice President and Director of Reliability Assessment and Performance Analysis, was initiated because NERC's assessments of the reliability and adequacy of the BPS have identified the electric industry's aging workforce and consequent prospective loss of accumulated knowledge and expertise, and the apparent lack of younger persons seeking and training for careers in the industry to replace the current workforce as its members reach

retirement, as a potentially serious problem for the reliability and adequacy of the BPS.[19] Thus, this activity is a logical component of NERC's statutory responsibility to assess the reliability and adequacy of the BPS, and the Draft Report's statement that there is "no linkage to ERO functions" is incorrect. Draft Report at 79. Further, as noted above, NERC's description of its programs in the Three-Year ERO Performance Assessment Report, which the Commission accepted, included "Develop[ing] Independent Short- and Long-Term Assessments of the Reliability and Adequacy of the Bulk Power System and **Focus[ing] Attention on Emerging Issues Important to Reliability**" (emphasis added). NERC has participated in five such events at universities over the period 2007-2011, or one per year on average. *Id*. at 78-79.[20]

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Based on the above discussion, and particularly in light of the long history of Commission approval of NERC's program areas as statutory activities to be funded under Section 215, the Draft Report's two recommendations on this topic, as written (Recommendations 37 and 38 – Draft Report at 81) are unnecessary and unwarranted. NERC

does not object to developing a set of general criteria to use in determining that proposed activities are statutory. However, because these are matters affecting the Commission's jurisdiction and NERC's budget, NERC's activities should not be subject to approval or change by Audit Staff. Any review of NERC's activities that the Commission determines should be undertaken can be performed in the context of the review of NERC's annual business plan and budget findings.

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

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

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

IV. Accounting, Budgeting and Cost Reporting

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

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

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

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

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

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

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

A. NERC Budget Process

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

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

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

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

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

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

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

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

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

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

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

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

[26] 18 C.F.R. §39.4(b).

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

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

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

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

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

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

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[28] 2010 ERO Budget Order at P 24.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[36] 2011 ERO Budget Filing at 50.

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

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

- NERC's existing data center (the relocation of which accounted for $1,953,000 of the aggregate cost of these projects[39]) was outdated, did not contain back up power or sufficient fire protection; and

- once the relocation was announced, accomplishing the relocation quickly would minimize disruptions to the organization and accelerate the benefits of the overall office relocation strategy, which had been reviewed and endorsed by NERC's Board.

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

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

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

1. Establish more robust procedures and controls over NERC's use of working capital reserves. [No change from the Draft Report.]

2. Continue to make improvements in budget transparency that informs the Commission, the Board of Trustees and stakeholders concerning the expenditure of funds approved for specific budgeted statutory activities on unbudgeted activities, and

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

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

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

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

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

B. Time Reporting and Accounting System

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

5. Lobbying Activities and Associated Expenses

    1. With the implementation of the new timekeeping system in January, 2012, employees record the hours spent preparing for and engaging in activities that may be considered as lobbying. All entries are reviewed by the General Counsel and costs associated with the employee's time are accumulated and reported by the Controller.

    2. Expenses associated with lobbying activities are identified in the expense system on separate expense reports for inclusion in the quarterly lobbying report.

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

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

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

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

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

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

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

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

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

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

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

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

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

C. **NERC Oversight of Regional Entity Budgets**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[52] FFT Order at P 41.

[53] FFT Order at P 40.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

A. Employee Compensation

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

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

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

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

[61] *Id*. at P 37.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

found in the executives of companies other than those included in the Primary Reference Group, and it is not essential for every NERC executive to have had experience with a utility or a utility-like organization in order to perform his or her job responsibilities at NERC.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

B. Employee Recruitment and Employee Retention

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

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

the employment offer terms that may be dictated by policy or procedure, in order to successfully recruit a candidate with the desired skills and capabilities.

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

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

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

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

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

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

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

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

C. Board of Trustees Compensation

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

D. Pension [Retirement] Plans

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

> The NERC CIP Audit Observers maintain a process based on location, Regional Entity and available resources. Each calendar year, the NERC Critical Infrastructure Department (CID) assesses U.S. and Canadian entities scheduled for a 706 audit using the master audit schedule maintained by the NERC Compliance group. In accordance with the list, NERC then takes in to account the following:
>
> 1. NERC registration of the Registered Entity (RC, BA, TOP, GO, GOP, etc.)
>
> 2. Geographic location. It is NERC's intent to attend an observation in all eight regional footprints. NERC also takes into account entities within multiple regions and states.
>
> 3. Prior NERC observations. Has NERC attended an audit of the registered entity in the past?
>
> 4. FERC attendance. NERC staff also considers what audits FERC observers attend and strives to have representation on those audits.

5. Compliance history of a registered entity.

6. Regional Entity auditing a Regional Entity Reliability Coordinator.[80]

Additionally, by focusing on the fact that NERC has had only two CIP auditors on staff, the Draft Report understates the number of personnel that NERC has devoted (fully or in part) to CIP compliance monitoring and oversight activities. In addition to the two CIP auditors, personnel in NERC's Compliance Operations Department are involved in overseeing the CIP audit reports, training CIP auditors, maintenance and revision of the Reliability Standard Audit Worksheets ("RSAWs") that are used by Regional Entity CIP auditors in conducting audits, development and issuance of Compliance Application Notices ("CANs," which provide guidance to auditors) relating to the CIP standards, and other activities to support NERC and Regional Entity CIP audit activities. NERC Legal staff also works closely with the Regional Entities with respect to the posting of Case Notes that pertain to the CIP standards. Further, personnel in NERC's Compliance Enforcement and Legal Departments provide support and guidance to the Regional Entities in CIP compliance monitoring, auditing and enforcement.[81] For example, all Possible Violations, including Possible Violations of CIP standards, are processed and reviewed in the NERC Compliance Enforcement and Legal Departments. NERC staff works closely with the Regional Entities in the ultimate disposition of the CIP Possible Violations to ensure the records are complete and support the ultimate disposition. NERC staff also fields questions and addresses issues that may arise in the context of compliance monitoring activities by the Regional Entities, including audits. NERC's Compliance Enforcement and Legal staffs also work closely with its CID staff in the review of violations and dismissals of CIP standards. NERC internal department meetings, as well as ERO working group meetings, are opportunities to provide ongoing guidance on CIP matters.

NERC disagrees with the implications of the discussion in the Draft Report that the only way to provide oversight to Regional Entity CIP compliance monitoring activities is to have NERC CIP auditors participate in or observe in person the Regional Entity CIP audits. Other oversight activities, such as CIP auditor training, maintenance of the RSAWs, development of CANs relating to the CIP standards, and review of CIP audit reports, are important components of support for the CIP compliance monitoring process.

The data on the large numbers of violations of CIP standards discovered in 2010 and 2011, and the large number of TFE requests processed from January 1, 2010 through September 28, 2011, presented in §IV.C above, shows that the CIP Compliance staffs of NERC and the Regional Entities have in fact been extremely active. Further, in 2010 and 2011, a total of 1,733 violations of CIP standards were identified through Self-Reports and Self-Certifications. This statistic indicate that NERC's CIP education and outreach activities have been effective, as Registered Entities are recognizing the need to self-identify, report and correct noncompliances with the CIP standards.

NERC's overall staffing for its Critical Infrastructure Protection Program has increased significantly in recent years as the CIP standards have become enforceable. For example, in its

[80] *See* response to Data Request No. 2, Set Request No. 2, Question No. 87.

[81] *See* responses to Data Request No. 2, Set Request No. 2, Question No. 87, and Data Request No. 6, Question No. 137.

2011 Business Plan and Budget, NERC increased its budget for the CIP Program to $6,351,709 from $917,551 in the 2010 budget, and increased the full-time equivalent employee ("FTE") staffing for the Situational Awareness and Infrastructure Security Program (which includes the CIP Program) from 9.75 FTE to 25.83 FTE.[82] NERC is continuing to make appropriate program adjustments for additional oversight of Regional Entity CIP audits. In NERC's 2012 Business Plan and Budget, two additional FTEs were approved for the CIP oversight team, consisting of one additional CIP auditor and one CIP Compliance Manager. Additionally, NERC is in the process of procuring independent contractors to assist in its CIP oversight, as well as its auditor training programs.

Accordingly, Recommendations 34 and 36 in the Draft Report should be modified to read as follows:

35. Conduct an assessment of existing CIP-related staffing levels to ensure there are adequate resources to accomplish CIP work, particularly with respect to Regional Entity CIP auditing and other Regional Entity CIP-related CMEP activities.

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

VII. NERC's Role as the ES-ISAC is an Important Function in Assuring the Reliability and Security of the BPS and Supports NERC's ERO Responsibilities

Audit Criteria. The only criteria stated by the Draft Report for auditing this area are: (i) two sentences from Order No. 672 stating that the ERO may perform statutory and non-statutory functions, (ii) a sentence from the ERO Certification order stating that NERC is approved as he ERO, and (iii) the NERC Rules of Procedure provision that states that NERC shall serve as the ES-ISAC.

Audit Findings. The Draft Report finds that the NERC's role as the ES-ISAC "may need to undergo additional significant changes to improve its effectiveness." Draft Report at 83-84. For example, Audit Staff contends that NERC staff performing ES-ISAC duties "were not clearly designated as such" and that this has caused "confusion." *Id.* at 84. More broadly, the Draft Report argues that, although "the Commission approv[ed] of NERC's ES-ISAC role for funding under section 215," NERC must now "show how the ES-ISAC continues to fall within the rubric of NERC's statutory activities and the Commission's oversight responsibilities." *Id.* at 84-85.

NERC Response. NERC strongly disagrees with these findings. *First*, we do not understand the basis for Audit Staff to question the Commission's own findings that the ES-ISAC as a statutory function. NERC's role in connection with the Electric Sector Information Sharing and Analysis Center (ES-ISAC) is set out in the Rules of Procedure as one of the functions through which NERC will accomplish the goals related to the Infrastructure Security

[82] 2011 ERO Budget Filing, Attachment 2 at 24-25. In contrast, NERC's staffing for the Situation Awareness and Infrastructure Security Program in its 2008 business plan and budget (before Registered Entities were required to be compliant with CIP standards) was only 5.0 FTE. 2008 ERO Budget Filing at 33.

Program (ROP § 1003). These provisions were filed by NERC with the Commission at the time of NERC's application for certification as the electric reliability organization and were accepted by the Commission as part of NERC's certification in the ERO Certification Order. Subsequently, in the order accepting NERC's 2007 Business Plan and Budget, FERC considered comments by intervenors who questioned the statutory nature of several of NERC's activities. In that order, FERC expressly found that NERC's proposed activities, including those related to the Infrastructure Security Program, are "covered by FPA section 215, i.e., the development and enforcement of reliability standards, and are entitled to receive funding under section 215 of the FPA."[83]

The Commission was correct to find the ES-ISAC to be a function that can be funded under Section 215. NERC's role as the ES-ISAC is an important function in assuring the reliability and security of the BPS, and supports NERC's ERO responsibilities. In Order No. 672, the Commission stated that the statutory functions of the ERO include "monitoring the reliability of the Bulk-Power System."[84] By serving as the ES-ISAC, NERC performs a critical role in real-time situation awareness and in protecting the electric industry's critical infrastructure against vulnerabilities. The ES-ISAC information sharing and analytical functions support the reliability of the BPS through dissemination of information to the industry regarding threats and vulnerabilities, disturbances, and off-normal occurrences. The information-sharing functions directly move analyses of threats to and impacts on the BPS from the ES-ISAC staff to the industry through a variety of means, such as the "Alerts" and "Notification" processes, web portals, webinars, and industry outreach presentations. These activities directly benefit the reliability and security of the BPS by educating industry on reliability issues and informing the industry on risks, vulnerabilities and mitigation strategies, as detailed in §1003 of the NERC Rules of Procedure. The ES-ISAC's activities therefore fall squarely within the ERO function identified in Order No. 672 of "monitoring the reliability of the Bulk-Power System."[85]

Second, NERC disagrees with the ES-ISAC role is creating "confusion." NERC has responded to industry concerns regarding potential conflict between the Compliance Monitoring and Enforcement Program and the ES-ISAC's information-sharing functions, by realigning all of the ES-ISAC functions within one unit and creating a protected communications corridor to facilitate greater industry engagement and information sharing.[86] Neither the Commission nor (by the Board-approved policy) NERC CMEP personnel will have access to the protected information (including entity attribution) that the ES-ISAC handles.[87] However, the Commission will continue to receive drafts of Alerts and Notifications generated from the ES-ISAC. Further, the ES-ISAC will remain a resource for the Commission.

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[83] 2007 ERO Budget Order at P 28.

[84] Order No. 672 at P 202.

[85] *Id*.

[86] The final, approved policy, which has been approved by the NERC Board, is available at: http://www.esisac.com/Public%20Library/Documents/ESISAC%20communications%20protocol.pdf.

[87] While the Commission may have legal means to demand access to this information, doing so would result in significant negative impacts to the ES-ISAC's functionality and usefulness.

Nevertheless, NERC recognizes that further analysis, and discussion with stakeholders, is appropriate to ensure the continued effective operation of the ES-ISAC. These questions include the impacts of "walling off" the ES-ISAC and its staff from NERC's compliance-related activities, what the flow of information between the ES-ISAC and the Commission should be, and how and why operation of the ES-ISAC continues to support NERC's ERO responsibilities and should continue as a statutory activity. Accordingly, the Draft Report's recommendations concerning the ES-ISAC should be combined into the following comprehensive recommendation, which incorporates the topics in Recommendations 39-41:

> 39. Provide additional information in NERC's 2013 Business Plan and Budget regarding NERC's role as the ES-ISAC and provide opportunities for stakeholder input regarding NERC's role as the ES-ISAC during the 2013 business plan and budget process. This should also include: (1) an evaluation of the impact, if any, on NERC's compliance-related activities of "walling off" certain staff from these activities; and (2) clarification of the flow of information between the ES-ISAC and the FERC staff for situational awareness and compliance purposes.

VIII. Employee and Board Expenses[88]

Audit Criteria. The only criteria identified by the Draft Report are: (i) the statutory requirement that the ERO "allocate equitably reasonable dues, fees and other charges among end users" and (ii) a description of NERC's accounts concerning travel, telephone, internet, office supplies, and miscellaneous expenses. Draft Report at 45, 51.

Audit Findings. The Draft Report criticizes NERC's budgeting and accounting for, and controls over, employee meals and hotel expenses, dinner expenses incurred in connection with Board of Trustee meetings, and employee "entertainment" expense. The Draft Report cites several instances in which, it contends, expenditures for meals and "entertainment" for employees and Trustees were not subject to appropriate controls or accounting, or were not broken out with sufficient granularity, in Audit Staff's opinion, in budgets or accounts.[89] Draft Report at 45-47, 51-55, 59-60.

NERC Response. This is another area where Audit Staff is not applying objective criteria, but rather criticizing NERC extensively with respect to its *opinion* on a wide variety of matters, ranging from when Board members or employees can be reimbursed for meals to how

[88] This section covers several related issues which the Draft Report raises under "Standard for Determining Reasonableness of Expenses," "Employee Entertainment," and "Board of Trustees Compensation and Entertainment." Collectively, the topics discussed in this section relate to Recommendations 19, 20, 22, 23, 24, 29, 30 and 31 of the Draft Report.

[89] The "entertainment" expenses discussed in the Draft Report were primarily meal expenses provided and paid for by NERC for NERC employees and Trustees, not expenses incurred by NERC or a NERC employee for the entertainment of a third party such as a customer. NERC believes that referring to the types of expenses under discussion as "entertainment" expenses is inaccurate and inconsistent with the typically-understood meaning of the term "entertainment." These expenses are more accurately referred to as dinner or meal expenses, or, where the meal is purchased or provided as a reward for or in recognition of employee performance or effort, as employee reward or recognition expenses.

much those meals should cost. Given this lack of objective criteria, NERC responds only briefly below to each category of allegation.

The Draft Report states that NERC has defined $50 as a reasonable level of dinner expense for employee dinners (*e.g.* while traveling on behalf of NERC), but that on numerous occasions NERC has reimbursed employees for dinner expenses in excess of $50. Draft Report at 46-47. However, NERC has not defined $50 as a "reasonable" level of dinner expense. Rather, $50 per person on dinner expense reimbursement requests is used as a flag to signal the need to verify that all attendees at the dinner have been identified on the reimbursement request.

The Draft Report also recommends that NERC establish additional standards and controls for determining and enforcing "reasonable" employee meal expenses, including expenses for meals that are provided to employees as a reward for outstanding performance or effort. Draft Report at 46-47. NERC management advised Audit Staff that in very limited and special circumstances, NERC sometimes rewarded staff who had put in extraordinary efforts to complete work requirements by treating them to a dinner. A specific example discussed was that the Information Technology Manager took IT staff members, who had worked a considerable number of hours including nights and weekends to complete NERC's data center relocation as early as possible, to dinner as a reward for their efforts. This expense was approved as a routine business expense. In another such instance that Audit Staff identified, Audit Staff was informed that the NERC CFAO had counseled the manager who submitted the reimbursement request regarding the cost of the meal. NERC believes that instances of employee meals being provided as a reward for performance or effort, such as the occurrences identified by or discussed with Audit Staff, are isolated and limited.

The Draft Report also states that NERC department managers expend a considerable amount of time reviewing employee expenses, and that this responsibility should be shifted to accounting staff. Draft Report at 47. NERC does not disagree that reviewing employee expense reports requires department manager time. However, NERC believes that to establish procedures by which its accounting staff reviews all employee expense reports would require NERC to hire one or more additional staff in its Finance and Accounting department. Therefore, NERC believe that it should first have an opportunity to implement improved controls, procedures and guidelines concerning these expenses prior to adding administrative and overhead costs to its operations.

With respect to employee reward and recognition expenses, the Draft Report expresses concern that NERC incurred significant costs for year-end employee meetings and dinners in 2010 and 2011, but that the expenses for these events were not separately budgeted, and were accounted for as routine business expenses. Draft Report at 52-55. As shown by the table on page 53 of the Draft Report, the expenses for the year-end employee dinners were $29,785 in 2010 and $39,721 in 2011. The higher cost figures cited in the Draft Report included the costs for employee travel to Princeton and Atlanta to attend meetings and training sessions that were scheduled in conjunction with the year-end events, and expenses for those meetings and training sessions. Such meetings and training sessions will continue, regardless of whether the year-end employee dinner continues. NERC did record the specific costs of the year-end employee dinners as Miscellaneous expenses, which appears to be the accounting Audit Staff believes to be appropriate (*see* Draft Report at 53). NERC does agree that, in the unlikely event such year-end parties are ever planned and held in future years, the projected expenses should be provided for and separately identified in NERC's budget and separately tracked.

Finally, with respect to Board of Trustee "entertainment" expenses, the Draft Report states that NERC "incurred various expenses to entertain BOT members outside the official BOT meetings." Draft Report at 56. However, these "various expenses to entertain BOT members outside the official BOT meetings" were actually payments or reimbursements for Trustee meal expenses in connection with Board, Board committee and other Board meetings (e.g., dinners for Board members the night before a Board meeting, when the meeting was to start in the morning and it therefore was necessary for the Board members to travel to the Board meeting location city to arrive the evening before the meeting; or where the Board or committee meeting spanned more than one day, which is usually the case for the regular quarterly Board meetings). These are ordinary and customary travel expenses associated with attendance at a business meeting – they are not "entertainment expenses." Contrary to the implication that might be created by the Draft Report's characterization of these costs as "entertainment expenses," NERC did not pay for or provide tickets to events or other such items which are more commonly referred to as "entertainment expense."

The Draft Report notes several instances where the dinner expenses incurred in connection with Board meetings exceeded the level NERC has defined as "reasonable."[90] The Draft Report recommends that such Board of Trustee dinners should be separately budgeted and that the expenses should be recorded as miscellaneous operating expenses. Draft Report at 59-60. Although NERC does not agree with the Draft report's characterization of these dinner expenses as "entertainment expenses," NERC does plan to clearly identify Board meeting meal expenses in its budget and to track those expenses. Additionally, NERC will adopt a policy regarding gifts to Trustees paid for by NERC or by an officer or employee. NERC already has a policy in place regarding the acceptance/prohibition of gifts to NERC employees from third parties.

The recommendations relating to the foregoing topics – Recommendations 19, 20, 22, 23, 24, 29, 30 and 31 – should be revised to read as follows:

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

20. [This recommendation is deleted as it is subsumed by revised Recommendation 19.]

22. Explicitly budget for employee rewards and recognition expenses, if any, by including line items of sufficient granularity in the budget filings.
23. Use miscellaneous expense accounts to track employee expenses which are primarily social in nature, if any, separately from other business-related expenses in its accounting system.

24. Ensure such expenses are clearly and transparently included in budgets submitted to the Board and Commission.

[90] As noted earlier, NERC has not defined $50 as the maximum "reasonable" dinner expense.

29. [This recommendation is deleted as it is subsumed by Recommendation 30.]

30. Track expenses actually incurred for Board activities to the budgeted amounts for such expenses.

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

Respectfully submitted,

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ELECTRIC RELIABILITY CORPORATION

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In Reply Refer To:
Office of Enforcement
Docket No. FA11-21-000
March 23, 2012 [revised April 23, 2012]

Gerry Cauley, President and CEO
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Dear Mr. Cauley:

The Division of Audits within the Office of Enforcement has completed an audit of North American Electric Reliability Corporation (NERC) for August 23, 2006 to March 9, 2012. The draft audit report contains 11 findings and 42 recommended corrective actions. The enclosed draft audit report describes our findings and recommendations.

Please respond to the draft audit report by April 9, 2012. Your response should state whether you agree or disagree with the audit findings and recommendations. Further, your response should describe any corrective actions taken and implementation dates for each recommendation, including the actions already included in the report. For any corrective action involving procedural changes, provide those procedures separately from your comments for review. Please send your response to:

Bryan K. Craig, Director and Chief Accountant
Division of Audits
Federal Energy Regulatory Commission
888 First Street, NE, Room 51-37
Washington, D.C. 20426

I appreciate the courtesies extended to the auditors. If you have any questions, please contact Alan Herd at (202) 502-6107 or Alan.Herd@FERC.gov, or Stephen Flanagan at (202) 502-8743 or Stephen.Flanagan@FERC.gov.

Sincerely,

Bryan K. Craig
Director and Chief Accountant
Office of Enforcement

Enclosure

2 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

Federal Energy Regulatory Commission

DRAFT

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

Docket No. FA11-21-000
March 23, 2012 [Revised April 23, 2012]

Office of Enforcement
Division of Audits

3 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

TABLE OF CONTENTS

I. EXECUTIVE SUMMARY 1

A. Overview 1

B. NERC as the ERO 1

C. Statutory ~~and Non-Statutory Philosophy~~Background 3

D. Summary of Audit Findings 5

E. Summary of Recommendations 7

F. Compliance and Implementation of Recommendations 11

II. BACKGROUND 13

A. NERC Budget 13

B. NERC Organizational Structure and Staffing 16

III. INTRODUCTION ..... ~~19~~20

A. Objectives ..... ~~19~~20

B. Scope and Methodology ..... ~~19~~20

IV. FINDINGS AND RECOMMENDATIONS ..... ~~23~~24

1. NERC Budget Process ..... ~~23~~24

2. NERC Oversight of the Regional Entities' Budgets ..... ~~30~~32

3. Time Reporting and Accounting System ..... ~~34~~37

4. Employee Compensation ..... ~~39~~42

5. Standard for Determining the Reasonableness of Expenses ..... ~~45~~46

6. Employee Entertainment 51

7. Board of Trustees Compensation and ~~Entertainment~~Expenses 56

8. ~~Pension~~Retirement Plans ..... ~~62~~63

9. NERC Critical Infrastructure Protection Program ..... ~~65~~67

10. NERC Activities ..... ~~70~~73

11. NERC as the Electric Sector - Information Sharing and Analysis Center ..... ~~82~~87

I. Executive Summary

A. Overview

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

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

B. NERC as the ERO

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

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

1 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

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

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

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

Order No. 672 lays out the mission for the newly created ERO: the establishment and approval of electric Reliability Standards, the enforcement of electric Reliability Standards, and the monitoring of the reliability and adequacy of the Bulk-Power System. These three enumerated activities are clearly defined as within the scope of activities for which the entity certified as the ERO should receive appropriate funding under section 215. Other activities falling within the (1) Situational Awareness and Infrastructure Security Program and (2) Reliability Assessment and Performance Analysis Program also received ~~initial Commission approval as ongoing activities that NERC as the ERO may be the best party to perform in the absence of any other entity assuming the responsibility of these activities.~~[5] Commission approval as statutory activities within the scope of section 215.[5] ~~However, the~~The Commission did not establish any criteria by which to determine whether ~~these activities, or any other activities falling under the scope of these programs, were never developed by NERC nor established by the Commission~~NERC's activities fall within the scope of section 215, and did not direct NERC to establish or propose such

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

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

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

[5] ~~117 FERC ¶ 61,126 at P 188~~. [This citation is incorrect and did not support the original statement in the Draft Report's text to which it related.]

criteria. The manner in which these initial activities would continue on a going-forward basis, or new reliability-related activities in these programs could be added, were subject to subsequent Commission review and approval. ~~However~~To date, the Commission has approved all of NERC's budgeted activities for section 215 funding in its orders on NERC's annual business plan and budget submissions. Additionally, the Commission clearly expressed its opinion that an entity selected to be the ERO might have an expanded scope of activities that it could perform, but not receive funding to perform under section 215:

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

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

C. ~~Statutory and Non-Statutory Philosophy~~Background on the Scope of NERC's Activities

[NOTE: NERC urges Audit Staff to delete all sections that address the scope of section 215 because these sections question or otherwise contradict prior orders, as discussed in NERC's Response to the Draft Report.]

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

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[6] *Id.* P 202. [This citation is also incorrect in the original Draft Report.]

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

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

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

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

~~Audit staff is concerned that NERC as the ERO has continued, and at times expanded, its historic mission of seeking voluntary reliability activities, rather than the specific mandatory objectives of the ERO as authorized in section 215. Through discussions with NERC senior officials and staff, audit staff found that NERC has operated under the assumption that its projects, initiatives, and tools are directly related to section 215. This has resulted in some projects, initiatives, and tools being undertaken and funded under section 215 that do not have either clear written criteria upon which to justify funding under section 215 or clearly discernible linkages to the development and enforcement of mandatory reliability standards or the monitoring of BPS reliability and adequacy.While the Commission provided instruction on how to identify activities as non-statutory and how NERC could seek funding apart from section 215, NERC has instead adopted a policy of including all activities into one or more of the six broad program areas~~

4 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

~~identified in its certification application and treating them as statutory. Also, NERC did not develop time-keeping and expense reporting that could track statutory and non-statutory activities, and instead rolled all activities into budget categories to be reported as statutory. By not tracking time by project, and not assigning projects to specific statutory activities, it is difficult for NERC, as well as audit staff and other entities responsible for oversight of NERC's activities, to determine how budgetary funds were used on specific statutory programs. Consequently, NERC's accountability for statutory and non-statutory activities has suffered.~~, but without using written criteria as to whether the activities were within the scope of section 215. Additionally, NERC believes it has not engaged in non-statutory activities. Audit staff is therefore recommending , as described further in this Report, that NERC provide greater transparency in its budgeting and accounting with respect to statutory versus non-statutory activities.

D. Summary of Audit Findings

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

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

NERC Oversight of the Regional Entities' Budgets – NERC's current process of reviewing Regional Entity budgets ~~is inadequate and lacks appropriate~~would benefit from further qualitative procedures to more efficiently and effectively assess Regional Entities' annual budgets. Greater qualitative oversight in this area may improve the efficiency and effectiveness of the ~~process, yielding savings for the ERO~~Regional Entity business plans and budgets and may identify cost reduction possibilities in some areas while identifying the need for Regional Entities to budget and expend additional resources in other areas.

5 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

Time Reporting and Accounting Systems – NERC's historic system and method for reporting and tracking employee time and expenses ~~failed to:~~ had limited capability to track time and attendance on ~~a~~an activity- or project-specific basis~~, or properly classify expenses in its accounting system at a level that provided sufficient transparency to permit effective budget oversight. These deficiencies were due to NERC's lack of adequate procedures for reporting and tracking employee time and insufficient functionality implemented in its accounting system. These shortcomings resulted in inefficient and ineffective~~ within NERC's defined Program Areas, or allow for the accounting for expenses at an activity- or project-specific level. Enhancements to NERC's time reporting and accounting systems would facilitate improvements in budget oversight, time and ~~expense tracking,~~ tracking and cost allocation and control over costs.

Employee Compensation – ~~NERC used studies to determine~~There were numerous weaknesses in the compensation studies conducted by NERC prior to the more recent compensation study conducted for NERC in late 2011-early 2012. This was in part due to the lack of adequate funding for these studies, which in turn limited the scope and depth of the studies. At the direction of the Corporate Governance and Human Resources Committee of the NERC Board in 2011, NERC commissioned new, comprehensive compensation studies, conducted by a nationally-recognized employee compensation consultant, regarding employee compensation levels~~ that did not have adequate support to justify the reasonableness of compensation NERC paid its officers and staff. Audit staff is concerned that NERC has not systematically assessed~~. These studies were completed in late 2011-early 2012. The new studies were designed to address a number of weaknesses which exited with prior studies which, as noted, were in part due to the lack of adequate funding for these studies. While the new studies are a significant improvement over the previous studies, audit staff believes that NERC should periodically update these studies. Audit staff also believes that NERC would benefit from more a more systematic assessment of its organizational staffing needs to determine the core competencies and skill sets required of employees.~~ This weakness occurred in part because NERC did not contract for an adequate compensation study and did not ensure that appropriate assumptions were used. As a result, NERC incurred considerable personnel costs funded by end-users under section 215.~~

Standard for Determining the Reasonableness of Expenses – NERC ~~does not have a clear~~would benefit from further defining the standard of reasonableness by which to judge certain types of expenses that it or a staff member incurs. Also, NERC's current ~~expense~~ review and approval process for these types of expenses is decentralized~~ and inefficient. These problems are exacerbated by NERC's lack of sufficient~~. NERC would benefit from adopting further policies, procedures, and controls over: (1) meal and hotel expenses incurred by its employees; (2) employee

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recruitment expenses; and (3) employee retention expenses. ~~As a result of not having a clear and well-documented standard of reasonableness, NERC did not have adequate cost controls to prevent end-users from paying for excessive expenses.~~

Employee ~~Entertainment~~ – NERC did not have adequate Reward and Recognition Related Expenses – NERC should adopt additional policies and procedures ~~governing~~and provide increased budget transparency regarding employee ~~entertainment~~reward and recognition expenses. ~~These~~Existing policies and procedures ~~were~~are deficient ~~as follows~~in that: (1) NERC did not have formal guidance for determining if ~~entertainment~~such expenses were reasonable and reimbursable; and (2) NERC ~~paid approximately $74,000 and $109,000, respectively for office holiday parties~~incurred expenses for year-end employee dinners in December 2010 and December 2011 ~~(Holiday Galas)~~ that were neither fully nor transparently budgeted for~~; and (3) NERC did not properly account for employee entertainment expenses, including those of the Holiday Galas~~. As a result of th~~e~~is~~e inadequacies~~ budgeting, the Commission, stakeholders, and other interested parties did not have the necessary information to ~~approve~~review these expenses ~~and consequently NERC used budgeted funds for expenses not represented in NERC's budget~~as part of the budget and true-up processes.

Board of Trustees Compensation and ~~Entertainment~~Meals – NERC ~~did not support its shift~~shifted to a ~~flat~~ fixed fee retainer methodology of compensating its Board of Trustees (BOT) ~~with a time study based on actual~~, with the amount of the fixed fee dependent on the number of committees the Trustee sits on, whether the Trustee is a committee chair and whether the Trustee is also the chairman of the Board. NERC's Board reviewed its proposed shift to a fixed fee retainer plus expenses methodology at several open board meetings with stakeholders present. NERC also conducts annual surveys of the NERC Members Representative Committee (MRC) regarding BOT effectiveness. A consultant also reviewed and rendered an opinion in support of the fixed fee retainer methodology and associated board compensation levels. Audit staff believes that in future compensation studies the Board should consider including a further evaluation of time spent by the BOT on BOT activities or a representative study of the ~~actual~~ time spent on these activities. Also, NERC incurred various expenses ~~to entertain BOT members outside the official BOT meetings. As a result, audit staff believes NERC's shift to a flat-fee compensation methodology was not adequately supported and the expenses incurred outside the official BOT meetings may have been improperly funded by end-users under section 215.~~for dinners for BOT members during the evenings after BOT committee meetings and the evenings before BOT meetings. Audit staff believes that these expenses should be more transparently set forth in NERC's annual budget to facilitate stakeholder and Commission review.

7 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

~~*Pension Plans* – NERC contributed 10 percent of the~~ *Retirement Plans* – In connection with the conversion of NERC's defined benefit plan to a defined contribution 401(k) plan, which occurred prior to NERC becoming the ERO, NERC amended its 401(k) plan to provide for a contribution of 10 percent of compensation (salary plus incentive) for each employee participating ~~in the pension plan, which is above energy sector norm~~. This 10 percent contribution was in addition to an up to 4.5 percent matching contribution for employees participating in NERC's 401(k) plan. Audit staff believes the 10 percent contribution component is above industry norms. NERC stated that the 10 percent contribution component was included because, as a nonprofit corporation, NERC cannot offer profit-based compensation components as can the for-profit entities with which NERC competes for employees. Also, NERC included bonuses as well as base salary in its determination of its ~~pension~~additional contribution obligations for employees. In addition, ~~NERC paid excess amounts above the allowable~~ to the extent a portion of the 10% additional amount could not be contributed to the participant employee's 401(k) account due to Internal Revenue Service (IRS) ~~limit for pension contributions to certain employees as additional compensation when it should have maintained these amounts in a tax- deferred account~~limits, NERC paid this excess portion to the participant as ordinary income, subject to current federal and state tax withholdings and taxation. Based upon a review of the recent employee compensation and benefits study and upon recommendation of NERC's Corporate Governance and Human Resources Committee, the NERC Board is scheduled to approve an amendment to NERC's 401(k) Plan and retirement polices in May 2012 to eliminate the inclusion of the bonus in the calculation of the additional contribution, as well as making the amount of the additional contribution a discretionary determination by the BOT. NERC has also established an employee funded 457(b) plan which allows employees meeting certain IRS eligibility requirements to defer additional amounts towards retirement. NERC does not provide any matching funding for 457(b) plan contributions, with all contributions made by employees, in their sole discretion.

NERC Critical Infrastructure Protection Program – NERC ~~inadequately staffed~~should further evaluate the sufficiency of its staffing for the needs of its critical infrastructure protection (CIP) program~~. NERC's senior management focused on a limited scope of activities that did not adequately address the~~, in particular with respect to the resources needed for oversight of the Regional Entities' CIP auditing and other CIP compliance monitoring and enforcement ~~program (CMEP) needs of the ERO in the CIP program. This lack of attention to compliance-related activities led to insufficient staffing for this section 215 responsibility~~activities. While NERC has significantly increased its CIP Program Area staffing over recent years, and has provided oversight through other means, audit staff believes that insufficient resources have been devoted to oversight of Regional Entity audit activities in the CIP area.

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NERC Activities – Neither the Commission nor NERC ~~did not~~ have established written criteria to determine whether specific activities NERC performs are statutory activities that should be funded under the Federal Power Act (FPA) section 215. ~~Audit staff is concerned that NERC's failure to develop written criteria to guide its decisions of what constitutes a statutory activity is directly related to its philosophy that all activities that promote the reliability of the Bulk Power System (BPS) are statutory.~~ As a result, it was difficult for audit staff to determine ~~the scope and extent of permissible~~whether all of the activities that ~~should be~~NERC performs are appropriately funded under section ~~215 and NERC's method of prioritizing such activities to ensure the appropriate focus of activities undertaken as the ERO.~~215.

NERC as the Electric Sector Information Sharing and Analysis Center – NERC's dual role as the Electric Sector-Information Sharing and Analysis Center (ES-ISAC) and as the ERO raises significant challenges. NERC ~~has continued functioning in both roles, resulting in internal confusion and confusion among the Commission and stakeholders~~should continue to address these challenges through appropriate separations and additional transparency.

E. Summary of Recommendations

This section summarizes audit staff's recommendations to remedy the audit findings and enhance performance of NERC's budget process. ~~Audit staff will conduct a post-audit site visit when NERC reports that it has completed all of the recommendations to ensure that all of the corrective actions taken as a result of implementing the recommendations were properly completed.~~[Note to Audit Staff: NERC does not believe that both a third party audit and a second audit by DA are appropriate, as explained in NERC's Response.] Detailed recommendations are included in section IV of this report. Audit staff recommends that NERC:

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

2. ~~Develop a transparent process that permits~~Continue to make improvements in budget transparency that informs the Commission, the ~~BOT~~Board and stakeholders ~~opportunity for authorizing~~concerning the expenditure of funds approved for specific budgeted statutory activities ~~to be redirected to~~on unbudgeted activities, and develop and obtain Board approval of enhanced guidelines governing such expenditures, including criteria for determining when Board approval is required;

3. ~~Request budgetary funds for activities initiated between budget cycles that were not included in the annual budget filing in accordance with section 1108 of the NERC Rules of Procedure (ROP);~~[Deleted];

9 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

4. Increase the granularity of the NERC budget filings by: (1) breaking out ~~significant cost categories in its expenses; (2) identifying proposed budgeted expenditures, at a minimum, on a project specific basis; and (3~~budgeted expenses, such as budgeted contractors and consultant expenditures, into more detailed cost categories; and (2) separating working capital reserves needed for operations from working capital reserves needed for contingencies and identifying those contingencies to the extent they are known during business planning;

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

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

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

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

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

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

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

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

13. ~~Implement functionality in the expense reporting software to allow the tracking of expenses on a project and activity basis;~~As part of its business

10 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

plan and budget, in 2013 conduct a cost-benefit analysis of implementing project level budgeting and accounting systems;

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

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

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

17. ~~Contract for new~~Continue to perform routine and periodic updates to employee compensation studies ~~that use~~, using comparability data that targets the required skill sets and competencies needed to carry out NERC's mission as the ERO~~. Submit the compensation studies with audit staff upon completion~~;

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

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

20. ~~Divide its process for approving expenses into two steps, leaving managers responsible for approving the purpose and rationale for incurring expenses and designating accounting staff to be responsible for evaluating the reasonableness of expenses;~~[Deleted, as this recommendation is subsumed in Recommendation 19];

11 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

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

22. Explicitly budget for employee ~~entertainment~~rewards and recognition expenses, if any, by including line items of sufficient granularity in the budget filings;

23. Use miscellaneous expense accounts to track ~~entertainment~~employee expenses which are primarily social in nature, if any, separately from business-related expenses in its accounting system;

24. Ensure ~~entertainment~~such expenses are clearly and transparently ~~presented~~included in budgets submitted to the ~~BOT,~~Board and Commission~~, and stakeholders in the budget before these costs are incurred~~;

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

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

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

28. ~~Conduct an analysis of BOT participation and effort based on a time study using actual time spent during BOT activities, or a representative study of the actual time spent, and implement a compensation methodology that pays BOT members reasonably for performance of their duties;~~Continue to conduct periodic updates and review of the Board compensation model and compensation levels, taking into account Board time and participation on Board activities and market comparability data of appropriate comparator organizations;

29. ~~Estimate and include in its annual budgets an amount of funding to cover BOT entertainment expenses that it deems appropriate and seek approval for such funding;~~[Deleted, as this recommendation is subsumed in Recommendation 30];

12 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

30. Track the ~~entertainment~~ expenses actually incurred for Board activities to the budgeted amounts for such expenses;

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

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

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

34. ~~Develop an alternative mechanism for addressing pension~~Continue to use the mechanism that has been adopted and consider additional mechanisms to allow employees to address tax deferred retirement savings of contributions in excess of the IRS cap ~~that maintains the payment as a retirement benefit and not as additional compensation to the employee~~on 401(k) contributions;

35. Conduct an assessment of existing CIP-related staffing levels to ensure ~~that NERC staff work aligns with section 215 activities and that~~ there are adequate resources to accomplish CIP work, particularly with respect to Regional Entity CIP auditing and other Regional Entity CIP-related CMEP activities;

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

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

38. ~~Identify all ERO activities funded under section 215, detailing, at a minimum: the purpose of the activity, a description, and the justification for using section 215 funding. Submit all documentation to audit staff for these reliability activities;~~In its annual business plan and budget filings, provide an explanation as to why the proposed activities to be undertaken by each program area for the budget year are statutory, including at a minimum: a

13 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

description and the purpose of the major activities to be undertaken by each program area and an explanation for why the activity is a statutory activity;

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

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

39. ~~41. Clarify~~Provide additional information in NERC's 2013 Business Plan and Budget regarding NERC's role as the ES-ISAC and provide opportunities for stakeholder input regarding NERC's role as the ES-ISAC during the 2013 business plan and budget process. This should also include: (1) an evaluation of the impact, if any, on NERC's compliance-related activities of "walling off" certain staff from these activities; and (2) clarification of the flow of information between the ES-ISAC and the ~~Federal Energy Regulatory~~ Commission ~~(FERC)~~ staff for situational awareness and compliance purposes; ~~and~~

40. [This recommendation is incorporated in Recommendation 39];

41. [This recommendation is incorporated in Recommendation 39]; and

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

F. Compliance and Implementation of Recommendations

Audit staff further recommends that NERC:

- Submit for audit staff ' s review its plans for implementing this report's recommendations. NERC should provide these plans to audit staff within ~~30~~60 days of the issuance of the final audit report in this docket.

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

14 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

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

- Select an independent third party~~, with DA staff approval, to~~ consultant to conduct an independent review of NERC's implementation of the agreed-upon audit recommendations regarding budget formulation, administration and execution processes~~. The third-party auditor shall~~ and submit a report contemporaneously directly to ~~DA~~Audit ~~s~~Staff and to NERC. ~~If DA staff so requests, NERC will contract for a second independent audit for the following year.~~

II. Background

A. NERC Budget

NERC Budget Process

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

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

NERC's annual business plan and budget process includes posting of assumptions for stakeholder comment, posting of multiple drafts of its business plans and budgets for stakeholder comment, meetings with stakeholder groups, and presentation and discussion of the proposed business plans and budgets at open meetings of the NERC Board Finance and Audit Committee ("FAC"), Member Representatives Committee ("MRC"), and the Board of Trustees. Additionally, after the Business Plan and Budget is filed with the Commission, the Commission provides stakeholders an additional opportunity to submit comments. Drafts of the business plan and budget are posted on NERC's website and are publicly available. Below is a summary of NERC's budget filings that the Commission accepted along with conditions on the acceptance of NERC's business plan and budget.

NERC and the Regional Entities' 2007 Budgets

On August 23, 2006, NERC filed its and the Regional Entities' 2007 business plans and budgets with the Commission. NERC then made a supplemental filing on October 6, 2006 to update information the Regional Entities provided in the original budget filing.

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

16 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

The Commission issued an order conditionally accepting the 2007 business plans and budgets on October 24, 2006. The Commission conditioned its acceptance of the budget filing on NERC's development of a system of accounts comparable to the Commission's Uniform System of Accounts. The Commission required NERC to develop its proposed system of accounts and record-keeping requirements, include it as part of its 2008 budget filing, and inform the Commission as to whether NERC's system of accounts complied with generally accepted accounting principles. Also, the Commission required NERC in its 2008 budget filing to identify its general statutory activity and the sub-activities NERC's 2008 budget and business plan covered. Moreover, the Commission directed NERC to provide further consistency and standardization in the formatting of its budget and those of the Regional Entities, and to identify the criteria used for categorizing statutory activities so proposed budgets are consistent across funded activities. Lastly, the Commission directed NERC to add detail to its 2008 budget on: (1) its compliance enforcement activities, including comparisons to its 2007 accomplishments; (2) the estimated number of staff it will provide to assist the Regional Entities; (3) the estimated number of ERO staff on each audit team; and (4) the percentage of reliability standard compliance audits in which the ERO will participate, and how the ERO will select which audits to monitor. NERC submitted compliance filings, as required, addressing these directives, which were accepted by the Commission. Among other things, NERC, in a compliance filing, submitted and described its system of accounts, which the Commission accepted in a subsequent order.

NERC and the Regional Entities' 2008 Budgets

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

17 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

NERC's performance assessment, due in 2009. NERC made compliance filings, as required, addressing the directives, which were accepted by the Commission in subsequent orders.

NERC and the Regional Entities' 2009 Budgets

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

NERC and Regional Entities' 2010 Budget

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

18 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

for conducting Compliance Violation Investigations (CVIs). NERC provided additional information in a compliance filing, as required, which was accepted by the Commission.

NERC and the Regional Entities' 2011 Budgets

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

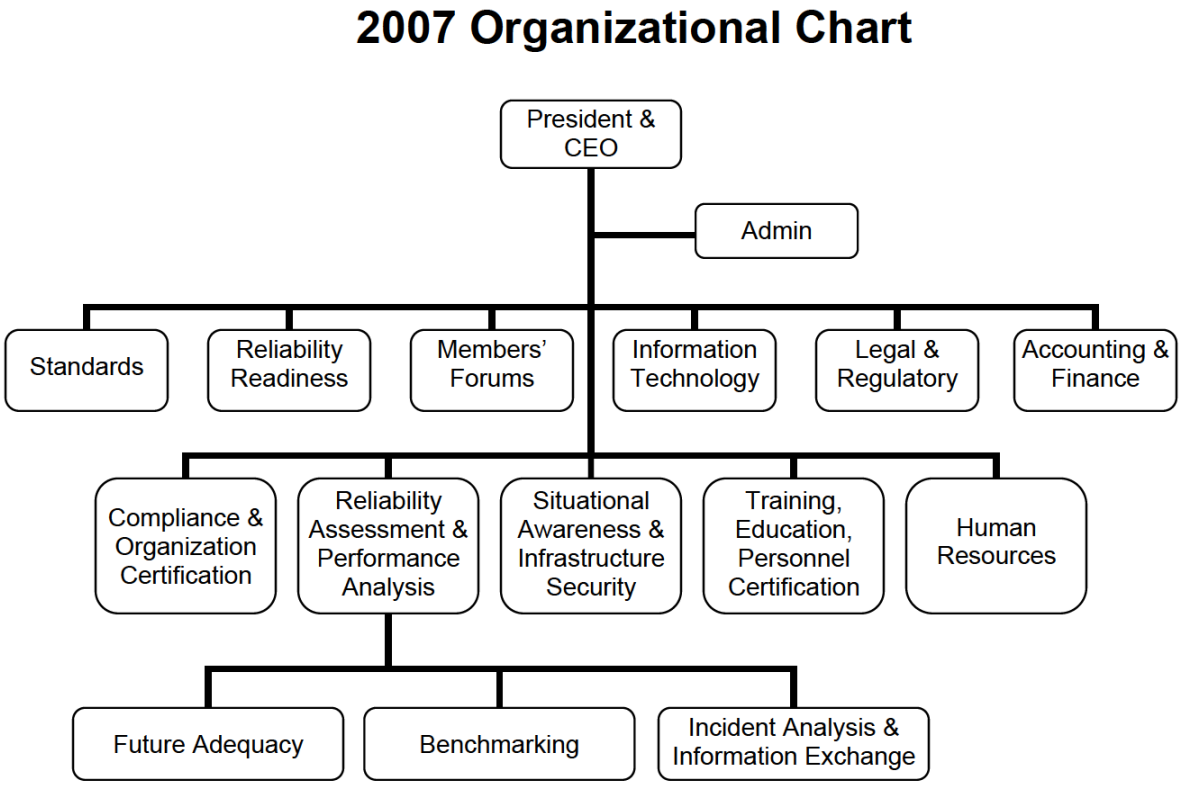
NERC and the Regional Entities' 2012 Budgets

On August 24, 2011, NERC filed its and the Regional Entities' 2012 business plans and budgets. The Commission issued an order accepting the 2012 business plans and budgets on October 20, 2011 without condition. In its order, the Commission accepted NERC's explanation concerning why a presentation and analysis of budget metrics for the current fiscal year was not a useful exercise that would provide meaningful information. The Commission did not identify any issues that required a compliance filing.

B. NERC Organizational Structure and Staffing

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

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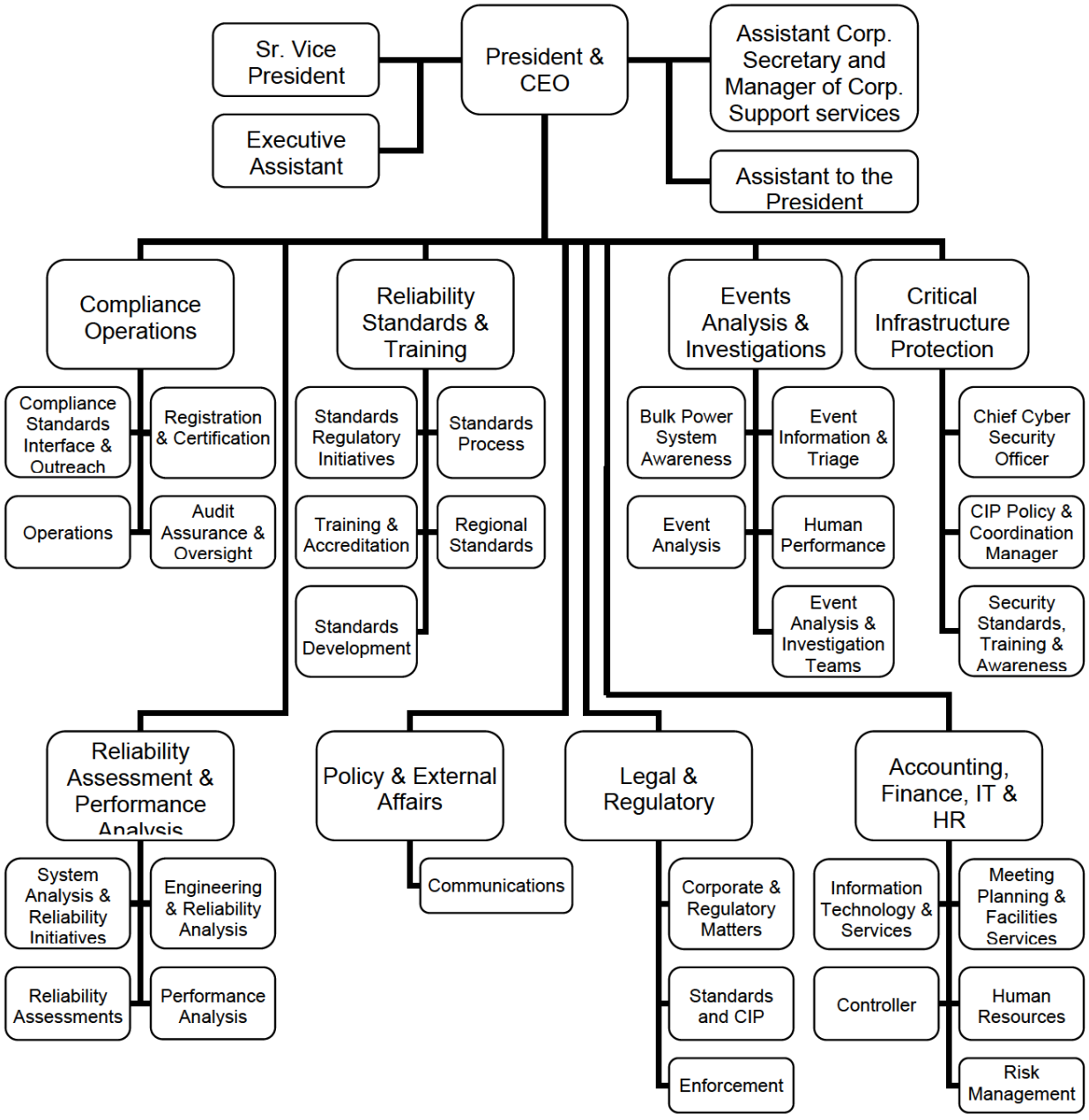


NERC's organizational charts have continued to generally reflect the broad functional categories initially approved by the Commission when it certified the ERO (i.e., operating divisions within NERC). ~~As such, they~~NERC does not view its organization as a matrix organization, but one in which resources from multiple departments support particular business needs requiring multidisciplinary support. However, in audit staff's view, the organizational charges do not clearly reflect the relationships that exist in the performance of particular tasks. Audit staff views NERC ~~operates~~as operating in a matrix

(i.e., cross-functional) environment with staff participating in specific programs that sometimes span operating divisions, ~~making~~which audit staff found made it difficult to discern lines of responsibility and authority.

Below is NERC's organizational chart effective February 2012:

2012 Organizational Chart



21 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

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

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III. Introduction

A. Objectives

The objective of this financial performance audit was to evaluate NERC's budget formulation, administration, and execution. This economy and efficiency audit focused on the costs and resources used to achieve program objectives. The audit covered the period from August 23, 2006 to March 15, 2012.

B. Scope and Methodology

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

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

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

- *Conducted Site Visits* – Audit staff conducted site visits to NERC facilities to gain a thorough understanding of NERC's processes, procedures, and operations. During the site visits, audit staff conducted extensive interviews, learned about NERC's operations, evaluated policies and controls, and sampled accounting records and supporting documentation. Audit staff interviewed the majority of NERC's executive management team, including ~~the~~but not limited to the President and Chief Executive Officer (CEO) and Chief Financial and Administrative Officer (CFO), as well as support personnel in the accounting, legal, and government affairs departments. Specific topics covered included:

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

23 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

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

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

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

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

Objectives of the ERO and NERC's Functional Organization

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

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

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

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

Budget Development, Administration, and Execution

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

- Reviewed NERC's process for compiling and submitting the annual budget and true-up filings for Commission approval;
- Discussed NERC's BOT involvement in the budget development and approval process;
- Interviewed ~~multiple~~three BOT members about their involvement in the budget development and approval process;
- Examined the controls in place to ensure adherence to the NERC budget, as well as the controls for overseeing the development, administration, and execution of the Regional Entity budgets;
- Interviewed the CEO and other executive management about their roles in developing and executing the annual budget; and
- Discussed how NERC budgets for particular programs and initiatives, as well as for day-to-day operations, contingencies, and other activities.

NERC's System of Accounts and Accounting for Expenses

- Examined the accounting system in place at NERC, including the associated policies, procedures, and controls;
- Evaluated the adequacy of the currently enabled functionality of the accounting system;
- Sampled travel and operating expenses and reviewed the supporting documentation;
- Interviewed the CFO and accounting staff about specific accounting treatments and activities, including NERC's headquarters relocation, working capital, line of credit, capital expenditures and depreciation, and interest income;
- Reviewed and discussed the lobbying activities and expenses of the legal, government affairs, and executive management staff;
- Discussed the role and responsibilities of the BOT Finance and Audit Committee (FAC); and
- Interviewed the chairperson of the FAC.

25 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

NERC Staffing and Organizational Responsibilities

- Discussed the alignment of NERC's staffing and resources to the responsibilities of the ERO;
- Examined the qualifications of NERC staff, including support personnel, executive management, and operational staff, as well as the qualifications of contractors;
- Examined the compensation of NERC staff, including benefits, bonuses, and other forms of incentive compensation;
- Evaluated the controls in place with respect to employee compensation;
- Reviewed the compensation studies and supporting documentation relied upon by NERC to determine employee base salary, bonuses, and other incentive compensation;
- Interviewed NERC Human Resources staff to discuss the NERC hiring process, including NERC's approach to succession planning for key staff and positions, employee qualifications, and employee retention and turnover;
- Discussed NERC's oversight of the Regional Entities' staff and contractors responsible for performing compliance monitoring and enforcement program (CMEP) activities;
- Discussed NERC's headquarters relocation, its effect on staffing, and the efforts taken by NERC to retain key employees;
- Discussed the compensation of NERC's BOT;
- Discussed the role and responsibilities of the BOT Corporate Governance and Human Resources Committee (CGHRC) in relation to employee and BOT compensation;
- Interviewed the chairperson of the CGHRC;
- Reviewed the employee performance evaluation process and discussed how it ties to the bonus allocation process; and
- Reviewed employment ~~contracts in place~~letters and written agreements with current and former employees.

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IV. Findings and Recommendations

1. NERC Budget Process

NERC's budget process ~~does not provide sufficient~~would benefit from additional transparency to allow the Commission, the BOT, and stakeholders to efficiently and effectively evaluate annual budget requests and subsequent ~~requests to change~~changes in the use of funds from the approved budgets. ~~This situation was due to a lack of~~These enhancements would include additional procedures and controls to:

- Address the use of ~~section 215 funds for unbudgeted activities as well as the redirection of~~ unused budgeted funds from approved ~~statutory~~budgeted activities ~~to~~for unbudgeted activities;
- Advise the Commission, BOT, and stakeholders of significant deviations from requested budgeted targets; and
- Develop budget filings with additional granularity ~~to~~at activity- and project-specific levels.

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

Pertinent Guidance

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

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

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

27 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

> annual Electric Reliability Organization budget shall include line item budgets for the activities of each Regional Entity that are delegated or assigned to each Regional Entity pursuant to § 39.8.[9]

18 C.F.R. § 39.4(d) further states:

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

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

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

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

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

[9] 18 C.F.R. § 39.4(b) (2011).

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

28 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

FERC and other Applicable Governmental Authorities having authority to approve the proposed budget.

The Commission has accepted each of the six annual business plans and budgets of NERC and the Regional Entities filed by NERC and the related assessments to U.S. LSEs to provide the funding for the statutory activities of NERC and the Regional Entities.

Background

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

Controls on Funding Unbudgeted Activities

Audit staff has concerns that NERC does not have sufficient procedures or controls to ensure~~: (1)~~budgeted section 215 funds are not used to pay for reliability activities that were not budgeted or approved~~, and (2) unused budgeted funds from statutory activities are not redirected to unbudgeted activities~~. NERC officials indicated during the audit that approved budgeted funds are at times seen as a cap on total spending ~~rather than as funds designated for accomplishing a specifically approved, statutory reliability activity. Such~~with management having discretion in how it elects to manage and utilize those funds within the context of the activities generally described in its business plan and budget. In audit staff's opinion, such practices erode the transparency of the budget, and cause the input and direction provided by the BOT, the Commission, and stakeholders through the budget review and approval process to be devalued or lost.

Audit staff believes that the manner in which NERC funded its recent office and data center relocations and the Washington, DC, expansion demonstrates NERC's ability to ~~redirect~~utilize a significant amount of unused funding without providing sufficient notice or transparency to the BOT, the Commission, and stakeholders. ~~Audit~~NERC management provided audit staff with an analysis of working capital ~~disclosed~~which showed that NERC's working capital reserves increased ~~by millions~~significantly over the projected working capital reserves for 2011. The significant increase in working capital reserves were generated primarily from unused funds, due to factors such as the inability to hire employees to fill unbudgeted positions by the dates assumed in the budgets, or the unexpected departures of existing employees, resulting in unfilled budgeted positions. NERC used these monies included in its working capital reserves to pay ~~for~~costs to

29 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

complete the relocations and expansion in 2011 in excess of the funds specifically budgeted for these purposes in the 2011 budget. While NERC stated in its 2011 business plan and budget that it would use working capital funds to fund the cost of the relocation in excess of funds specifically set forth in its budget, information regarding the total projected cost of relocation was not included in the 2011 budget since NERC could not project these costs at the time the budget was submitted to the Commission for approval.

In 2011 NERC relocated its corporate headquarters from Princeton, NJ to Atlanta, GA, expanded its office space in the Washington, DC area, and accelerated the relocation of its data center. ~~NERC accomplished these~~The plans to relocate NERC's headquarters from Princeton to Atlanta, and to expand the Washington, D.C. office, were justified internally, including Board approval, and the plans and the basis for the decisions were described in the 2011 Business Plan and Budget filing,[11] which was accepted by the Commission. The need for the relocation of the data center was due to the facts that the existing data center was outdated, did not contain back-up power or sufficient fire protection. NERC believed that once the headquarters relocation was announced, accomplishing it quickly would minimize disruptions to the operations of the organization, including having office space available for additional personnel which were budgeted but not yet hired and replacement of personnel for employees choosing not to relocate. NERC accomplished the three parts of the relocation almost entirely during 2011, though its final 2011 budget expressed only an intention to *begin* the process of relocating its corporate headquarters to a location suitable to effectively conduct its role as the ERO. ~~In the~~The 2011 budget filing~~, NERC stated the budgeted~~ included expenses for 2011 related to the relocation total~~ed~~ing $1,175,000, including $200,000 in moving expenses, $750,000 in unspecified relocation expenses, and $225,000 in startup costs for the data center relocation.[~~11~~] ~~In that filing, NERC also stated that it expected to incur further relocation expenses gradually in 2012 and 2013, and that it would end the relocation no later than May 2013.~~[~~12~~][12] NERC indicated that it would fund the balance of the relocation using working capital reserves. In that filing, NERC also stated that it expected to incur further relocation expenses in 2012 and 2013, and that it expected it would complete the relocation no later than May 2013, the date of the expiration of the lease for its headquarters space in

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

~~[11] North American Electric Reliability Corporation, Request, Docket No. RR10-13-000 (filed Aug. 24, 2010) (submitting its 2011 business plan and budget, for approval) at P 34 and P 86.~~

[12] ~~*Id.*~~North American Electric Reliability Corporation, Request, Docket No. RR10-13-000 (filed Aug. 24, 2010) (submitting its 2011 business plan and budget, for approval) at P ~~50.~~34 and P 86.

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Princeton, New Jersey.[13] Given that (1) the NERC Board approved the headquarters relocation in June 2010, a short time before the 2011 budget needed to be completed for filing with the Commission, and (2) NERC was in the early stages of implementation of its relocation strategy and was not able to project relocation costs with a sufficient level of certainty or develop more detailed cost estimates in time to include in the 2011 budget filed with the Commission, NERC did not include an estimate of the total costs of the relocation in its 2011 budget submission.[13][14] However, NERC spent a total of $6,540,000 on the relocation in 2011, completing

NERC completed the entire headquarters and data center relocation efforts and the majority of the Washington, DC, office expansion during that year. Audit staff's analysis of NERC accounting records revealed2011. NERC spent a total of $6,375,000 on the relocation in 2010, 2011 and 2012, including $747,000 of recorded rent expense that was abated and did not require a cash expenditure. Of this total amount, $1,953,000 was for the costs of the data center facility relocation. Additionally, NERC received significant rent abatement and tenant improvement allowances in 2011 and 2012 for its new office space in Atlanta under the terms of that lease, as well as access to significant furnished temporary space in the same building free of charge. NERC also negotiated free temporary space and a significant tenant improvement allowance in connection with its new space in Washington, D.C. which was need to accommodate NERC's additional Washington-based staff given limitations with its former Washington office space. Actual and projected budget impacts of the relocation were included in the quarterly variance reports that NERC posted in its website and reviewed at open meetings of the NERC Board's Finance and Audit Committee. Although NERC used working capital reserves in 2011 to fund a substantial portion of the office relocation costs, NERC did not find it necessary to include a component in its assessment to load-serving entities for 2012 to increase or restore its working capital reserve.[15]

NERC provided audit staff with an analysis that showed that approximately $3,278,000 of NERC's additional expenditures over the budgeted amount to fund the relocation came from unused funds redirected from other approved budgeted activities. Since NERC had no guidelines placing limits on the use of such available funds, audit staff believes that NERC elected to use them for its relocation.Audit staff believes that working capital should be usedhigher than projected balances of working capital reserves which, as noted, resulted primarily from under-runs in costs incurred for personnel expenses. Working capital reserves are maintained both to cover short-term operating cash flow

[13] *Id.* P 50.

[13][14] *Id.* P 50.

[15] *Request of the North American Electric Reliability Corporation for Acceptance of its 2012 Business Plan and Budget and the 2012 Business Plans and Budgets of Regional Entities and for Approval of Proposed Assessments to Fund Budgets*, Docket No. RR11-7-000, filed Aug. 24, 2011 ("2012 ERO Budget Filing"), at 53-54.

31 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

concerns due to timing differences between when expenses are paid and when funding is received~~.~~, and to provide readily available funds to meet unforeseen expenditures.[16] In interviews, NERC officers stated that working capital reserves are seen more as contingency funding, used for unexpected expenditures (e.g., an unanticipated event investigation) and for projects that were not finalized at the time of the budget filing but came to fruition during the operating year. Audit staff believes that a distinction needs to be made between reserves needed for continuing operations (working capital reserves) and reserves needed for contingencies (contingency reserves). Audit staff also believes that NERC should use the Commission-approved process set forth in section 39.4(d) of the Commission's regulations for requesting additional funding for projects that are initiated or completed outside of the budget cycle, where an additional or supplemental assessment to LSEs is needed due to insufficient funds or to maintain an adequate working capital reserve. This process exists not merely to provide NERC ~~funding for~~with the ability to collect an additional or supplemental assessment to fund an activity, but also to give the BOT, the Commission, and stakeholders a chance to evaluate ~~and~~the activity and for the BOT and the Commission to approve the ~~activity~~expenditure and the associated additional or supplemental assessment.

~~Significant~~ Deviations from Budgets

Audit staff identified some ~~significant~~ deviations between the budget formulation and execution phases of NERC's budget process that resulted in ~~divergence from budgeted expenditures~~funds being expended on items which were not specifically identified in NERC's budget. Audit staff believes NERC operates as if the approved budget sets a cap under which NERC ~~may redirect~~management may exercise considerable day-to-day discretion in the management of its budgeted resources ~~without disclosure to the BOT, the Commission, and stakeholders prior to expending such funds~~and activities. Rather than retain ~~these funds~~excess working capital to offset future assessments or seek approval to use these funds, NERC expended the funds as it ~~saw fit~~deemed necessary, either on activities or projects that were not specifically approved through the budget process, including activities or projects the need for which was identified or arose after the budget for the year was finalized, or on approved projects that were budgeted at levels significantly below what NERC actually ~~expended~~needed to expend on them.

For a variety of reasons during the operating years, NERC has been unable to expend funds according to the proposed expenditures it presented in its budget. Some of these reasons include: (1) an inability to use approved ~~fulltime~~funding for full-time equivalent (FTE) ~~funding~~positions because NERC is ~~unable~~operating in a tight market to attract ~~suitable~~qualified candidates in ~~a timely fashion~~the time frames assumed in the budget; (2) unanticipated resignation of staff members; and (3) fewer industry participants than projected when formulating the budget. Moreover, NERC must reprioritize its

[16] 2010 ERO Budget Order at P 24.

 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

planned activities to address unanticipated events that occur during the operating year after budget approval. While audit staff recognizes these possible disconnects between budget formulation and execution, we believe NERC should develop more robust procedures to allow the BOT, the Commission, and stakeholders to see, and the BOT and Commission to approve where appropriate, how unused funds are redirected during the operating year.

Increased Granularity of the Budget

NERC's budget filings are broken out into the functional categories that were approved by the Commission when NERC was certified as the ERO, and as amended in subsequent Commission orders. ~~While this~~This breakdown may be useful to examine cost trends over time; however, NERC's operational structure has notably evolved since it first became the ERO. NERC currently engages in reliability activities that span multiple functional areas ~~(i.e., a matrix environment). As a result, it is~~. While NERC tracks costs and provided audit staff with copies of monthly variance reports by department and Program Area, as well as publicly posts and reviews quarterly variance reports by Program Area with its Finance and Audit Committee, audit staff found it difficult to understand the amount and level of NERC's funding expended on general functional areas, much less on specific activities, taking into account cross departmental support. Audit staff believes that budget reporting at a more granular level would allow for a greater understanding and appreciation by the BOT, the Commission, and stakeholders of the reliability activities NERC is undertaking and the costs associated with them. For example, other sections of this audit report indicate specific areas that audit staff has identified as warranting a more detailed level of reporting than is currently provided in the budget process.[~~14~~17]

An example of an area that audit staff believes needs more granularity in budget filings is the manner in which the total cost of BOT oversight responsibilities is reported. While NERC separately reports Board of Trustee members' compensation, this is only a portion of the actual costs of providing BOT oversight to the ERO. Reporting the costs associated with holding periodic board meetings (e.g., hotel conference facility charges), the costs of the various BOT committee meetings that are convened, BOT travel expenses for attending BOT and Regional Entity board meetings, and other BOT-related costs as elements of total BOT expenses would allow greater attention to be focused on this important element of the NERC budget. (See Finding 5 below.) This level of granularity would provide greater opportunity to the BOT, the Commission, and stakeholders to

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[~~14~~17] For example, Finding ~~5 recommends that BOT entertainment expenses not be recorded as general business expenses, Finding~~ 7 deals with employee expenses that need to be separately reported and Finding 10 concludes that expenses for employee ~~entertainment~~rewards and recognition should be presented as a discrete line item in the budget.

33 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

review and comment on costs directly incurred by the ERO with an effort to increase efficiency and effectiveness.

~~Audit staff also found that NERC was directed to file true-ups~~In accordance with Commission orders, NERC files annual true-up reports with the Commission to provide the Commission and stakeholders with information that will help in analyzing the following year's budget.[~~15~~18] ~~Reviewing~~To date, all of NERC's annual true-up filings have been accepted by the Commission. However, reviewing these true-up filings, audit staff ~~discovered that~~experienced difficulty in following actual expenditures in the budget true-up filings ~~was difficult~~ because of the lack of granularity in reporting certain expenditures, the ~~redirection~~use of funds for other budgeted activities, and the funding of unbudgeted programs. This difficulty diminishes the usefulness of true-up filings for informing the following year's budgets. In line with improved transparency and granularity in the budget approval process, audit staff believes the annual budget true-up filings should be reported with a degree of granularity that is similar to the initial budget request. True-up filings should clearly ~~distinguish which projects came in under budget, which projects had funds redirected to other programs and the effect of those redirections, and which unbudgeted projects were funded~~explain variances in projected costs with the same level of detail contained in the budget or as otherwise specified by the Commission, including the use of funds for activities not specifically set forth in the budget.

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

Recommendations:

We recommend that NERC:

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

2. ~~Develop a transparent process that permits~~Continue to make improvements in budget transparency that informs the Commission, the BOT and stakeholders ~~opportunity for authorizing~~concerning the expenditure of funds approved for specific budgeted statutory activities ~~to be redirected to~~on unbudgeted activities, and develop and obtain Board approval of guidelines

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[~~15~~18] *North American Electric Reliability Corporation*, 121 FERC ¶ 61,057 at P 23 (2007).

34 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

governing such expenditures, including criteria for determining when Board approval is required;

3. ~~Request budgetary funds for activities initiated between budget cycles that were not included in the annual budget filing in accordance with section 1108 of the NERC Rules of Procedure (ROP);~~[Deleted];

4. Increase the granularity of the NERC budget filings by: (1) breaking out ~~significant cost categories in its expenses; (2) identifying proposed budgeted expenditures, at a minimum, on a project specific basis; and (3~~budgeted expenses, such as budgeted contractors and consultant expenditures, into more detailed cost categories; and (2) separating working capital reserves needed for operations from working capital reserves needed for contingencies and identifying those contingencies to the extent they are known during business planning; and

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

 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

2. NERC Oversight of the Regional Entities' Budgets

NERC's current process of reviewing Regional Entities' budgets ~~is inadequate and lacks appropriate~~would benefit from further qualitative procedures to efficiently and effectively assess Regional Entities' annual budgets. Greater qualitative oversight in this area may improve the efficiency and effectiveness of the ~~process, yielding savings for the ERO~~Regional Entity business plans and budgets, and may identify cost reduction possibilities in some areas while identifying the need for Regional Entities to budget and expend additional resources in other areas.

Pertinent Guidance

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

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

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

In addition, the Commission reiterated in Order No. 672 that the ERO may delegate its enforcement activities to the Regional Entities.[~~16~~19]

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

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

[~~16~~19] Order No. 672, 114 FERC ¶ 61,104 at P 23.

36 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

> Accordingly, the ERO must exercise budgeting oversight over the Regional Entities.

On April 4, 2006, NERC filed its Rules of Procedure with the Commission.[~~17~~20] The Rules of Procedure include a section on Submittal of Regional Entity Budgets to NERC (section 1104). In the filing, NERC's section 1104.2 stated NERC will presume each regional entity's budget is reasonable if their governing body has approved the budget for submission to NERC. However, a Commission order addressed the issue of the reasonable budget of the regional entity:

> NERC has not provided sufficient rationale for the provision that would establish a presumption of reasonableness by the ERO of a Regional Entity's budget if the Regional Entity's governing body has approved its budget. We believe that this proposed provision could hinder the ERO's ability to conduct a meaningful review of the proposed Regional Entity budgets as contemplated by Order No. 672 and is inconsistent with the overarching goal of establishing a strong ERO. Accordingly, we direct NERC to remove this provision from the *pro forma* delegation agreement…We agree with the California Commission that the budget should provide for performance and funding of reliability functions that are essential for maintaining overall reliability, that the way to accomplish this is by having the ERO review the budget and, where necessary, suggest or make changes and not presume the budget and thus the activities to be reasonable.[~~18~~21]

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

> We direct NERC and the Regional Entities to examine the various activities proposed by each Regional Entity to be performed under each statutory function, and to determine what activities need to be performed consistently across the Regional Entities. They should develop their budgets for 2008 to reflect the best practices found from this examination.[~~19~~22]

[~~17~~20] North American Electric Reliability Council and North American Electric Reliability Corporation, Application, Docket No. RR06-1-000, (filed Apr. 4, 2006) (requesting certification as the Electric Reliability Organization).

[~~18~~21] *North American Electric Reliability Corporation*, 116 FERC ¶ 61,062 (2006), *order on reh'g*, 118 FERC ¶ 61,111 at P 203 (2007), *order on compliance filing*, 118 FERC ¶ 61,257 (2007), *order on reh'g*, 119 FERC ¶ 61,257 (2007), *order on reh'g*, 120 FERC ¶ 61,260 (2007).

[~~19~~22] North American Electric Reliability Corporation, 117 FERC 61,091 (2006).

37 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

Background

NERC is responsible for ensuring that funds collected under section 215, including those funds allocated to the Regional Entities, are being used efficiently and effectively. ~~To~~Audit staff's observation is that, to date, NERC's review of the Regional Entities' budgets primarily consisted of ensuring that across the regions: (1) similar costs are reported in a uniform manner; (2) staffing (FTEs) and funding are consistently distributed between major program components; (3) increases and decreases in proposed budgets and staffing by program area compared to the previous year's budgets are adequately explained; (4) variances between regions appear reasonable; ~~and~~ (~~4~~5) stakeholder comments received from the budget review process are incorporated; (6) narrative explanation of programs, staffing and initiatives are reasonable and complete; and (7) where applicable, statutory and non-statutory costs are properly separated. Audit staff noted that NERC's method of review is in accordance with its Rules of Procedure, and that in recent budget cycles NERC has improved consistency by coordinating with Regional Entities to develop a common set of assumptions. However, with maturation of the ERO, audit staff believes, as discussed in greater detail below, that NERC should conduct more focused reviews to oversee Regional Entities adequately, and to ensure their budgets are sufficient to accomplish duties delegated under section 215 in an effective and efficient manner.

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

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

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would improve NERC's oversight of the Regional Entity CIP audit program budgets and promote consistency among Regional Entity execution of their delegated duties.

Audit staff further believes NERC should address the significant costs incurred by the Regional Entities for processing compliance violations. NERC's review of Regional Entity budgets for violations processing did not include: (1) a review of the policies and procedures used by Regional Entity staff or (2) examination of the training and qualifications of the staff processing the violations. ~~Without~~While audit staff recognizes that NERC oversight of Regional Entity processing of violations occurs on an ongoing basis through the Compliance Program rather than through the budgeting (Finance and Accounting) function, nonetheless, without considering these important aspects~~,~~ as part of the budget process, audit staff believes NERC was unable to provide effective guidance and oversight to the Regional Entities in the development of their business plans and budgets to ensure consistency across the regions and efficiency of this delegated responsibility. Greater qualitative oversight in this area may improve the efficiency and effectiveness of the process, yielding significant savings for the ERO.

NERC has recently taken steps to address the costs incurred and the amount of time spent by the Regional Entities for processing compliance violations, by implementing the "Find, Fix, Track and Report" (FFT) and the "Spreadsheet Notice of Penalty" enforcement alternatives to the development of a full NOP for every Alleged Violation.[23] In approving the proposal, the Commission stated that NERC's proposal "will be the first step to a more efficient and effective compliance and enforcement process"[24] and that "we believe that the FFT proposal may significantly reduce the time and resources needed to resolve minor possible violations of Reliability Standards and thereby permit NERC and the Regional Entities to reprioritize their compliance efforts toward more important violations and matters."[25] Earlier, NERC had adopted other approaches to improve the efficiency of violations processing and dispositioning, including an Abbreviated Notice of Penalty Format, a Deficiency Notice of Penalty Format, and an Administrative Citation Notice format. The Commission stated that the Abbreviated Notice of Penalty Format and Deficiency Notice of Penalty format "have been successful in increasing efficiency" and that it expected the Abbreviated Citation Notice Format "will be a successful tool in improving the efficiency of NERC's enforcement process, thereby reducing the time and

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

[24] *North American Electric Reliability Corp., Order Accepting with Conditions the Electric Reliability Organization's Petition Requesting Approval of New Enforcement Mechanisms and Requiring Compliance Filing*, 138 FERC ¶ 61,193 (2012) ("FFT Order"), at P 41.

[25] FFT Order at P 40.

39 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

resources expended by the Regional Entities, NERC and Commission staff while still achieving transparency and consistency in penalty determinations for violations that are appropriate for this format."[26]

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

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

Recommendations

We recommend that NERC:

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

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

8. Provide budget changes and recommendations to the Regional Entities during the ~~preliminary~~early stages of the Regional Entity budget processes

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

40 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

so there is sufficient time to incorporate NERC's recommendations prior to final review and approval of such business plans and budgets by the Board.

41 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

3. Time Reporting and Accounting System

NERC's historic systems and method for reporting and tracking employee time and expenses ~~failed~~had limited capability to~~:~~ track time and attendance on ~~a~~an activity- or project-specific basis~~, or properly classify expenses in its accounting system at a level that provided sufficient transparency to permit effective budget oversight. These deficiencies were due to NERC's lack of adequate procedures for reporting and tracking employee time and insufficient functionality implemented in its accounting system. These shortcomings resulted in inefficient and ineffective~~ within NERC's defined Program Areas, or allow for the accounting of expenses at an activity- or project-specific level. Enhancements to NERC's time reporting and accounting systems, if justified by cost-benefit analysis, would facilitate improvements in budget oversight, time and expense tracking, and control over cost.

Pertinent Guidance

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

18 C.F.R. § 39.4 sets out the requirements for funding an ERO. Specifically, section 39.4(b) addresses ERO annual budget requirements.[~~20~~27]

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

> "~~Proper charges of personnel expenses~~From a financial accounting and reporting perspective, the NERC System of Accounts provides a sufficiently detailed set of Functional Categories and Accounts to result in proper recording of income and expenses by function/activity and type. For example, each item of expense received or incurred by NERC or a Regional Entity (e.g., invoices received for services and products, disbursements for salaries, payroll tax payments and medical benefits, and so forth) must be coded by Functional Category and Expense Account and then recorded accordingly in the entity's general ledger. In addition, proper charging of Personnel Expenses (including Salaries, Payroll Taxes, Employee Benefits and Savings and Retirement expenses) incurred by employees whose activities involve more than one ~~f~~Functional ~~c~~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

[~~20~~27] *See supra* text accompanying note 9.

42 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

time spent during the reporting period on activities in each Functional Category."[21][28]

In that filing, NERC submitted for Commission review NERC's proposed System of Accounts and provided a detailed description of the NERC System of Accounts. The filing was accepted by the Commission with no directives for additional detail or further changes to the NERC System of Accounts.[29]

Background

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

Tracking of Employee Time

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

Audit staff noted that in an April 1, 2008 response to the Commission's 2008 ERO budget order, NERC indicated the existence and use of agenerically described the various time reporting systems used by NERC and the Regional Entities by stating that "proper charging 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 employees were "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

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

[21] North American Electric Reliability Corporation, Filling, Docket No. RR07-16-003 at P 7 (filed Apr. 1, 2008) (responding to the Commission's 2008 ERO Budget Order[29] *Order Conditionally Accepting Compliance Filing*, 123 FERC ¶ 61,282 (2008).

43 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

Functional Category~~.~~,." The "Functional Categories" NERC referenced were originally equivalent to the operating divisions, i.e., the statutory Program Areas existing when the order was issued. ~~Thus, audit staff understood that in this filing NERC committed to maintain a reliable contemporaneous record of the time spent by each staff member on each Commission-approved function. Tracking of hours to this~~In audit staff's view tracking of hours to the level of detail described in the April 1, 2008 filing would facilitate ~~more~~ accurate and effective budget formulation and oversight.

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

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

- ~~Evaluate the effectiveness and efficiency in achieving statutory goals;~~
- ~~Submit a budget with sufficient detail to show NERC's statutory projects and activities;~~
- ~~Assist the development of core competencies required for the hiring process;~~
- ~~Track the actual effort being expended on specific projects;~~
- ~~Track and evaluate individual employee performance;~~

 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

- ~~Analyze and report on differences between incurred costs and budgeted amounts; and~~

- ~~Facilitate the development of meaningful position descriptions reflecting actual work performed.~~

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

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

NERC Accounting System

Audit staff found ~~deficiencies~~opportunities for improvement in NERC's ~~implementation of its~~ accounting and expense reporting software. These ~~deficiencies~~opportunities for improvement became apparent during the audit as NERC expended an excessive amount of time and effort to respond to certain basic requests for

45 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

data. For example, NERC was unable to readily produce records of all expenses incurred for any given event, such as a BOT meeting, or travel for a specific audit. ~~These requests required NERC~~While BOT meeting costs are budgeted and tracked separately, employee travel, meal and lodging expenses to attend BOT meetings are not budgeted or tracked as part of BOT meeting expenses and are instead budgeted and tracked by department with other employee travel, meal and lodging expenses. In order to gather information regarding the total cost of BOT meetings, NERC was required to conduct an analysis of individual expense reports to aggregate the necessary data, as NERC had no software functionality in place to efficiently aggregate the costs of a given event. Audit staff believes that NERC ~~must improve its accounting software by using: (1)~~should conduct a cost-benefit analysis of implementing project-specific and business activity codes when recording expenses~~, and (2)~~. NERC should also implement improved automated flags to alert internal users, as well as reviewers, of possible data entry problems and violations of NERC's policies and procedures.

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

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

 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

Recommendations

We recommend that NERC:

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

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

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

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

13. ~~Implement functionality in the expense reporting software to allow the tracking of expenses on a project and activity basis;~~As part of its business plan and budget, in 2013 conduct a cost-benefit analysis of implementing project level budgeting and accounting systems;

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

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

47 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

4. Employee Compensation

~~NERC used studies to determine~~There were numerous weaknesses in the compensation studies conducted by NERC prior to the more recent compensation study conducted for NERC in late 2011-early 2012. This was in part due to the lack of adequate funding for these studies which in turn limited the scope and depth of the studies. At the direction of the Corporate Governance and Human Resources (CGHR) Committee of the NERC Board in 2011, NERC commissioned new, more comprehensive compensation studies, conducted by a nationally-recognized employee compensation consultant, regarding employee compensation levels ~~that did not have adequate support to justify the reasonableness of compensation NERC paid its officers and staff. Audit staff is concerned~~. These studies were completed in late 2011-early 2012. The new studies were designed to address a number of weaknesses which existed with prior studies which, as noted, were in part due to the lack of adequate funding for these studies. While the new studies are a significant improvement over the previous studies, audit staff believes that NERC should periodically update these studies. Audit staff also believes that NERC ~~has not systematically assessed~~would benefit from a more systematic assessment of its organizational staffing needs to determine the core competencies and skill sets required of employees. ~~This weakness occurred in part because NERC did not contract for an adequate compensation study. As a result, NERC incurred considerable personnel costs funded by end-users under section 215.~~

Pertinent Guidance

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

18 C.F.R. § 39.4 sets out the requirements for funding an ERO. Specifically, section 39.4(b) addresses ERO annual budget requirements.[~~22~~30]

Background

Since becoming the ERO, NERC grew from an organization with approximately 70 employees in 2006 to over 175 budgeted employees in 2012. Examination of NERC's budgets showed that ~~employee compensation~~Personnel Expenses (i.e., salaries, payroll taxes, employee benefits, and retirement) dramatically increased during this growth period.

[~~22~~30] *See supra* text accompanying note 9.

48 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

~~Employee compensation~~Personnel Expense is the largest cost category in the NERC budget, amounting to $30.1 million in 2012, representing 61.4 percent of the budget.[~~23~~31]

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

In November 2008, the BOT established and approved a process for determining compensation levels for the CEO, executives, and employees (Compensation Policy).[~~24~~32] This document outlines the process guiding the BOT's consideration of employee compensation levels. The essential element of this process is the need for reliable "comparability data" by which to measure remuneration.

During the ~~audit~~ period covered by this audit, NERC contracted ~~four~~three independent firms to conduct ~~eight~~a total of four compensation studies. NERC ~~meant~~'s intent was that the compensation studies ~~to~~would provide guidance on compensation levels and benefits for the CEO, executives, and employees. Given the nature of NERC's role as the ERO, audit staff believes that detailed compensation studies should take NERC's functional and operational responsibilities into consideration to determine the most applicable comparability data. However, NERC appropriated a relatively low level of funding to the ~~first six~~2011 staff and management compensation studies it commissioned, resulting in insufficient analyses and inadequate "comparability data." While audit staff does not believe that more funding would necessarily produce higher quality studies, nonetheless, in audit staff ~~believes the lack of sufficient funding is an indicator of the relative importance that NERC attributed to the studies. Audit staff is concerned that the low level of funding coupled with NERC's lack of attention and control over the assumptions used in the studies led to the inclusion of companies in the compensation studies that did not operationally correlate to NERC. These studies~~'s opinion, the 2011 studies prior to the more recent studies which were completed in 2012 provided limited

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[~~23~~31] North American Electric Reliability Corporation, Request, Docket No. RR11-7-000 at Attachment 2 at page 25 (filed Aug. 24, 2011)(submitting the 2012 business plans and budgets of NERC and Regional Entities for acceptance and Proposed Assessments to Fund Budgets for approval)

[~~24~~32] Process for Determining Annual Compensation of Independent Trustees, Chief Executive Officer, Other Officers, and Key Employees, November 13, 2008 (http://www.nerc.com/files/Process%20for%20Determining%20Annual%20Compensation.pdf).

49 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

relevance and usefulness as "comparability data" and lacked the substance needed to provide reasonable compensation comparators for NERC staff and BOT to make appropriate compensation decisions. ~~As one NERC executive characterized these efforts: "You get what you pay for."~~ The following table describes the compensation studies NERC undertook to establish a basis for CEO, executive, and employee compensation levels:

NERC Compensation Studies

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

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

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

~~*2011 Executive and Staff Compensation Study*~~

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

51 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

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

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

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

~~*More Recent Compensation Studies*~~

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

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

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

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

NERC was dissatisfied with the Executive and Staff Compensation study and benefits study conducted in early 2011, primarily because the consultant did not have data for, and therefore did not include, many representative companies that NERC was recruiting from or targeting to recruit from. NERC decided that there was no value to trying to improve these studies given the year-end timing of compensation decisions and the weakness of the relevant market data available in the studies. Therefore, NERC commissioned Mercer Group, Inc., an internationally-recognized compensation consulting firm, to conduct a new set of compensation studies. Mercer conducted separate compensation studies relating to NERC executive direct compensation, executive

retirement and supplemental benefits, and NERC staff total compensation. When the studies were completed, the NERC Board met with Mercer in a six-hour meeting, a portion of which was without management present, in February 2012 to review the studies, and then held a meeting with management to give specific direction on how the results of the studies should be implemented.

~~For the study of total compensation and rewards for NERC staff, the Mercer report found that total cash compensation was in line with or above market levels~~Audit staff had concerns with respect to the January 2011 Executive and Staff Compensation Study and the more recent Mercer Studies. With respect to the January 2011 study, audit staff believes that the study had several flaws, including treating companies from outside the electric sector as comparable and having limited supporting data. With respect to the Mercer study, audit staff also had concerns with respect to the companies that were treated as comparable, particularly with respect to the size (in revenue) of such companies. While audit staff has not ~~received and~~ evaluated all of the Mercer study's supporting materials, including the list of comparators used, audit staff notes that at the time the audit began NERC had only just begun to ~~a~~ systematically analyze staffing positions within NERC and rewrite employee job descriptions. Audit staff believes these elements are important in determining total staff compensation, as they are used to determine the necessary skills each position requires and ensures the descriptions reflect the necessary skills and competencies. Absent this process being completed, audit staff believes making appropriate comparisons of compensation would be difficult, even if appropriate comparables were applied.

Recommendations

We recommend that NERC:

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

17. ~~Contract for new~~Continue to perform routine and periodic updates to employee compensation studies ~~that use~~, using comparability data that target the required skill sets and competencies needed to carry out NERC's mission as the ERO~~. Submit the compensation studies with audit staff upon completion~~; and

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

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5. Standard for Determining the Reasonableness of Expenses

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

Pertinent Guidance

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

18 C.F.R. § 39.4 sets out the requirements for funding an ERO. Specifically, section 39.4(b) addresses ERO annual budget requirements.[~~25~~33]

Background

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

[~~25~~33] *See supra* text accompanying note 9.

55 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

Expenses Incurred by NERC Employees

During its review of NERC's accounting software and records, audit staff selected a sample of accounting records and reviewed the supporting documentation. Audit staff's sample identified various instances of noncompliance with NERC's policies and procedures, including missing documentation, misclassified expenses, and unusually expensive meals and hotels. These instances revealed inadequacies in the current practices and the need for improvement in NERC's existing cost controls over expense reporting, tracking, and accounting.

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

Meal Expenses

Audit staff's examination of meal expenses from meetings attended by NERC and Regional Entity staff and others found that NERC paid for ~~meals that were beyond what NERC considers reasonable.[26] For the sample period February 2011 through December 2011, audit staff analyzed documentation supporting meal expenses that were incurred at NERC meetings and in connection with travel, and observed that the cost of meals range up to $126 per attendee with numerous meals ranging above the $50 threshold trigger point.~~dinners that sometimes exceeded $50 per person.[34] During interviews, audit staff

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

[34] Although NERC's policies reference the term "reasonable" without defining it, based upon interviews and expense reporting practices a reimbursement request of $50 or more is a trigger for verifying that all attendees at the meal have been identified in the reimbursement request documentation. NERC's expense accounting software prompts the user to input a list of attendees for any meal expense entered into the system that exceeds $50 incurred. Additionally, an email dated November 2010 from the CEO to senior NERC

56 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

was informed that NERC sometimes rewarded its staff ~~by paying for high-priced meals. NERC approved these employee entertainment~~for additional or extraordinary efforts by taking the employees to dinner. An example given was that members of the IT staff who had worked additional hours over a period of time to complete the data center relocation were taken to dinner in appreciation of their efforts. Further, NERC recorded these dinner expenses as routine business expenses, which audit staff believes was inappropriate. When another employee dinner of this ~~topic~~type was discussed with the CEO, he was not aware of this matter and agreed that such costs were in excess of the guidance he provided and some of the costs should not have been ~~incurred. Therefore, it is clear~~occurred. In this particular instance, the CFAO stated that he counseled the manager who had taken his staff to dinner concerning the cost of the dinner. Therefore, the existing policies, procedures, and controls in place ~~were inadequate to~~did not prevent the costs of these ~~costs~~dinners from being included for ~~recovery~~reimbursement as approved business expenses~~. Due to this lack of formalized guidance, other~~, or incurred in the first place. Other senior management allowed the practice to occur and only "spoke to" employees incurring excessive costs without requiring assumption of personal responsibility for the excess cost. These admonishments were not documented, and audit staff questions their effectiveness. In further discussions about the matter, the CEO stated that employee rewards for performance ~~should~~could be made in more transparent categories, such as salaries or bonuses. Audit staff believes that the development of formalized guidance for the ~~entertainment~~recognition and reward of employees is necessary to ensure costs are appropriate and transparent.

Hotel Expenses

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

Audit staff believes it is very important for NERC to have a well-documented standard of reasonableness of costs in this area to achieve effective cost controls and provide guidance to its staff as to cost guidelines and limits, and the types of employee costs that are reimbursable from NERC. NERC can also benefit from additional policies, procedures and controls on travel-related hotel expenses.

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managers indicating that he would expect "staff would consider $50 to $60 per person to be a high-end dinner."

57 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

Review of Employee Expenses

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

Employee Recruitment

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

~~In discussions with NERC staff, audit staff learned that all NERC employee contracts were "at will," meaning NERC or the employee may terminate employment at any time, without cause. Rather than formal employment contracts, NERC detailed employment terms in offer letters or Memorandums of Understanding (MOUs). When audit staff inquired about the use of "at-will" contracts, NERC executives stated that NERC used this approach prior to certification as the ERO, and that these arrangements provided flexibility in the recruitment process. However, audit staff reviewed various offer letters and MOUs and noted significant accommodations offered to candidates. In discussions with NERC staff and its review of accounting records, audit staff was concerned by the lack of accountability for these costs exercised by NERC. Since these~~

costs are not required to be linked with any assurance that the candidate's services will be retained for any specific period of time such costs may not result in value being provided to the ERO. Therefore, maintaining NERC's accountability in incurring these costs to achieve a specific outcome (i.e. the recruitment and retention of the candidate) has not been done by NERC to date.

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

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

Employee Retention

In conjunction with its headquarters relocation in 2011, NERC gave certain support staff retention bonuses to incentivize them to remain at NERC through the relocation. The

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

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

Audit Staff reviewed several individual employee arrangements and had several concerns. For example, some employees were offered recruitment bonuses but there was no requirement that the employee remain with NERC for any set period of time. Also, with respect to retention bonuses associated with the relocation to Atlanta, staff was concerned that there was not sufficient transparency or documentation by which those bonuses were provided.

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

Recommendations

We recommend that NERC:

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

20. ~~Divide its process for approving expenses into two steps, leaving managers responsible for approving the purpose and rationale for incurring expenses, and designating accounting staff to be responsible for evaluating the reasonableness of expenses; and~~[This recommendation is deleted because it is subsumed in Recommendation 19]; and

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

61 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

6. Employee ~~Entertainment~~Reward and Recognition Expenses

NERC ~~did not have adequate~~should adopt additional policies and procedures ~~governing~~and provide increased budget transparency regarding employee ~~entertainment~~reward and recognition expenses. ~~These~~Existing policies and procedures ~~were~~are deficient ~~as follows~~in that:

- NERC did not have formal guidance for determining if ~~entertainment~~such expenses were reasonable and reimbursable; and
- NERC ~~paid approximately $74,000 and $109,000, respectively for office holiday parties~~incurred expenses for year-end employee dinners in December 2010 and December 2011 ~~(Holiday Galas)~~ that were neither fully nor transparently budgeted for~~; and~~
- ~~NERC did not properly account for employee entertainment expenses, including those of the Holiday Galas.As a result of these inadequacies, the Commission, stakeholders, and other interested parties did not have the necessary information to comment on and approve these expenses, and consequently NERC used budgeted funds for expenses not represented in NERC's budget~~.

Pertinent Guidance

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

18 C.F.R. § 39.4 sets out the requirements for funding an ERO. Specifically, section 39.4(b) addresses annual budget requirements.[~~27~~35]

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

> 62000 - Travel - This account shall include charges for expenses for employees, trustees, and contractors to travel to meetings and workshops in support of functional

[~~27~~35] *See supra* text accompanying note 9.

62 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

71000 - Telephone - This account shall include charges for telephone services (land lines and cellular)

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

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

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

Background

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

NERC ~~Holiday Galas~~Year-End Events

NERC incurred considerable expense for year-end meetings and employee ~~holiday parties~~dinners held in December 2010 ~~(2010 Gala)~~ and December ~~2011 (2011 Gala) (collectively referred to as the Holiday Galas). Audit staff's~~2011. NERC provided audit staff with an analysis ~~divided the Holiday Galas' costs~~dividing the costs of the year-end meetings and employee dinners into four main categories: travel costs ~~to and from the Holiday Galas~~, lodging ~~while at the Holiday Galas~~costs, the expenses of the ~~Holiday Galas~~dinner events themselves, and other expenses, as reflected in the following table:

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Expenses Incurred in Connection with ~~the Holiday Galas~~Year-End Meetings and Parties

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

~~Due to the way NERC accounted for these expenses, NERC was unable to readily identify the total cost of the Holiday Galas, which raised concerns about the way costs were recorded in NERC's books and records. For the 2010 Gala~~For the 2010 employee dinner, audit staff determined that NERC properly recorded in its books and records $35,127 of the ~~Holiday Gala~~dinner event expenses in Account No. 99000, Miscellaneous Operating Expenses under the General and Administrative function. However, NERC recorded the other costs ~~related to the Holiday Gala~~incurred during the same week as the employee dinner event, which included the travel, a portion of the lodging costs, gifts, and equipment, as approved business-related expenses in various operating expense accounts.[~~28~~36] Audit staff believes these ~~company-wide entertainment~~ costs should be recorded in Account No.

[~~28~~36] Travel Expenses: Travel – Account No. 62000; Office Costs: Telephone – Account No. 71000, Internet Expense – Account No. 71100; and Office Supplies – Account No. 71200

64 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

99000, Miscellaneous Operating Expenses. Additionally, audit staff believes NERC incorrectly recorded employee breakfast and award costs as travel expenses.

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

NERC's 2010 budget true-up filing stated that it was $65,954 over the $4,000 budget for Miscellaneous Operating Expenses under the General and Administrative function, and referenced a "provision for uncollected accounts receivable related to unpaid assessments and GADS Services" as the cause for the variance.[~~29~~37] NERC accounting records showed these items totaled $31,000. NERC ~~failed to mention~~'s explanation of the variance in this account did not include the variance resulting from the $35,000 of ~~Holiday Gala~~year-end employee dinner expenses, which appear to have accounted for ~~an even~~a larger portion of the variance. However, NERC did report a variance due to the 2011 year-end employee dinner costs in its 2011 Q4 variance report. Additionally, NERC's 2012 budget filing proposed to increase the budget for this account from $4,000 to $26,000 to account for "recent experience" without mention of funding for ~~its annual holiday party~~a year-end employee dinner event. Audit staff is concerned by the lack of transparency in NERC's budget and true-up filing for these expenses.

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

[~~29~~37] North American Electric Reliability Corporation, Report, Docket No. RR11-4-000, (filed May 31, 2011) (comparing budgeted to actual costs for 2010 for NERC and the Regional Entities).

65 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

dinner was in the midst of the training sessions that were held the day before, the morning of, and the day after.

Audit staff believes that for most public utilities regulated by the Commission, employee entertainment expenses as described in the above table are not generally recoverable from ratepayers but recorded as "below-the-line" expenses recovered from stockholders. However, NERC is a non-profit corporation with no shareholders and is subject to a cost recovery funding mechanism, and to protect ratepayers it is imperative that NERC not incur costs that have not been explicitly approvedthe electric industry entities that provide the funding, it is imperative that there be transparency with respect to any such expenses so that they may be considered appropriately in the budget review and approval process. For these reasons, audit staff believes employee entertainmentthese costs must be transparently presented in budgets and recorded in appropriate accounts, so the BOT, the Commission, and interested partiesstakeholders can review, and comment on, and the BOT and Commission approve whetherwhere necessary, such expenses should be incurred under section 215.

Recommendations:

We recommend that NERC:

22. Explicitly budget for employee entertainmentrewards and recognition expenses, if any, by including line items of sufficient granularity in the budget filings;

23. Use miscellaneous expense accounts to track entertainment expenses which are primarily social in nature, if any, separately from other business-related expenses in its accounting system;

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

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7. Board of Trustees Compensation and Entertainment

NERC ~~did not support its shift~~shifted to a ~~flat~~fixed-fee retainer plus expenses methodology of compensating its Board of Trustees (BOT), with ~~a time study based on actual~~the amount of the fixed fee dependent on the number of committees the Trustee sits on, whether the Trustee is a committee chair and whether the Trustee is also the chairman of the board. NERC's Board reviewed its proposed shift to a fixed fee retainer methodology at several open board meetings with stakeholders present. NERC also conducts annual surveys of the NERC Members Representative Committee (MRC) regarding BOT effectiveness. A consultant also reviewed and rendered an opinion in support of the fixed fee retainer methodology and associated Board compensation levels. Audit staff believes that in future compensation studies the Board should consider including a further evaluation of time spent by the BOT on BOT activities or a representative study of the ~~actual~~ time spent on these activities. Also, NERC incurred various expenses ~~to entertain BOT members outside the official BOT meetings. As a result, audit staff believes NERC's shift to a flat fee compensation methodology was not adequately supported, and the expenses incurred outside the official BOT meetings may have been improperly funded by end users under section 215.~~for dinners of BOT members during the evenings after BOT committee meetings and the evenings before BOT meetings. Audit staff believes these expenses should be more transparently set forth in NERC's annual budget to facilitate stakeholder and Commission review.

Pertinent Guidance

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

18 C.F.R. § 39.4 sets out the requirements for funding an ERO. Specifically, section 39.4(b) addresses ERO annual budget requirements.[~~30~~38]

Background

Board of Trustee Compensation

NERC compensated its BOT based upon a participation-based methodology from the inception of the ERO until January 2011. Beginning January 2011, NERC switched to a flat-fee plus expense methodology of compensating its BOT~~.~~, with the amount of the flat fee dependent on the number of committees the Trustee sits on, whether the Trustee is a

[~~30~~38] *See supra* text accompanying note 9.

67 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

committee chair and whether the Trustee is also the chairman of the board. In audit staff's opinion, NERC did not provide adequate support for the change in BOT compensation. In response to data requests and during onsite interviews, NERC staff stated that the BOT initiated the move to alter compensation and implied that the change was not initiated by or under NERC~~'s~~ control. NERC staff further indicated that it supported the change due to the administrative burden to NERC of providing compensation based upon meeting attendance. ~~Audit staff believes this burden was self-imposed by NERC's inadequate policies and procedures for tracking BOT time and meeting participation.~~ The study supporting the change in compensation methods consisted of a four-page report and two presentations to the BOT. The study was intended to deal with both the appropriate level of compensation and the manner in which compensation should be provided. The proposed change to a fixed fee retainer methodology was discussed at several open board meetings with stakeholders present. However, as discussed below, in audit staff's opinion, the study's report failed to accomplish either objective.

Level of Compensation

In November 2008, NERC's BOT established and approved a process for determining compensation levels, including levels for its BOT (Compensation Policy).[~~31~~39] The Compensation Policy outlined the process guiding the BOT's consideration of compensation at each level. Two elements of the trustee compensation process are the need for the BOT's Corporate Governance and Human Resources Committee (CGHRC) to~~:~~ evaluate the amount of work and level of responsibility the BOT is being asked to undertake, and examine comparability data of representative organizations as part of that review.

NERC commissioned an independent consulting firm in the spring of 2010 to conduct an Executive Compensation study based on data from other entities that it believed to be comparable with NERC. This consulting firm has an extensive compensation practice with the ISOs. However, in audit staff's ~~review of~~opinion, the data supporting the compensation study ~~revealed that it~~ did not address the first objective of the trustee compensation process and failed to meet the second. The data ~~supporting~~included in the study ~~were~~was sparse and ~~did not adequately address~~the report did discuss NERC's role in the electric industry, the complexity of the various entities' operations and structures, those entities' total budgets, and the degree of involvement (including actual hours worked or meetings attended) of those entities' trustees. Rather, the study's author included a list of comparators consisting of ISOs, RTOs, and Regional Entities to which surveys were sent. Only eight entities submitted data in response to the survey, with one of the responders not

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[~~31~~39] Process for Determining Annual Compensation of Independent Trustees, Chief Executive Officer, Other Officers, and Key Employees, November 13, 2008 (http://www.nerc.com/files/Process%20for%20Determining%20Annual%20Compensation.pdf).

68 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

providing compensation levels. The author relied on those eight responses and did not use publicly available data sources, such as IRS Form 990 annual filings that contain data on trustee compensation, to support the analysis. The author instead used ~~another~~the survey's results from ~~utility boards~~two nationally recognized compensation firms and its own ISO surveys to determine the baseline compensation recommendation.

In terms of competitive practice, the author concluded that the proposed total compensation retainers appear relatively conservative as compared to both utilities nationally and the ISO sector. The author concluded that the proposed 2010 NERC Level 1 trails the ISO median by 14% while the "Level 2" (serves on Compliance Committee, or serves as Committee Chair, or Serves on ESSG) and "Level 3" (serves on more than one of the Level 2 committees) and "Level 4" (Chairman of the Board) appear consistent with current practice for these additional responsibilities. In February 2012, the consultant performed a follow up study and reaffirmed its support for a flat fee board compensation structure, noting that in their 2010 review they cited research at that time showing that 20%-30% of companies were no longer paying meeting fees and that more recent surveys show this trend continuing. The author cited a 2011 survey of Director Compensation by The Conference Board found that 40% of non financial service firms (industrials) and 43% of financial service firms no longer pay meeting fees and that the 2011 survey by AonHewitt indicated that 51% of the organizations, across diverse industries, now use the retainer only approach .

~~When all of these factors are considered~~Despite the foregoing, audit staff questions the adequacy of the analysis supporting the compensation of NERC's BOT. NERC significantly increased the total and per-trustee compensation levels for the BOT despite the inadequacies in the analysis. This increase is depicted in the following table:[~~32~~40]

[~~32~~40] The 2008, 2009, and 2010 data is based on NERC's IRS 990 filings. The 2011 data is based on the new BOT flat fee structure in place for that year.

69 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

Average Compensation per Trustee

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

Manner of Compensation

As discussed above, in moving to the flat fee compensation approach in 2010, the Board obtained an evaluation from SMN Associates, a consulting firm on board compensation in the utility industry, which endorsed the annual retainer approach. Additionally, NERC staff provided audit staff a 2011 report by SpencerStuart, another leading executive search and compensation consultant, that reported that only 37% of boards are paid per-meeting fees, down from 72% in 2001 and 57% in 2006; and that 35% of companies pay fees for Board committee meetings, down from 68% in 2001 and 58% in 2006.[41]

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

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

70 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

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

~~Discussion with Compensation Firm~~

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

~~Audit staff believes the prior performance-based compensation method provided greater accountability by coupling compensation with participation in BOT activities. In the absence of accountability initiatives to support NERC's policy change, it appears switching to a flat-fee retainer reduced BOT accountability instead of reinforcing the appropriate role of the BOT. Audit staff notes that NERC has recently started working to integrate new software tools to better track, among other matters, BOT Committee meetings and the time and attendance of BOT members. This improved practice could greatly reduce the administrative burden of a participation-based compensation structure, a burden stated as one of the reasons NERC moved toward flat-fee retainers.~~

NERC stated that the Board compensation was changed to an annual flat-fee retainer because the objective of the Board compensation is to compensate the Board members for a full year's work attending to their responsibilities as Trustees, not to attend meetings. NERC also stated that considerable time is required of Trustees, and considerable work is performed by them, outside of the scheduled Board meetings and committee meetings, particularly in light of the considerable amounts of materials that the Trustees must read and review to prepare for meetings and to carry out their

responsibilities. Additionally, NERC has a process in place for surveys of members of the NERC MRC, which elects the Trustees, of the performance of the Board, to be conducted approximately annually. The assessment results are made available and are discussed at open meetings of the CGHR Committee and the Board. Additional reasons given for adopting the annual flat fee retainer method include: (1) To enable NERC to more accurately budget the annual expense for Trustee compensation, since each Trustee's projected compensation would be based on an annual fee. (2) To enable NERC to give potential candidates for current or upcoming Board vacancies a fairly accurate estimate of the compensation the candidate would receive as a Trustee, to help the candidate evaluate the Trustee position against other opportunities he or she may have. (3) To relieve NERC staff of the administrative burden of tracking each Trustee's attendance at meetings to keep track of the bases on which each Trustee's compensation would be based. (4) To remove the incentive inherent in the per-activity approach for more meetings or calls to be scheduled. (5) To eliminate the inequities inherent in the per-activity compensation system in which the same amount of compensation would be paid for a Board or committee conference that lasts 30 minutes as for one that lasts three hours or as for one that requires a full day. (6) To enable the Trustees to more accurately estimate their compensation, and therefore their estimated tax obligations, over the course of the year. In adopting the flat fee annual retainer approach, the Board committed to reviewing the approach (as well as the overall level of Board compensation) in one to two years.

BOT ~~Entertainment~~Meeting Meal Expenses

Audit staff sampled four months of BOT meetings by examining NERC's accounting records and found that NERC staff commonly hosted the BOT ~~at banquet-type dinner events that were separate and apart from the meals offered during normal business meetings~~dinners on the evenings between Board committee meetings and Board meetings, since the committee and Board meetings typically span a three-day period. Most of the costs involved with these events consisted of meal expenses (i.e., food and beverages) that ranged up to $146 per-person~~, which resulted in meal expenses well in excess of the "reasonable" level NERC provided as guidance to its employees.[33]~~. Also, these events included not only the BOT and NERC staff, but also on some occasions spouses or invited guests of attendees. NERC stated that the expenses for these dinners were appropriate travel-related expenses since, as noted, the Board meetings and related committee

~~[33] Audit staff notes that the term "reasonable" is not explicitly defined by NERC. However, the CFO stated that a cost of approximately $50 to $60 per person was the upper bound for a reasonable dinner meal, and NERC's expense reporting system triggers a prompt for a user to enter "additional attendees" if the meal cost entered is greater than $50.~~

72 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

meetings usually span more than one day, and depending on the schedules of events and meeting location, Board members may need to arrive in the city where the meetings are to be held on the evening prior to the first meeting. NERC also claimed that official business was ~~conducted at these events. However, audit staff found no evidence in NERC's board minutes or any other supporting documents showing that these events had a legitimate business purpose. In addition, audit staff examination revealed that some of the BOT members did not attend the events, and neither the Commission nor the public were invited to participate in these events if business was being conducted as NERC claimed~~discussed at these events. Audit staff believes that, while business may well be discussed at these gatherings, the primary purpose of the gatherings, as evidenced by the presence on occasion of spouses and guests, was social — to strengthen ties ~~between~~among the BOT members and among the BOT members and the senior management of NERC. Audit staff believes that such gatherings are within the discretion of NERC as a private corporation, but that funding for these activities must be clearly budgeted and approved ~~by the stakeholders~~ if it is to be paid from section 215 funds.

Audit staff notes that NERC did not record these meeting costs in any one particular account; rather NERC recorded the costs in various accounts as routine business expenses. ~~To~~In audit staff's opinion, to properly account for these costs in its books and records, NERC should have classified these costs in Account No. 99000, Miscellaneous Operating Expenses, instead of using several expense accounts to account for these costs. This accounting would also provide more transparency for these types of costs. NERC believes that the costs should be recorded in Account 62000, Business Travel Expenses.

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

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

only a small portion of NERC's budget, audit staff is concerned that the independence and integrity of the BOT members be carefully preserved.

Recommendations

We recommend that NERC:

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

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

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

28. ~~Conduct an analysis of BOT participation and effort based on a time study using actual time spent during BOT activities, or a representative study of the actual time spent and implement a compensation methodology that pays BOT members reasonably for performance of their duties;~~Continue to conduct periodic updates and review of the Board compensation model and compensation levels, taking into account Board time and participation on Board activities and market comparability data of appropriate comparator organizations;

29. ~~Estimate and include in its annual budgets an amount of funding to cover BOT entertainment expenses that it deems appropriate and seek approval for such funding;~~[Deleted – this recommendation is covered in Recommendation 30];

30. Track the ~~entertainment~~ expenses actually incurred for Board activities to the budgeted amounts for such expenses; and

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

74 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

8. ~~Pension~~Retirement Plans

~~NERC contributed 10 percent of salaries~~In connection with the conversion of NERC's defined benefit plan to a defined contribution 401(k) plan, which occurred prior to NERC becoming the ERO, NERC amended its 401(k) plan to provide for a contribution of 10 percent of compensation (salary and incentive) for each employee participating ~~in the pension plan, which is above energy sector norm~~. This 10 percent contribution was in addition to an up to 4.5 percent matching contribution for employees participating in NERC's 401(k) plan. Audit staff believes the 10 percent contribution component is above industry norms. NERC stated that the 10 percent contribution component was included because, as a nonprofit corporation, NERC cannot offer profit-based compensation components as can the for-profit entities with which NERC competes for employees. Also, NERC included bonuses as well as base salary in its determination of its ~~pension~~additional contribution obligations for employees. In addition, ~~NERC paid excess amounts above the allowable IRS limit for pension contributions to certain employees as additional compensation when it should have maintained these amounts in a tax-deferred account.~~to the extent a portion of the 10% additional amount could not be contributed to the participant employee's 401(k) account due to Internal Revenue Service (IRS) limits, NERC paid this excess portion to the participant as ordinary income, subject to current federal and state tax withholdings and taxation. Based upon a review of the recent employee compensation and benefits study and upon recommendation of NERC's Corporate Governance and Human Resources Committee, the NERC Board is scheduled to approve an amendment to NERC's 401(k) Plan and retirement polices in May 2012 to eliminate the inclusion of the bonus in the calculation of the additional contribution, as well as making the amount of the additional contribution a discretionary determination by the BOT. NERC has also established an employee funded 457(b) plan which allows employees meeting certain IRS eligibility requirements to defer additional amounts towards retirement. NERC does not provide any matching funding for 457(b) plan contributions, which are funded solely by the employee, in its discretion.

Pertinent Guidance

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

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

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

Background

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

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

In interviews, NERC senior management defended the practice, explaining that the 10 percent guaranteed contribution is NERC's alternative to a profit-sharing element. NERC cannot offer profit-sharing elements, such as stock options, as NERC is a non-profit entity and does not have profits to share with its employees or anyone else. NERC has fully budgeted for its ~~pension~~retirement contribution obligations as a cost included in its annual budget that is funded by ~~end-users~~statutory assessments. NERC senior management justified the additional compensation from a "total compensation"

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perspective, stating that it was a necessary element to stay competitive in the marketplace for skilled professionals. ~~However, former employees interviewed by audit staff did not state inadequate compensation as a primary factor for their departure.~~

In discussions with audit staff regarding this compensation element, the NERC CEO agreed that guaranteeing a 10 percent contribution lacked the appearance of the performance-based compensation of more traditional profit sharing programs ~~that NERC is attempting to emulate~~. The CEO also indicated that NERC would consider a different approach going forward, such as guaranteeing a smaller percentage and subjecting the remainder to annual review and approval by the BOT. This approach is in line with the benefits study that NERC commissioned, which recommends the guaranteed pension contribution component be lowered from 10 percent to 5 percent so that this amount, when coupled with the 4.5 percent matching 401(k) contribution, would equal up to "9.5 percent of pay, which is more in line with typical market practices."[~~34~~42] Audit staff noted that any changes in compensation, including changes to the guaranteed portion of the contribution, would not appear to violate any contractual entitlements to current employees, as all NERC officers and staff serve on the basis of "at will" arrangements.

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

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

[~~34~~42] The term "pay" used in the study is ambiguous in this context. The study report does not address whether bonuses should or should not be included when making ~~pension~~retirement contributions. The study itself indicates that a majority of capital accumulation plans do not count bonuses as compensation for determining contributions.

77 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

Based upon a review of the recent employee compensation and benefits study and upon recommendation of NERC's Corporate Governance and Human Resources Committee, NERC will be amending its 401(k) Plan and retirement polices in May 2012 to eliminate the inclusion of the bonus in the calculation of the additional contribution, as well as making the amount of the additional contribution a discretionary determination by the BOT. NERC has also established an employee funded 457(b) plan which allow employees meeting certain IRS eligibility requirements to defer additional amounts towards retirement. NERC does not provide any matching funding for 457(b) plan contributions.

Recommendations:

We recommend that NERC:

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

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

34. ~~Develop an alternative mechanism for addressing pension~~Continue to use the mechanism that has been adopted and consider additional mechanisms to allow employees to address tax deferred retirement saving of contributions in excess of the IRS cap ~~that maintains the payment as a retirement benefit and not as additional compensation to the employee~~on 401(k) contributions.

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9. NERC Critical Infrastructure Protection Program

NERC ~~inadequately staffed~~should further evaluate the sufficiency of its staffing for the needs of its critical infrastructure protection (CIP) program~~. NERC's senior management focused on a limited scope of activities that did not adequately address the CMEP needs of the ERO in the CIP program. This lack of attention to compliance-related activities led to insufficient staffing for this section 215 responsibility~~, in particular with respect to the resources needed for oversight of the Regional Entities' CIP auditing and other CIP compliance monitoring and enforcement activities. While NERC has significantly increased its CIP Program Area staffing over recent years, and has provided oversight through other means, audit staff believes that insufficient resources have been devoted to oversight of Regional Entity audit activities in the CIP area.

Pertinent Guidance

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

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

Background

As a program element under section 215, CIP has undergone significant changes since NERC was certified as the ERO. At the time NERC filed its 2007 Business Plan and Budget, the CIP program focused primarily on NERC's role as the US Department of Energy (DOE)-approved Information Sharing and Analysis Center for the electric sector (ES-ISAC). In its business plan and budget filing for 2007, NERC treated its role as the ES-ISAC as a situational awareness element under section 215, one of its purposes being to identify the need for mandatory standards to be developed in the CIP area.[~~35~~43] The CIP

[~~35~~ North American Electric Reliability Corporation, Request, Docket No. RR06-03-000, (filed Aug. 23, 2006) (submitting the 2007 business plans and budgets of

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standards were approved by the Commission in January 2008[36][44] and the first CIP standards became auditably compliant for high-priority "Table 1" entities (i.e., Reliability Coordinators, Balancing Authorities, and Transmission Operators) in July 2010. By late 2011, as the audit commenced, the ERO was tasked with ensuring compliance with the full slate of currently approved and applicable CIP standards for an expanded list of registered entities. The roll-outapplicability and enforcement of these new Reliability Standards resulted in a significant increase in reported possible violations, both in self-reports by registered entities but also more importantly in the initial CIP compliance audits conducted by Regional Entity staff. In 2010 and 2011, a total of 2,511 violations of the CIP standards were discovered, including 772 violations through compliance audits and spot checks. In 2010, eight of the ten most frequently violated standards were CIP standards, and in 2011, seven of the most frequently violated standards were CIP standards. Audit staff believes as NERC's responsibilities grew in this area, it failed to adequately budget and allocate resources to CIP. NERC should have established stronger oversight ofover the Regional Entities' programs for monitoring and enforcing compliance with thesse emerging CIP standards, ensuringin order to ensure consistency of auditing and commitment to establishment of a high-level of security for the BPS. Instead, audit staff believes NERC focused a disproportionate amount of its attention and limited budgeted resources on what it perceived were higher-priority demands in other program areas (e.g., dealing with Commission directives in the operating and planning standards), educating the electric industry on overall critical infrastructure protection and security concerns, and in expanding the functionality of NERC'sthe ES-ISAC.

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

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

NERC and Regional Entities for acceptance and Proposed Assessments to Fund Budgets for approval[43] 2007 ERO Budget Filing.

[36][44] Mandatory Reliability Standards for Critical Infrastructure Protection, Order No. 706, 122 FERC ¶ 61,040 (2008).

80 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

~~As indicated by~~Audit staff interpreted this organizational chart~~,~~ to mean NERC only had only two CIP staff dedicated to Regional Entity compliance oversight activities. Th~~is~~e low level of CIP staffing perceived by audit staff at NERC for compliance activities did not, in audit staff's opinion, allow for adequate oversight of the Regional Entities' enforcement of CIP standards across the entire BPS. Moreover, NERC's CIP staffing levels did not address the need for contingencies, succession planning, and other continuity of functions to be maintained.

Despite NERC's growing responsibilities in the CIP area, audit staff noted NERC's commitment and staffing levels for ~~its~~ CIP ~~compliance program~~oversight remained low throughout the audit period. In fact, NERC tasked only the two CIP Compliance FTEs (i.e., two auditors) with providing oversight to all eight Regional Entity CIP audit programs. ~~It was not until the current Commission staff audit commenced that~~ During the course of this audit, NERC began ~~the preliminary stages of~~ increasing its staffing and resources in this area. In addition to their Regional Entity audit oversight responsibilities, NERC's two auditors were also assigned to support NERC's duties as the Compliance Enforcement Authority (CEA), which oversees compliance with the CIP Reliability Standards for those Regional Entities registered to perform critical reliability functions (e.g., SPP, WECC, FRCC, and Texas Regional Entity). Furthermore, the two NERC auditors performed the following other duties: oversight of the Regional Entity program to implement Technical Feasibility Exemptions to CIP standards, routine meetings and calls to ensure consistency between regions and answer questions from FERC staff, communications with Commission staff on cyber-related incidents, participation in pilot programs to involve auditors in standards development, attendance at ERO auditor training workshops, and educational efforts at Regional Entity workshops. This was a significant amount of responsibility for two auditors, and given the difficulties encountered in implementing new reliability standards in this important area, audit staff believes the commitment of such a limited number of resources did not allow for a robust CIP compliance program to effectively and efficiently carry out NERC's CIP compliance-related activities.

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

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NERC CIP auditors attended a NERC auditor training workshop rather than perform their oversight obligations.

Audit staff noted in NERC's response to data requests that during 2010 and 2011 the NERC CIP auditors attended about half the number of compliance audits that FERC staff observed. Rather than taking the lead on providing oversight of the Regional Entity audits, NERC relied upon FERC's efforts to fulfill its oversight role.[~~37~~45] Audit staff believes that during the audit period NERC's ~~commitment to~~oversight of Regional Entity CIP auditing activities was weak primarily due to inadequate staffing levels and increased attention to other areas (e.g., ES-ISAC). As evidenced by interviews conducted by audit staff, significant attention, resources, and funding were devoted to expanding the NERC ES-ISAC capabilities under the tenure of the recently departed Director of NERC's Critical Infrastructure Division (CID), while attention to CIP compliance activities at the senior management level was minimal. CID leadership demonstrated limited knowledge of the state of compliance-related activities for CIP program elements at either the NERC or Regional Entity level. Senior management review of the Regional Entity CIP compliance programs was limited to a high-level budget check that lacked any substantive elements that might enable NERC to assist the Regional Entities in achieving improved performance in CIP compliance.

~~Despite the shortfalls in the NERC CIP program,~~ NERC senior management did not express any concern about the staffing levels for this program area in discussions with audit staff until late in the Commission staff audit ~~process. For example, when audit staff inquired how NERC selected the Regional Entity CIP compliance audits for which to provide oversight, NERC's senior management indicated that NERC had followed FERC's lead. However, NERC's senior management did not demonstrate that NERC had developed its own independent criteria to determine whether the risks in the Regional Entity CIP compliance auditing program were being addressed by the NERC oversight~~ process. Audit staff's review of the NERC CIP compliance program disclosed that NERC had not conducted any analysis to determine whether NERC or the Regional Entities had the appropriate resources to properly execute the CIP compliance program or whether NERC had developed a systematic process, plan, and schedule for conducting Regional Entity compliance audit oversight activities. Further ~~confusion in the direction of NERC's CIP compliance program was revealed during the audit period, when~~compounding these concerns, the recently hired Director of NERC's CID left NERC ~~in the midst of the Commission staff audit~~during 2011 and significant organizational changes in the CID thereafter took place.

[~~37~~45] Audit staff notes that the compliance audits of non-CIP (i.e., Order No. 693) standards had a much better initial track record in the early years, but dipped in 2011. However, audit staff noted a major staffing effort and recommitment to this important compliance area planned for 2012.

82 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

NERC indicated that the requirements for **c**ompliance with the CIP standards have been fluid and evolving with the rapid succession of revisions to the CIP standards: in 2010 three versions of the CIP standards were in effect; at the time the audit was being concluded, Version 4 of the CIP standards was pending at the Commission for approval, and the Version 5 CIP standards were under development. NERC stated that it therefore made a conscious decision to focus on education and training of the industry to understand, identify and respond to cyber threats. As a result, NERC stated that during 2010-2011, it focused on assistance, training and education to the industry on the broader CIP and infrastructure security concerns.

Since the Commission staff audit began, NERC has indicated that in 2012 it will make an effort to ~~reallocate~~further allocate resources into critical CIP compliance activities. NERC indicated its plan to hire an additional CIP auditor as well as a compliance manager, but the position descriptions and defined responsibilities for these proposed positions had not been completed and provided to audit staff when fieldwork concluded. Despite these changes, audit staff believes that NERC still does not appear to have conducted a rigorous assessment of the commitment that should be made in the CIP compliance activities. For example, CID management indicated that upwards of 21 CIP compliance audits were being planned for 2012, even if a third auditor were not hired. NERC's draft audit procedure guidelines outline the intensive efforts necessary to plan, prepare, and implement effective NERC oversight for a Regional Entity compliance audit. Audit staff believes that an adequate program of CIP oversight cannot be conducted by a staff of two auditors for that many audits, especially given their other assigned duties. NERC's failure to expand its compliance staff in a timely manner for CIP compliance activities contrasts markedly with efforts made on compliance to the operating and planning standards (i.e., Order No. 693). In this area, audit staff observed a significant growth in staffing for audits and other compliance-related activities~~.~~, although that growth has been occurring over a longer period of time since NERC began enforcing mandatory standards in 2007.

NERC also indicated that, in addition to the two CIP auditors, personnel in NERC's Compliance Operations Department are involved in overseeing the CIP audit reports, training CIP auditors, maintenance and revision of the Reliability Standard Audit Worksheets ("RSAWs") used by Regional Entity CIP auditors in conducting audits, development and issuance of Compliance Application Notices ("CANs," which provide guidance to auditors) relating to the CIP standards, and other activities to support NERC and Regional Entity CIP audit activities. NERC Legal staff also works closely with the Regional Entities with respect to the posting of Case Notes that pertain to the CIP standards. Further, personnel in NERC's Compliance Enforcement and Legal Departments provide support and guidance to the Regional Entities in CIP compliance monitoring, auditing and enforcement. For example, all Possible Violations, including Possible Violations of CIP standards, are processed and reviewed in the NERC Compliance Enforcement and Legal Departments. NERC staff works closely with the Regional Entities in the ultimate disposition of the CIP Possible Violations to ensure the records are complete and support

83 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

the ultimate disposition. NERC staff also fields questions and addresses issues that may arise in the context of compliance monitoring activities by the Regional Entities, including audits. NERC's Compliance Enforcement and Legal staffs also work closely with its CID staff in the review of violations and dismissals of CIP standards. NERC internal department meetings, as well as ERO working group meetings, are opportunities to provide ongoing guidance on CIP matters. NERC indicated that, as described above, it is continuing to make appropriate program adjustments for additional oversight of Regional Entity CIP audits. In NERC's 2012 Business Plan and Budget, two additional FTEs were approved for the CIP oversight team, consisting of one additional CIP auditor and one CIP Compliance Manager.

Recommendations

We recommend that NERC:

35. Conduct an assessment of ~~existing~~ CIP-related staffing levels to ensure ~~that NERC staff work aligns with section 215 activities, and that~~ there are adequate resources to accomplish CIP work, particularly with respect to Regional Entity CIP auditing and other Regional Entity CIP-related CMEP activities; and

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

84 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

10. NERC Activities

[NOTE: NERC recommends that this section be deleted, as noted above and discussed in the Response to the Draft Report.]

Neither the Commission nor NERC ~~did not~~ have established written criteria to determine whether specific activities NERC performs are statutory activities that should be funded under the Federal Power Act (FPA) section 215. ~~Audit staff is concerned that NERC's failure to develop written criteria to guide its decisions of what constitutes a statutory activity is directly related to its philosophy that all activities that promote the reliability of the Bulk-Power System (BPS) are statutory.~~ As a result, it was difficult for audit staff to determine whether all the ~~scope and extent of permissible~~ activities that ~~should be~~NERC performs are appropriately funded under section 215 ~~and NERC's method of prioritizing such activities to ensure the appropriate focus of activities undertaken as the ERO.~~

Pertinent Guidance

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

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

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

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

85 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

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

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

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

> On August 8, 2005, EPAct was enacted as law. New Section 215 of the FPA provides for a system of mandatory enforceable Reliability Standards. Under the new electric power reliability system enacted by the Congress, the United States will no longer rely on voluntary compliance by participants in the electric industry . . . [38][46]

> Section 215 of the FPA generally provides for Commission authorization of funding for statutory functions, such as the development of Reliability Standards and their enforcement, and monitoring the reliability of the Bulk-Power System. The Final Rule clarifies, however, that while the ERO or a Regional Entity is not necessarily precluded from pursuing other activities, it may not use Commission-authorized funding for such activities.[39][47]

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

> We generally believe that anything required of the ERO or a Regional Entity by the statute, Order No. 672 pursuant to the statute, or any subsequent Commission order pursuant to section 215 of the FPA is a statutory activity.[48]

> We agree with National Grid that NERC's funding proposal at a very high level seems appropriate, but lacks details. Consistent with Order No. 672, we direct NERC to submit in its compliance filing a list of budget principles for approval. These principles should include budget execution as well as budget formulation matters, including: (1) budget component justification based on statutory or other authorities; (2) how the budgeted activity lends

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~~[38] *Rules Concerning Certification of the Electric Reliability Organization; and Procedures for the Establishment, Approval, and Enforcement of Electric Reliability Standards*, Order No. 672, 114 FERC ¶ 61,104~~[46] *Order No. 672* at P 20 (2006)~~, *order on reh'g*, Order No. 672-A, 114 FERC ¶ 61,328 (2006), *modified*, 123 FERC ¶ 61,046 (2007).~~

[39][47] *Id.* P 34.

[48] ERO Certification Order at P 185.

86 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

> itself to the accomplishment of the statutory or other authorities; (3) methods of calculating budget estimates; (4) who prioritizes competing needs; (5) affordability, sustainability, and efficiency and effectiveness of expenditures; (6) implementation to meet international standards; (7) transparency; and (8) accountability and execution in accordance with operating plan, performance measures, and shifting priorities. Moreover, we expect NERC to submit its first detailed budget in the coming months that should answer many of these questions.[40][49]

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

> We find that NERC's proposed activities reasonably fall within the types of activities the Commission considers to be covered by FPA Section 215, i.e., the development and enforcement of reliability standards, and are entitled to receive funding under Section 215 of the FPA. As explained in the *ERO Certification Order*, anything required of the ERO or a Regional Entity by the statute, Order No. 672 pursuant to the statute, or any subsequent Commission order pursuant to Section 215 of the FPA is a statutory activity. NERC, in its budget filing and subsequent response, has provided an explanation for each of its program areas that relates to a function for which the ERO is responsible pursuant to section 215 of the FPA, Order No. 672 or the *ERO Certification Order*. Accordingly, we find acceptable NERC's designation of specific program activities as "statutory[.]"[41][50]

In the same order, the Commission stated in part:

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

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[40] ~~North American Electric Reliability Corporation, 116 FERC ¶ 61,062~~[49] ERO Certification Order at P ~~202 (2006).~~202.

[41] ~~North American Electric Reliability Corporation, 117 FERC ¶ 61,091 at P 28 (2006) (citing North American Electric Reliability Corporation, 116 FERC ¶ 61,062~~[50] 207 ERO Budget Order at P 28 (citing ERO Certification Order at P ~~185 (2006)).~~185.

87 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

> NERC should provide greater detail and justification for the criteria it uses to designate statutory activities.
>
> Accordingly, we require that, when NERC files its 2008 budget and business plan, it identify the general statutory activity, and which sub- activities, are covered by the 2008 budget and business plan. [~~42~~51]

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

> NERC will insert a new Section 1103.3 to its Rules of Procedure, as follows:
>
> The NERC annual budget submittal to governmental authorities shall provide for the following principles: (1) budget component justification based on statutory or other authorities; (2) how the budgeted activity lends itself to the accomplishment of the statutory or other authorities; (3) methods of calculating budget estimates; (4) who prioritizes competing needs; (5) how the budget meets the objectives of affordability, sustainability, and efficiency and effectiveness of expenditures; (6) implementation to meet international standards; (7) transparency; and (8) accountability and execution in accordance with operating plan, performance measures, and shifting priorities.[~~43~~52]

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

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

[~~42~~51] *Id.* P 30.

[~~43~~52] North American Electric Reliability Council and the North American Electric Reliability Corporation, Filing, Docket No. RR06-1-003, at P 5 (filed Oct. 18, 2006) (addressing non-governance issues).

88 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

> Specifically: (1) the Reliability Standards Program implements the statutory activity of development of reliability standards. (2) The Compliance Enforcement and Organization Registration and Certification Program implements the statutory activity of enforcement of compliance with reliability standards, including imposition of penalties and sanctions for violations of standards. (3) The Reliability Readiness Evaluation and Improvements Program supports the statutory activity of enforcing and achieving compliance with reliability standards and the statutory activity of conducting assessments of the reliability of the bulk power system. This program also provides information and feedback that supports the statutory activity of development of reliability standards. (4) The Training, Education and Operator Certification Program supports the statutory activity of enforcing and achieving compliance with reliability standards, and also provides information and feedback that supports the statutory activity of development of reliability standards. (5) The Reliability Assessment and Performance Analysis Program implements the statutory activity of conducting periodic assessments of the reliability and adequacy of the bulk power system in North America. This program also provides information and feedback that supports the statutory activities of development of reliability standards and achieving compliance with reliability standards. (6) The Situation Awareness and Infrastructure Security Program supports the statutory activity of enforcing and achieving compliance with reliability standards, and also provides information and feedback that supports the statutory activities of development of reliability standards and conducting assessments of the reliability and adequacy of the bulk power system.[4453]

In its order on NERC's 2008 business plan and budget filing, the Commission concluded:

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

[4453] North American Electric Reliability Corporation, Request, Docket No. RR07-16-000, at 45-46 (filed Aug. 24, 2007) (submitting its 2008 business plan and budget for acceptance).

89 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

672 pursuant to the statute, or any subsequent Commission order pursuant to section 215 of the FPA is a statutory activity.[54]

Similarly, in its order on NERC's 2009 Business Plan and Budget, the Commission stated:

> We find that NERC's 2009 Business Plan provides sufficient detail for us to determine whether NERC intends to pursue appropriate activities. NERC's proposed categories of activities for 2009 are the same as those approved by the Commission for NERC's 2007 and 2008 budgets, except for the proposed discontinuance of the Reliability readiness Evaluation and Improvement Program (discussed below), and reasonably fall within the types of activities the Commission considers to be covered by FPA section 215.[55]

In an order issued July 16, 2009 accepting in part a NERC compliance filing ~~on the 2009 NERC business plan and budget~~required by the Commission's 2009 ERO Budget Order, the Commission stated:

> The Commission accepts the ERO's proposal to terminate funding of the Reliability Readiness Program. As described above, documents provided in response to the Commission's data request indicate that the ERO engaged in a thorough vetting, both internally and with stakeholders, on the decision to eliminate the Reliability Readiness Program. The ERO's documentation provides in detail how, over time, the Reliability Readiness Program had become redundant of other ERO and Regional Entity activities. Further, the ERO's response to the data request indicates that the ERO considered alternative solutions before concluding that the best option was to eliminate funding for the program.[~~45~~56]

18 C.F.R. § 39.4 sets out the requirements for funding an ERO. Specifically, section 39.4(b) addresses ERO annual budget requirements~~.~~[~~46~~]:

> The Electric Reliability Organization shall file with the Commission its proposed entire annual budget for statutory and any non-statutory activities, including the entire annual budget for statutory and any non-statutory

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[54] 2008 ERO Budget Order at P 21.

[55] *North American Electric Reliability Corporation, Order Conditionally Accepting 2009 Business Plan and Budget of the North American Electric Reliability Corporation and Ordering Compliance Filing*, 125 FERC ¶ 61,056 (2008), at P 18.

[~~45~~56] *North American Electric Reliability Corporation*, 128 FERC ¶ 61,025 P 28.

[~~46~~] ~~*See supra* text accompanying note 9.~~

 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

activities of each Regional Entity, with supporting materials, including the ERO's and each Regional Entity's complete business plan and organization chart, explaining the proposed collection of all dues, fees and charges and the proposed expenditure of funds collected in sufficient detail to justify the requested funding collection and budget expenditures 130 days in advance of the beginning of each Electric Reliability Organization fiscal year. The annual Electric Reliability Organization budget shall include line items budgets for the activities of each Regional Entity that are delegated to each regional Entity pursuant to §39.8.

Background

Audit staff interviewed NERC senior management, staff, and various Board of Trustee (BOT) members to understand the criteria NERC used to determine whether its activities should be funded under FPA section 215. Audit staff believes such criteria are necessary because section 215 allows funding for: (1) development of mandatory standards; (2) enforcement of those standards; and (3) monitoring the BPS.[~~47~~57] NERC has organized each of its six annual business plans and budgets around the program Areas described in the 2007 budget filing, and the Commission has approved the budgeted activities in these Program Areas, as well as the related General and Administrative or overhead/indirect activities, as statutory activities to be funded through section 215, in each of the Commission's six annual ERO budget orders. Through these discussions, audit staff discovered that NERC has not developed any policies, procedures, processes, or practices (i.e., criteria) to guide its staff on the types of activities permissible under section 215. ~~These discussions also revealed that NERC adopted a philosophy that the development of criteria was unnecessary because all NERC activities promote reliability, and therefore should be funded under section 215.~~ Audit staff notes that the Regional Entities have undertaken efforts to determine activities performed that are non-statutory in nature and have transparently reflected these activities in their budget submissions to the Commission. However, audit staff found no evidence that the BOT undertook an independent review of NERC's activities as part of its oversight responsibilities to determine that all NERC activities are statutory. ~~As~~Although audit staff has not identified any specific NERC activities that fell outside of the scope of the NERC Program Areas that the Commission

[~~47~~57] In the Commission order certifying NERC as the ERO, the Commission interpreted the monitoring activities to include the periodic BPS reliability assessment activities that were ongoing at NERC prior to being approved as the ERO~~.~~ and which are expressly included in the ERO activities listed in Section 215. While these activities were approved during NERC's transition as the ERO, NERC has continued to be responsible for such existing assessments and has assumed even greater assessment responsibilities in other areas. ~~The degree to which such assessment and monitoring activities currently ongoing should be deemed statutory is therefore also an element that audit staff believes should be revisited.~~

91 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

has concluded are statutory activities to be funded under section 215, as described below, audit staff is concerned that the scope of some activities NERC undertook was not specifically required by the Commission in Order No. 672 or any subsequent order. ~~Also~~Further, although audit staff did not find any NERC activities that did not or do not contribute to and support the reliability and security of the bulk power system, audit staff questions whether some of these activities exceeded the functions of the ERO explicitly defined in section 215.

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

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

When the Commission reviewed NERC's application to become the ERO, and certified NERC as the ERO, it approved the ongoing programs but stated that "the funding proposal at a high level seems appropriate but lacks details" and directed NERC to "submit in its compliance filing a list of budget principles . . . including: (1) budget component justification based on statutory or other authorities; (2) how the budgeted activity lends itself to the accomplishment of the statutory or other authorities . . . "[~~48~~58]

NERC's compliance filing stated that each budget filing would provide for each principle.[~~49~~59] When reviewing the 2007 business plan and budget, the Commission stated that, "The 2007 budget provides sufficient information for the Commission to determine that the proposed designated activities are statutory," but in order to "provide greater detail and justification for the criteria [NERC] uses to designate statutory activities," the Commission required NERC to "identify the general statutory activity, and which sub-activities, are covered by the budget and business plan in the 2008 business plan and

[~~48~~58] *See* case cited *supra* note 40.

[~~49~~59] *See* pleading cited *supra* note 43.

92 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

budget filing."[50][60] In its 2008 business plan and budget filing, NERC vaguelycomprehensively addressed this requirement by stating that each of its program areas "carries out or supports implementation of one or more of the statutory activities."[51] to the Commission's satisfaction, as shown above. Although many of the ongoing activities NERC performeddescribed were consistent with this Commission determination that additional details were required in order to clarify theire status as statutory activities, audit staff has concerns that the manner in which NERC addressed the Commission's requirement for greater detail was insufficient to allow NERC itself, or the Commission audit staff, to verify that specific NERC programs and activities should be funded as section 215.in subsequent years' business plan and budget filings, NERC has not provided sufficiently specific details on each of its planned activities within the Program Areas that the Commission has found to be statutory, to enable the Commission to verify that all activities fall within the scope that the Commission has defined as statutory.

The Commission order certifying NERC as the ERO outlined the process NERC would follow to pursue reliability-related activities other than those specified in section 215. The Commission also recognized that the ERO is not precluded from pursuing these activities as long as the funding comes from non-section 215 sources,[52][61] and as long as the non-statutory activities are included in its business plan and budget. If NERC had followed this process, it would "provide the Commission with necessary information about any non-statutory activities, the source of their funding, and whether the pursuit of such activities presents a conflict of interest for the ERO."[53][62] However, to date, NERC has not usedmaintained a policy of not engaging in any non-statutory activities, and therefore has not sought to use the Commission's process for seeking approval of non-statutory activities.

Since becoming the ERO, NERC has embarked on new or expanded programs it believes maintain and improve the reliability and security of the BPS. Audit staff questions whether some of these programs fall outside the explicit scope of the ERO under section 215, which is the development and enforcement of mandatory reliability standards and monitoring of the BPS[54], but are more consistent with how NERC historically pursued its mission prior to its certification as ERO (i.e., the pursuit of reliability and security through voluntary programs)scope of what the Commission has previously approved as statutory programs and activities. Audit staff understands that NERC has the authority to perform any activities that do not conflict with its role as the ERO; however, itif any such activities

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[50][60] North American Electric Reliability Corporation, 117 FERC ¶ 61,091 at P 30 (2006).

[51] See pleading cited supra note 44.

[52][61] Order No. 672, 114 FERC ¶ 61,104 at P 202.

[53][62] *Id*. P. 198

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

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are non-statutory, NERC must designate them as non-statutory and fund them separately and apart from the permitted section 215 activities. Several of the Regional Entities have adopted this approach and continue to pursue their historic missions as well as undertaking their responsibilities and duties under section 215.

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

~~Audit staff sampled~~After exhaustively reviewing NERC's current activities ~~and~~over a period of many months, audit staff found three activities that it questions whether ~~several~~they are, in whole or in part, appropriate under section 215 because NERC presented ~~little to no documentation~~insufficient explanation, in audit staff's opinion, explaining how ~~some~~these three activities link to section 215. ~~However~~

With respect to the three activities that audit staff questions as being statutory, NERC presented ~~only verbal~~information and arguments defending the value of each activity and how each contributes to BPS reliability and security. While audit staff recognizes the~~se~~ facts~~, it~~ presented by NERC, audit staff remains unconvinced that ~~an~~NERC adequately explained why each activity's admitted contribution to BPS reliability and security ~~is an adequate criterion to determine whether an~~adequately establishes that the activity should be funded under section 215. To facilitate such determinations in the future, audit staff believes that NERC should develop clear written criteria by which to demonstrate activities undertaken are statutory in nature within the scope of the Program Areas previously approved by the Commission and therefore are allowable as activities to be funded under section 215. ~~Sampled~~

The three activities ~~that fall into this category~~questioned by audit staff, as detailed below, include:

- Conducting presentations and speeches at universities encouraging students to seek electric power industry careers (an activity that was initiated because NERC's assessments of the reliability of the BPS have identified the electric

industry's aging workforce, and the apparent lack of younger individuals seeking and training for careers in the industry, as a potential problem for the reliability and adequacy of the BPS);

- Conducting the GridEx exercise; and
- Hosting a grid security conference;

In addition, activities NERC itself termed "non-compliance" in nature are of concern to audit staff. These activities are pursued as part of NERC's function as the Electric Sector – Information Sharing and Analysis Center (ES-ISAC). The audit report deals with these concerns in a separate finding, Finding 11 in section IV of the audit report.

Aging Workforce

NERC's concerns about the electric power industry's aging workforce began before it became the ERO. NERC's Long-term Reliability Assessment identified the issue in 2006, and again in 2007 and 2009. In its first year as the ERO in 2007, NERC developed an initial action plan that involved coordination with the National Science Foundation in which NERC would take an active role in facilitating an industry action plan addressing the aging workforce issue. In November 2007, the two organizations hosted an industry workshop to develop a nationwide action plan with collaborative industry effort. This plan included action items, best practices, and recommendations for recruiting new talent, supporting university programs, and raising awareness.[~~55~~63]

NERC continued to support the initiative, hosting an Aging Workforce Webinar in July 2008. In addition, a senior NERC staff member continued to engage in activities addressing the issue, including travel to U.S. and Canadian universities to give presentations and speeches encouraging greater interest in electric power industry careers among students. Those efforts began under a plan developed by NERC's former CEO, starting with a May 2007 meeting. The staff member has continued to execute the plan under the new CEO, and in total has participated in five activities hosted at universities between 2007 and ~~2011.~~2011, or one such activity per year on average.

NERC believes that this activity is a logical component of its statutory responsibility to assess the reliability and adequacy of the bulk power system. In its Three-Year ERO Performance Assessment Report, which the Commission accepted, NERC described this program as "Develop[ing] Independent Short- and Long-Term Assessments of the Reliability and Adequacy of the Bulk Power System and Focus[ing] Attention on Emerging Issues Important to Reliability."

[~~55~~63] North American Electric Reliability Corporation, *NERC & National Science Foundation Partner with Industry to Create Action Plan on the Aging Workforce*, NERC News, (Sept. 18 2007), *available at* http://www.nerc.com/fileUploads%5CFile%5Cnewsletters/NERCNews-2007-09.pdf.

95 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

Audit staff believes that conducting a reliability assessment to identify this issue as a reliability concern was appropriate under section 215, but has no clearly articulated criteria upon which to assess undertaking non-mandatory corrective actions in response to any needs identified. NERC's response to the concern identified ~~concern~~by audit staff did not seek to directly address any staffing needs of NERC itself. Rather, NERC acted on behalf of the electric power industry through an activity ~~with no~~whose only linkage to ERO functions~~. Absent having written criteria linking the activities to ERO functions, audit~~ appears to be that they were identified in the course of performing one of the ERO duties specified in section 215, performing assessments of the reliability and adequacy of the BPS. Audit staff questions whether NERC's activities to address the issue have not been appropriate activities under section ~~215.~~215 within the scope of the statutory Program Areas previously approved by the Commission.

GridEx

In November 2011, NERC's Critical Infrastructure Division (CID) planned and hosted a cyber security incident readiness exercise, known as GridEx. During the entire development process, NERC did not seek to involve FERC staff in any oversight of this project. Participants in the exercise consisted of 75 U.S. and Canadian organizations, including 48 utilities, 21 government and academic organizations including FERC, and six Regional Entities. NERC designed the exercise to test participants' readiness to respond to a cyber incident, strengthen registered entities' crisis response functions, and provide input for internal security program improvements.

NERC stated that GridEx was consistent with NERC's Situation Awareness and Infrastructure Security Program, as set forth in §1003 of its Rules of Procedure, which provides that:

- NERC shall encourage and participate in coordinated Critical Infrastructure Protection exercises, including interdependencies with other Critical Infrastructure sectors.

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

NERC indicated that the findings and recommendations from the exercise were designed to strengthen the readiness of NERC and the industry to identify, defend against and respond to a cyber attack or incident that threatens the security and reliability of the Bulk Power System – including, where appropriate, through development of new Reliability Standards and modification of existing Reliability Standards.

Audit staff's review of the materials supporting the exercise ~~revealed no indication that it was designed to result in any changes to, or the development of, reliability standards.~~

96 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

~~Instead, the exercise~~indicated that it related primarily, in audit staff's opinion, to NERC's role as the ES-ISAC, a function that it carried prior to becoming the ERO~~.~~, and which the Commission has, in its budget orders, accepted as a statutory activity that should be funded through section 215. While audit staff believes the exercise may be helpful, audit staff is concerned that the exercise was contemplated and designed without ~~criteria in place to ensure~~establishing that it was an appropriate activity under section 215.

In addition, NERC had not included or described this exercise in its 2011 budget, approved in 2010, and therefore it was not subject to ~~approval~~consideration by the Commission, the BOT or the stakeholders, or approval by the BOT or the Commission, during the budget process. NERC's CEO authorized the CID to conduct GridEx ~~despite~~, although no similar activity ~~having~~had ever been approved or conducted in previous years at NERC. Moreover, NERC neither presented any cost/benefit analysis to the Commission or the BOT nor did it present to audit staff with any meaningful degree of specificity the exercise's justification as statutory under section 215. In the absence of adequate criteria and a process to implement them, audit staff questions whether GridEx is an appropriate activity under section 215.

Grid Security Conference

In October 2011, NERC held its first grid security conference, a two-day event known as GridSec. GridSec consisted of speakers from NERC, government agencies, security agencies, registered entities, vendors of consulting services and software/hardware products, and other parties involved in cyber security issues. More than 260 industry and government security professionals attended the conference, including representatives from the Commission. NERC stated that the conference focused on security threats to Bulk Power System reliability, including threats to industrial control systems, hacker exploits, facility threats and violence, and how the CIP standards support Bulk Power System reliability, and was consistent with the requirements in NERC's Situation Awareness and Infrastructure Security Program, as set forth in Section 1003 of its Rules of Procedure, which include requirements to strengthen relationships with government agencies and the industry in support of critical infrastructure matters and engage in education and outreach to increase awareness of these matters.

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Audit staff's review of the costs associated with GridSec showed that commercial vendors contributed approximately $50,000 toward the event by sponsoring some meals and refreshments for attendees. While Critical Infrastructure Protection (CIP) standards were discussed during one half-hour presentation and the ES-ISAC was the subject of another half-hour talk, the bulk of the conference dealt with cyber security ~~from a primarily non- compliance context (i.e.~~ without any linkage to the identification of the need for new or revised standards~~)~~ or to specific compliance issues with respect to existing Reliability Standards. Audit staff notes that during the Commission staff audit of NERC, NERC staff informed FERC staff that in future years greater inclusion of CIP compliance issues in such conferences will be planned.

NERC believes that hosting this conference ~~falls under~~, in addition to being within the scope of its ~~Commission-approved training function. However, NERC made no showing that the budget for the training function contemplated the costs of hosting this event~~Situation Awareness and Infrastructure Security Program as described in its Rules of Procedure, also provides important training for industry. NERC did not document this event in any context during the 2011 budget review process, and therefore did not provide an opportunity for stakeholder review, or seek Commission~~,~~ or BOT~~, or stakeholder~~ approval, for its funding in the 2011 operational year by means of the budget process. Audit staff reviewed the materials associated with GridSec and believes that the education provided was at best only tangentially related to the statutory duties of NERC as the ERO, within the statutory program scopes as previously accepted by the Commission. On this basis, audit staff questions the appropriateness of funding this activity under section 215.

Summary

While each of the above examples promotes reliability and has reliability or security aspects (to a greater or lesser extent), audit staff believes that these alone are not appropriate criteria upon which to assess their statutory nature. NERC needs to establish and operate under formal criteria that ensure all of its program activities that are funded pursuant to FPA section 215 are statutory. ~~By having engaged in the activities described above without written criteria~~In the opinion of audit staff, NERC did not provide adequate support ~~for engaging in~~during the audit that these activities were statutory. If NERC embarks on new projects within an operating year that were not budgeted and approved through the budget process, NERC needs clear guidance to ensure that the funds expended are for statutory purposes.

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Recommendations

We recommend that NERC:

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

38. ~~Identify all ERO activities funded under section 215, detailing at a minimum: the purpose of the activity, a description, and the justification for using section 215 funding. Submit all documentation to audit staff for these reliability activities.~~In its annual business plan and budget filings, provide an explanation as to why the proposed activities to be undertaken by each Program Area for the budget year are statutory, including, at a minimum: a description and the purpose of the major activities to be undertaken by each Program Area and an explanation for why the activity is a statutory activity.

99 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

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

NERC's dual role as the Electric Sector-Information Sharing and Analysis Center (ES-ISAC) and as the ERO raises significant challenges. NERC ~~has continued functioning in both roles, resulting in internal confusion and confusion among the Commission and stakeholders~~should continue to address these challenges through appropriate separations and additional transparency.

Pertinent Guidance

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

> Section 215 of the FPA generally provides for Commission authorization of funding for statutory functions, such as the development of Reliability Standards and their enforcement, and monitoring the reliability of the Bulk-Power System. The Final Rule clarifies, however, that while the ERO or a Regional Entity is not necessarily precluded from pursuing other activities, it may not use Commission-authorized funding for such activities.[~~56~~64]

~~Commission Order No. 672 Certifying~~In its order certifying NERC as the ERO ~~states~~, the Commission stated, in part:

> The Commission finds that NERC has met the requirements of Order No. 672 and we hereby certify NERC as the ERO for the United States.[~~57~~65]

Section 1000, Situation Awareness and Infrastructure Security, of the NERC Rules of Procedure ~~include~~, which have been approved by the Commission pursuant to section 215 and Part 39 as ERO Rules, includes a section on the Electric Sector Information Sharing and Analysis Center (Section ~~1003.1). Subsection 1003.1.1 states:~~1003), which states in part that "NERC shall coordinate electric industry activities to promote Critical Infrastructure protection of the Bulk Power System in North America by taking a leadership role in Critical Infrastructure protection of the electricity sector so as to reduce vulnerability and improve mitigation and protection of the electricity sector's Critical Infrastructure" and further that "NERC shall serve as the electricity sector's sector coordinator and operate its Information Sharing and Analysis Center to gather information and communicate security-related threats and incidents within the sector, with United

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[~~56~~64] Order No. 672, 114 FERC ¶ 61,104 at P 34.

[~~57~~ North American Electric Reliability Corporation, 116 FERC ¶ 61,062[65] ERO Certification Order at P ~~3 (2006).~~3.

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States and Canadian government agencies, and with other Critical Infrastructure sectors.[58],,[66]

Background

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

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

NERC's role in connection with the ES-ISAC is set out in §1003 of its Rules of Procedure as one of the functions through which NERC will accomplish the goals related to the Infrastructure Security Program. In the order accepting NERC's 2007 Business Plan and Budget, FERC considered commenters by intervenors who questioned the statutory nature of several of NERC's activities. In that order, FERC expressly found that NERC's proposed activities, including those related to the Infrastructure Security Program, are "covered by FPA section 215, i.e., the development and enforcement of reliability standards, and are entitled to receive funding under section 215 of the FPA."[67]

Under the ISAC program, NERC, as the ES-ISAC, receives physical security, cyber security, and operational security event and incident reporting from the electricity sector and Bulk-Power System entities. This reporting requirement is reflected in the current CIP

[58] North American Electric Reliability Council and North American Electric Reliability Corporation, Application, Docket No. RR06-1-000, (filed Apr. 4, 2006). (requesting certification as the Electric Reliability Organization).[66] NERC's Rules of Procedure are available at: http://www.nerc.com/fileUploads/File/Rules_of_Procedure/NERC_ROP_Effective_20120315_without_appendices.pdf

[67] 2007 ERO Budget Order at P 28.

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standards under CIP-~~008 security incident reporting~~008, Incident Reporting and Response Planning. Requirement ~~1.3.~~1.3 reads: "The Responsible Entity must ensure that all reportable Cyber Security Incidents are reported to the ES-ISAC either directly or through an intermediary." The required reports are ~~filed~~the DOE OE-417 reports, and are subject to the applicable rules and regulations of the DOE reporting system.

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

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

Audit staff noted that ~~at~~, coinciding with the conclusion of ~~its~~the audit fieldwork, NERC proposed a significant organizational change to its CID to its BOT. This proposal was reflected in a policy statement presented to, and approved by, NERC's BOT at its February 2012 meeting. The proposal would define the operation of the ES-ISAC as a "non-compliance obligated function" to, in effect, "wall off" certain staff within its CID from compliance- related activities. In interviews, NERC staff stated the primary motivation for the change was to increase industry participants' use of ES-ISAC and encourage information sharing. NERC believed industry's use of the site would increase if ES-ISAC staff were perceived and accepted by industry participants as "non-compliance obligated." In particular, NERC believed the industry would more readily report to the ES-ISAC site non-mandatory high-frequency/low-risk incidents. While NERC said it

might at some unspecified date in the future be able to use these incident reports to identify activity patterns that pose security threats to the electric grid, this provided, in audit staff's opinion, a very weak linkage to the standards development function of the ERO.

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

Additionally, audit staff noted that the Commission's approval of NERC's ES-ISAC role for funding under section ~~215 was~~215, which the Commission has provided in accepting each of NERC's six annual business plans and budgets from 2007 through 2012, was initially, at least in part, based on NERC's 2007 Business Plan and Budget. In that budget filing, NERC stated the ES-ISAC was a statutory, compliance-related program to the extent that "performance of the function included in this program will assist NERC in identifying areas for which new or revised reliability standards may be required."[~~59~~68] NERC's proposal sought to maintain a link between the ES-ISAC and compliance-related activities by flowing "sanitized trends" in security-related matters to assist in the development of reliability standards. This process would involve removing all identifiable information from collected data in order to maintain anonymity prior to conducting trend analysis. Audit staff believes this could present issues regarding the Commission's oversight responsibilities for NERC's performance in this process. NERC's proposal must address, at a minimum, the Commission's mandate to oversee all programs funded under section 215, and sufficiently show how the ES-ISAC continues to fall within the rubric of NERC's statutory activities and the Commission's oversight responsibilities.

[~~59~~68] North American Electric Reliability Corporation, Request, Docket No. RR06-3-000 at Attachment 2 at page 25 (filed Aug. 23, 2006)(submitting the 2007 business plans and budgets of NERC and Regional Entities for acceptance and Proposed Assessments to Fund Budgets for approval).

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Recommendations

We recommend that NERC:

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

39. ~~40. Evaluate the impact on~~Provide additional information in NERC's 2013 business plan and budget regarding NERC's role as the ES-ISAC and provide opportunities for stakeholder input regarding NERC's role as the ES-ISAC during the 2013 business plan and budget process. This should also include: (1) an evaluation of the impact, if any, on NERC's compliance-related activities of "walling off" certain staff from these activities~~, and modify NERC's current proposal for redefining the operation of the ES-ISAC to include clear guidance on how the "walled-off" sub-division will interact with the ERO~~; and (2) clarification of the flow of information between the ES-ISAC and the Commission staff for situational awareness and compliance purposes;

40. [This recommendation is incorporated in Recommendation 39];

41. ~~Clarify the flow of information between the ES-ISAC and the FERC staff for situational awareness and compliance purposes; and~~[This recommendation is incorporated in Recommendation 39]; and

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

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Document 2	pcdocs://wassr02a/1028608/1
Rendering set	Option 3a strikethrough double score no moves

Legend:	
Insertion	
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Padding cell	

Statistics:	
	Count
Insertions	853
Deletions	751
Moved from	0
Moved to	0
Style change	0
Format changed	6
Total changes	1610

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D.C. 20426

In Reply Refer To:
Office of Enforcement
Docket No. FA11-21-000
March 23, 2012 [revised April 23, 2012]

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

Dear Mr. Cauley:

The Division of Audits within the Office of Enforcement has completed an audit of North American Electric Reliability Corporation (NERC) for August 23, 2006 to March 9, 2012. The draft audit report contains 11 findings and 42 recommended corrective actions. The enclosed draft audit report describes our findings and recommendations.

Please respond to the draft audit report by April 9, 2012. Your response should state whether you agree or disagree with the audit findings and recommendations. Further, your response should describe any corrective actions taken and implementation dates for each recommendation, including the actions already included in the report. For any corrective action involving procedural changes, provide those procedures separately from your comments for review. Please send your response to:

Bryan K. Craig, Director and Chief Accountant
Division of Audits
Federal Energy Regulatory Commission
888 First Street, NE, Room 51-37
Washington, D.C. 20426

I appreciate the courtesies extended to the auditors. If you have any questions, please contact Alan Herd at (202) 502-6107 or Alan.Herd@FERC.gov, or Stephen Flanagan at (202) 502-8743 or Stephen.Flanagan@FERC.gov.

Sincerely,

Bryan K. Craig
Director and Chief Accountant
Office of Enforcement

Enclosure

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Federal Energy Regulatory Commission

DRAFT

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

Docket No. FA11-21-000
March 23, 2012 [Revised April 23, 2012]

Office of Enforcement
Division of Audits

3 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

TABLE OF CONTENTS

I. EXECUTIVE SUMMARY 1

A. Overview 1

B. NERC as the ERO 1

C. Statutory ~~and Non-Statutory Philosophy~~Background 3

D. Summary of Audit Findings 5

E. Summary of Recommendations 7

F. Compliance and Implementation of Recommendations 11

II. BACKGROUND 13

A. NERC Budget 13

B. NERC Organizational Structure and Staffing 16

III. INTRODUCTION ..... ~~19~~20

A. Objectives ..... ~~19~~20

B. Scope and Methodology ..... ~~19~~20

IV. FINDINGS AND RECOMMENDATIONS ..... ~~23~~24

1. NERC Budget Process ..... ~~23~~24

2. NERC Oversight of the Regional Entities' Budgets ..... ~~30~~32

3. Time Reporting and Accounting System ..... ~~34~~37

4. Employee Compensation ..... ~~39~~42

5. Standard for Determining the Reasonableness of Expenses ..... ~~45~~46

6. Employee Entertainment 51

7. Board of Trustees Compensation and ~~Entertainment~~Expenses 56

8. ~~Pension~~Retirement Plans ..... ~~62~~63

9. NERC Critical Infrastructure Protection Program ..... ~~65~~67

10. NERC Activities ..... ~~70~~73

11. NERC as the Electric Sector - Information Sharing and Analysis Center ..... ~~82~~87

I. Executive Summary

A. Overview

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

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

B. NERC as the ERO

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

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

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

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

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

Order No. 672 lays out the mission for the newly created ERO: the establishment and approval of electric Reliability Standards, the enforcement of electric Reliability Standards, and the monitoring of the reliability and adequacy of the Bulk-Power System. These three enumerated activities are clearly defined as within the scope of activities for which the entity certified as the ERO should receive appropriate funding under section 215. Other activities falling within the (1) Situational Awareness and Infrastructure Security Program and (2) Reliability Assessment and Performance Analysis Program also received ~~initial Commission approval as ongoing activities that NERC as the ERO may be the best party to perform in the absence of any other entity assuming the responsibility of these activities.~~[5] Commission approval as statutory activities within the scope of section 215.[5] ~~However, the~~The Commission did not establish any criteria by which to determine whether ~~these activities, or any other activities falling under the scope of these programs, were never developed by NERC nor established by the Commission~~NERC's activities fall within the scope of section 215, and did not direct NERC to establish or propose such

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

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

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

[5] ~~117 FERC ¶ 61,126 at P 188~~. [This citation is incorrect and did not support the original statement in the Draft Report's text to which it related.]

criteria. The manner in which these initial activities would continue on a going-forward basis, or new reliability-related activities in these programs could be added, were subject to subsequent Commission review and approval. ~~However~~To date, the Commission has approved all of NERC's budgeted activities for section 215 funding in its orders on NERC's annual business plan and budget submissions. Additionally, the Commission clearly expressed its opinion that an entity selected to be the ERO might have an expanded scope of activities that it could perform, but not receive funding to perform under section 215:

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

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

C. ~~Statutory and Non-Statutory Philosophy~~Background on the Scope of NERC's Activities

[NOTE: NERC urges Audit Staff to delete all sections that address the scope of section 215 because these sections question or otherwise contradict prior orders, as discussed in NERC's Response to the Draft Report.]

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

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[6] *Id.* P 202. [This citation is also incorrect in the original Draft Report.]

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

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

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

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

~~Audit staff is concerned that NERC as the ERO has continued, and at times expanded, its historic mission of seeking voluntary reliability activities, rather than the specific mandatory objectives of the ERO as authorized in section 215. Through discussions with NERC senior officials and staff, audit staff found that NERC has operated under the assumption that its projects, initiatives, and tools are directly related to section 215. This has resulted in some projects, initiatives, and tools being undertaken and funded under section 215 that do not have either clear written criteria upon which to justify funding under section 215 or clearly discernible linkages to the development and enforcement of mandatory reliability standards or the monitoring of BPS reliability and adequacy.While the Commission provided instruction on how to identify activities as non-statutory and how NERC could seek funding apart from section 215, NERC has instead adopted a policy of including all activities into one or more of the six broad program areas~~

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~~identified in its certification application and treating them as statutory. Also, NERC did not develop time-keeping and expense reporting that could track statutory and non-statutory activities, and instead rolled all activities into budget categories to be reported as statutory. By not tracking time by project, and not assigning projects to specific statutory activities, it is difficult for NERC, as well as audit staff and other entities responsible for oversight of NERC's activities, to determine how budgetary funds were used on specific statutory programs. Consequently, NERC's accountability for statutory and non-statutory activities has suffered.~~, but without using written criteria as to whether the activities were within the scope of section 215. Additionally, NERC believes it has not engaged in non-statutory activities. Audit staff is therefore recommending , as described further in this Report, that NERC provide greater transparency in its budgeting and accounting with respect to statutory versus non-statutory activities.

D. Summary of Audit Findings

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

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

NERC Oversight of the Regional Entities' Budgets – NERC's current process of reviewing Regional Entity budgets ~~is inadequate and lacks appropriate~~would benefit from further qualitative procedures to more efficiently and effectively assess Regional Entities' annual budgets. Greater qualitative oversight in this area may improve the efficiency and effectiveness of the ~~process, yielding savings for the ERO~~Regional Entity business plans and budgets and may identify cost reduction possibilities in some areas while identifying the need for Regional Entities to budget and expend additional resources in other areas.

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Time Reporting and Accounting Systems – NERC's historic system and method for reporting and tracking employee time and expenses ~~failed to:~~ had limited capability to track time and attendance on ~~a~~an activity- or project-specific basis~~, or properly classify expenses in its accounting system at a level that provided sufficient transparency to permit effective budget oversight. These deficiencies were due to NERC's lack of adequate procedures for reporting and tracking employee time and insufficient functionality implemented in its accounting system. These shortcomings resulted in inefficient and ineffective~~ within NERC's defined Program Areas, or allow for the accounting for expenses at an activity- or project-specific level. Enhancements to NERC's time reporting and accounting systems would facilitate improvements in budget oversight, time and ~~expense tracking,~~ tracking and cost allocation and control over costs.

Employee Compensation – ~~NERC used studies to determine~~There were numerous weaknesses in the compensation studies conducted by NERC prior to the more recent compensation study conducted for NERC in late 2011-early 2012. This was in part due to the lack of adequate funding for these studies, which in turn limited the scope and depth of the studies. At the direction of the Corporate Governance and Human Resources Committee of the NERC Board in 2011, NERC commissioned new, comprehensive compensation studies, conducted by a nationally-recognized employee compensation consultant, regarding employee compensation levels~~ that did not have adequate support to justify the reasonableness of compensation NERC paid its officers and staff. Audit staff is concerned that NERC has not systematically assessed~~. These studies were completed in late 2011-early 2012. The new studies were designed to address a number of weaknesses which exited with prior studies which, as noted, were in part due to the lack of adequate funding for these studies. While the new studies are a significant improvement over the previous studies, audit staff believes that NERC should periodically update these studies. Audit staff also believes that NERC would benefit from more a more systematic assessment of its organizational staffing needs to determine the core competencies and skill sets required of employees.~~ This weakness occurred in part because NERC did not contract for an adequate compensation study and did not ensure that appropriate assumptions were used. As a result, NERC incurred considerable personnel costs funded by end-users under section 215.~~

Standard for Determining the Reasonableness of Expenses – NERC ~~does not have a clear~~would benefit from further defining the standard of reasonableness by which to judge certain types of expenses that it or a staff member incurs. Also, NERC's current ~~expense~~ review and approval process for these types of expenses is decentralized~~ and inefficient. These problems are exacerbated by NERC's lack of sufficient~~. NERC would benefit from adopting further policies, procedures, and controls over: (1) meal and hotel expenses incurred by its employees; (2) employee

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recruitment expenses; and (3) employee retention expenses. ~~As a result of not having a clear and well-documented standard of reasonableness, NERC did not have adequate cost controls to prevent end-users from paying for excessive expenses.~~

Employee ~~Entertainment~~ – NERC did not have adequate Reward and Recognition Related Expenses – NERC should adopt additional policies and procedures ~~governing~~and provide increased budget transparency regarding employee ~~entertainment~~reward and recognition expenses. ~~These~~Existing policies and procedures ~~were~~are deficient ~~as follows~~in that: (1) NERC did not have formal guidance for determining if ~~entertainment~~such expenses were reasonable and reimbursable; and (2) NERC ~~paid approximately $74,000 and $109,000, respectively for office holiday parties~~incurred expenses for year-end employee dinners in December 2010 and December 2011 ~~(Holiday Galas)~~ that were neither fully nor transparently budgeted for~~; and (3) NERC did not properly account for employee entertainment expenses, including those of the Holiday Galas~~. As a result of th~~e~~is~~e inadequacies~~ budgeting, the Commission, stakeholders, and other interested parties did not have the necessary information to ~~approve~~review these expenses ~~and consequently NERC used budgeted funds for expenses not represented in NERC's budget~~as part of the budget and true-up processes.

Board of Trustees Compensation and ~~Entertainment~~Meals – NERC ~~did not support its shift~~shifted to a ~~flat~~ fixed fee retainer methodology of compensating its Board of Trustees (BOT) ~~with a time study based on actual~~, with the amount of the fixed fee dependent on the number of committees the Trustee sits on, whether the Trustee is a committee chair and whether the Trustee is also the chairman of the Board. NERC's Board reviewed its proposed shift to a fixed fee retainer plus expenses methodology at several open board meetings with stakeholders present. NERC also conducts annual surveys of the NERC Members Representative Committee (MRC) regarding BOT effectiveness. A consultant also reviewed and rendered an opinion in support of the fixed fee retainer methodology and associated board compensation levels. Audit staff believes that in future compensation studies the Board should consider including a further evaluation of time spent by the BOT on BOT activities or a representative study of the ~~actual~~ time spent on these activities. Also, NERC incurred various expenses ~~to entertain BOT members outside the official BOT meetings. As a result, audit staff believes NERC's shift to a flat-fee compensation methodology was not adequately supported and the expenses incurred outside the official BOT meetings may have been improperly funded by end-users under section 215.~~for dinners for BOT members during the evenings after BOT committee meetings and the evenings before BOT meetings. Audit staff believes that these expenses should be more transparently set forth in NERC's annual budget to facilitate stakeholder and Commission review.

7 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

~~*Pension Plans* – NERC contributed 10 percent of the~~ *Retirement Plans* – In connection with the conversion of NERC's defined benefit plan to a defined contribution 401(k) plan, which occurred prior to NERC becoming the ERO, NERC amended its 401(k) plan to provide for a contribution of 10 percent of compensation (salary plus incentive) for each employee participating ~~in the pension plan, which is above energy sector norm~~. This 10 percent contribution was in addition to an up to 4.5 percent matching contribution for employees participating in NERC's 401(k) plan. Audit staff believes the 10 percent contribution component is above industry norms. NERC stated that the 10 percent contribution component was included because, as a nonprofit corporation, NERC cannot offer profit-based compensation components as can the for-profit entities with which NERC competes for employees. Also, NERC included bonuses as well as base salary in its determination of its ~~pension~~additional contribution obligations for employees. In addition, ~~NERC paid excess amounts above the allowable~~ to the extent a portion of the 10% additional amount could not be contributed to the participant employee's 401(k) account due to Internal Revenue Service (IRS) ~~limit for pension contributions to certain employees as additional compensation when it should have maintained these amounts in a tax- deferred account~~limits, NERC paid this excess portion to the participant as ordinary income, subject to current federal and state tax withholdings and taxation. Based upon a review of the recent employee compensation and benefits study and upon recommendation of NERC's Corporate Governance and Human Resources Committee, the NERC Board is scheduled to approve an amendment to NERC's 401(k) Plan and retirement polices in May 2012 to eliminate the inclusion of the bonus in the calculation of the additional contribution, as well as making the amount of the additional contribution a discretionary determination by the BOT. NERC has also established an employee funded 457(b) plan which allows employees meeting certain IRS eligibility requirements to defer additional amounts towards retirement. NERC does not provide any matching funding for 457(b) plan contributions, with all contributions made by employees, in their sole discretion.

NERC Critical Infrastructure Protection Program – NERC ~~inadequately staffed~~should further evaluate the sufficiency of its staffing for the needs of its critical infrastructure protection (CIP) program~~. NERC's senior management focused on a limited scope of activities that did not adequately address the~~, in particular with respect to the resources needed for oversight of the Regional Entities' CIP auditing and other CIP compliance monitoring and enforcement ~~program (CMEP) needs of the ERO in the CIP program. This lack of attention to compliance-related activities led to insufficient staffing for this section 215 responsibility~~activities. While NERC has significantly increased its CIP Program Area staffing over recent years, and has provided oversight through other means, audit staff believes that insufficient resources have been devoted to oversight of Regional Entity audit activities in the CIP area.

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NERC Activities – Neither the Commission nor NERC ~~did not~~ have established written criteria to determine whether specific activities NERC performs are statutory activities that should be funded under the Federal Power Act (FPA) section 215. ~~Audit staff is concerned that NERC's failure to develop written criteria to guide its decisions of what constitutes a statutory activity is directly related to its philosophy that all activities that promote the reliability of the Bulk Power System (BPS) are statutory.~~ As a result, it was difficult for audit staff to determine ~~the scope and extent of permissible~~whether all of the activities that ~~should be~~NERC performs are appropriately funded under section ~~215 and NERC's method of prioritizing such activities to ensure the appropriate focus of activities undertaken as the ERO.~~215.

NERC as the Electric Sector Information Sharing and Analysis Center – NERC's dual role as the Electric Sector-Information Sharing and Analysis Center (ES-ISAC) and as the ERO raises significant challenges. NERC ~~has continued functioning in both roles, resulting in internal confusion and confusion among the Commission and stakeholders~~should continue to address these challenges through appropriate separations and additional transparency.

E. Summary of Recommendations

This section summarizes audit staff's recommendations to remedy the audit findings and enhance performance of NERC's budget process. ~~Audit staff will conduct a post-audit site visit when NERC reports that it has completed all of the recommendations to ensure that all of the corrective actions taken as a result of implementing the recommendations were properly completed.~~[Note to Audit Staff: NERC does not believe that both a third party audit and a second audit by DA are appropriate, as explained in NERC's Response.] Detailed recommendations are included in section IV of this report. Audit staff recommends that NERC:

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

2. ~~Develop a transparent process that permits~~Continue to make improvements in budget transparency that informs the Commission, the ~~BOT~~Board and stakeholders ~~opportunity for authorizing~~concerning the expenditure of funds approved for specific budgeted statutory activities ~~to be redirected to~~on unbudgeted activities, and develop and obtain Board approval of enhanced guidelines governing such expenditures, including criteria for determining when Board approval is required;

3. ~~Request budgetary funds for activities initiated between budget cycles that were not included in the annual budget filing in accordance with section 1108 of the NERC Rules of Procedure (ROP);~~[Deleted];

9 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

4. Increase the granularity of the NERC budget filings by: (1) breaking out ~~significant cost categories in its expenses; (2) identifying proposed budgeted expenditures, at a minimum, on a project specific basis; and (3~~budgeted expenses, such as budgeted contractors and consultant expenditures, into more detailed cost categories; and (2) separating working capital reserves needed for operations from working capital reserves needed for contingencies and identifying those contingencies to the extent they are known during business planning;

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

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

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

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

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

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

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

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

13. ~~Implement functionality in the expense reporting software to allow the tracking of expenses on a project and activity basis;~~As part of its business

10 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

plan and budget, in 2013 conduct a cost-benefit analysis of implementing project level budgeting and accounting systems;

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

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

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

17. ~~Contract for new~~Continue to perform routine and periodic updates to employee compensation studies ~~that use~~, using comparability data that targets the required skill sets and competencies needed to carry out NERC's mission as the ERO~~. Submit the compensation studies with audit staff upon completion~~;

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

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

20. ~~Divide its process for approving expenses into two steps, leaving managers responsible for approving the purpose and rationale for incurring expenses and designating accounting staff to be responsible for evaluating the reasonableness of expenses;~~[Deleted, as this recommendation is subsumed in Recommendation 19];

11 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

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

22. Explicitly budget for employee ~~entertainment~~rewards and recognition expenses, if any, by including line items of sufficient granularity in the budget filings;

23. Use miscellaneous expense accounts to track ~~entertainment~~employee expenses which are primarily social in nature, if any, separately from business-related expenses in its accounting system;

24. Ensure ~~entertainment~~such expenses are clearly and transparently ~~presented~~included in budgets submitted to the ~~BOT,~~Board and Commission~~, and stakeholders in the budget before these costs are incurred~~;

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

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

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

28. ~~Conduct an analysis of BOT participation and effort based on a time study using actual time spent during BOT activities, or a representative study of the actual time spent, and implement a compensation methodology that pays BOT members reasonably for performance of their duties;~~Continue to conduct periodic updates and review of the Board compensation model and compensation levels, taking into account Board time and participation on Board activities and market comparability data of appropriate comparator organizations;

29. ~~Estimate and include in its annual budgets an amount of funding to cover BOT entertainment expenses that it deems appropriate and seek approval for such funding;~~[Deleted, as this recommendation is subsumed in Recommendation 30];

12 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

30. Track the ~~entertainment~~ expenses actually incurred for Board activities to the budgeted amounts for such expenses;

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

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

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

34. ~~Develop an alternative mechanism for addressing pension~~Continue to use the mechanism that has been adopted and consider additional mechanisms to allow employees to address tax deferred retirement savings of contributions in excess of the IRS cap ~~that maintains the payment as a retirement benefit and not as additional compensation to the employee~~on 401(k) contributions;

35. Conduct an assessment of existing CIP-related staffing levels to ensure ~~that NERC staff work aligns with section 215 activities and that~~ there are adequate resources to accomplish CIP work, particularly with respect to Regional Entity CIP auditing and other Regional Entity CIP-related CMEP activities;

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

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

38. ~~Identify all ERO activities funded under section 215, detailing, at a minimum: the purpose of the activity, a description, and the justification for using section 215 funding. Submit all documentation to audit staff for these reliability activities;~~In its annual business plan and budget filings, provide an explanation as to why the proposed activities to be undertaken by each program area for the budget year are statutory, including at a minimum: a

13 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

description and the purpose of the major activities to be undertaken by each program area and an explanation for why the activity is a statutory activity;

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

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

39. ~~41. Clarify~~Provide additional information in NERC's 2013 Business Plan and Budget regarding NERC's role as the ES-ISAC and provide opportunities for stakeholder input regarding NERC's role as the ES-ISAC during the 2013 business plan and budget process. This should also include: (1) an evaluation of the impact, if any, on NERC's compliance-related activities of "walling off" certain staff from these activities; and (2) clarification of the flow of information between the ES-ISAC and the ~~Federal Energy Regulatory~~ Commission ~~(FERC)~~ staff for situational awareness and compliance purposes; ~~and~~

40. [This recommendation is incorporated in Recommendation 39];

41. [This recommendation is incorporated in Recommendation 39]; and

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

F. Compliance and Implementation of Recommendations

Audit staff further recommends that NERC:

- Submit for audit staff ' s review its plans for implementing this report's recommendations. NERC should provide these plans to audit staff within ~~30~~60 days of the issuance of the final audit report in this docket.

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

14 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

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

- Select an independent third party~~, with DA staff approval, to~~ consultant to conduct an independent review of NERC's implementation of the agreed-upon audit recommendations regarding budget formulation, administration and execution processes~~. The third-party auditor shall~~ and submit a report contemporaneously directly to ~~DA~~Audit ~~s~~Staff and to NERC. ~~If DA staff so requests, NERC will contract for a second independent audit for the following year.~~

II. Background

A. NERC Budget

NERC Budget Process

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

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

NERC's annual business plan and budget process includes posting of assumptions for stakeholder comment, posting of multiple drafts of its business plans and budgets for stakeholder comment, meetings with stakeholder groups, and presentation and discussion of the proposed business plans and budgets at open meetings of the NERC Board Finance and Audit Committee ("FAC"), Member Representatives Committee ("MRC"), and the Board of Trustees. Additionally, after the Business Plan and Budget is filed with the Commission, the Commission provides stakeholders an additional opportunity to submit comments. Drafts of the business plan and budget are posted on NERC's website and are publicly available. Below is a summary of NERC's budget filings that the Commission accepted along with conditions on the acceptance of NERC's business plan and budget.

NERC and the Regional Entities' 2007 Budgets

On August 23, 2006, NERC filed its and the Regional Entities' 2007 business plans and budgets with the Commission. NERC then made a supplemental filing on October 6, 2006 to update information the Regional Entities provided in the original budget filing.

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

16 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

The Commission issued an order conditionally accepting the 2007 business plans and budgets on October 24, 2006. The Commission conditioned its acceptance of the budget filing on NERC's development of a system of accounts comparable to the Commission's Uniform System of Accounts. The Commission required NERC to develop its proposed system of accounts and record-keeping requirements, include it as part of its 2008 budget filing, and inform the Commission as to whether NERC's system of accounts complied with generally accepted accounting principles. Also, the Commission required NERC in its 2008 budget filing to identify its general statutory activity and the sub-activities NERC's 2008 budget and business plan covered. Moreover, the Commission directed NERC to provide further consistency and standardization in the formatting of its budget and those of the Regional Entities, and to identify the criteria used for categorizing statutory activities so proposed budgets are consistent across funded activities. Lastly, the Commission directed NERC to add detail to its 2008 budget on: (1) its compliance enforcement activities, including comparisons to its 2007 accomplishments; (2) the estimated number of staff it will provide to assist the Regional Entities; (3) the estimated number of ERO staff on each audit team; and (4) the percentage of reliability standard compliance audits in which the ERO will participate, and how the ERO will select which audits to monitor. NERC submitted compliance filings, as required, addressing these directives, which were accepted by the Commission. Among other things, NERC, in a compliance filing, submitted and described its system of accounts, which the Commission accepted in a subsequent order.

NERC and the Regional Entities' 2008 Budgets

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

17 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

NERC's performance assessment, due in 2009. NERC made compliance filings, as required, addressing the directives, which were accepted by the Commission in subsequent orders.

NERC and the Regional Entities' 2009 Budgets

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

NERC and Regional Entities' 2010 Budget

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

18 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

for conducting Compliance Violation Investigations (CVIs). NERC provided additional information in a compliance filing, as required, which was accepted by the Commission.

NERC and the Regional Entities' 2011 Budgets

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

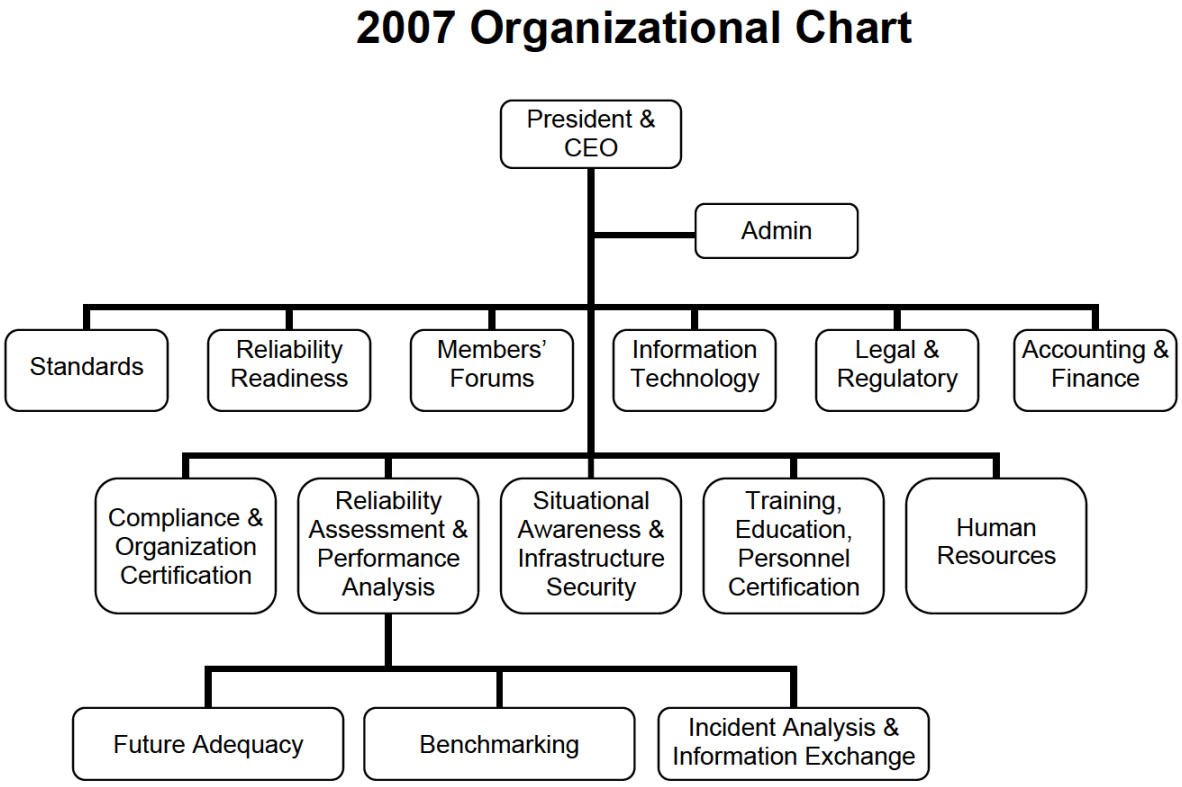
NERC and the Regional Entities' 2012 Budgets

On August 24, 2011, NERC filed its and the Regional Entities' 2012 business plans and budgets. The Commission issued an order accepting the 2012 business plans and budgets on October 20, 2011 without condition. In its order, the Commission accepted NERC's explanation concerning why a presentation and analysis of budget metrics for the current fiscal year was not a useful exercise that would provide meaningful information. The Commission did not identify any issues that required a compliance filing.

B. NERC Organizational Structure and Staffing

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

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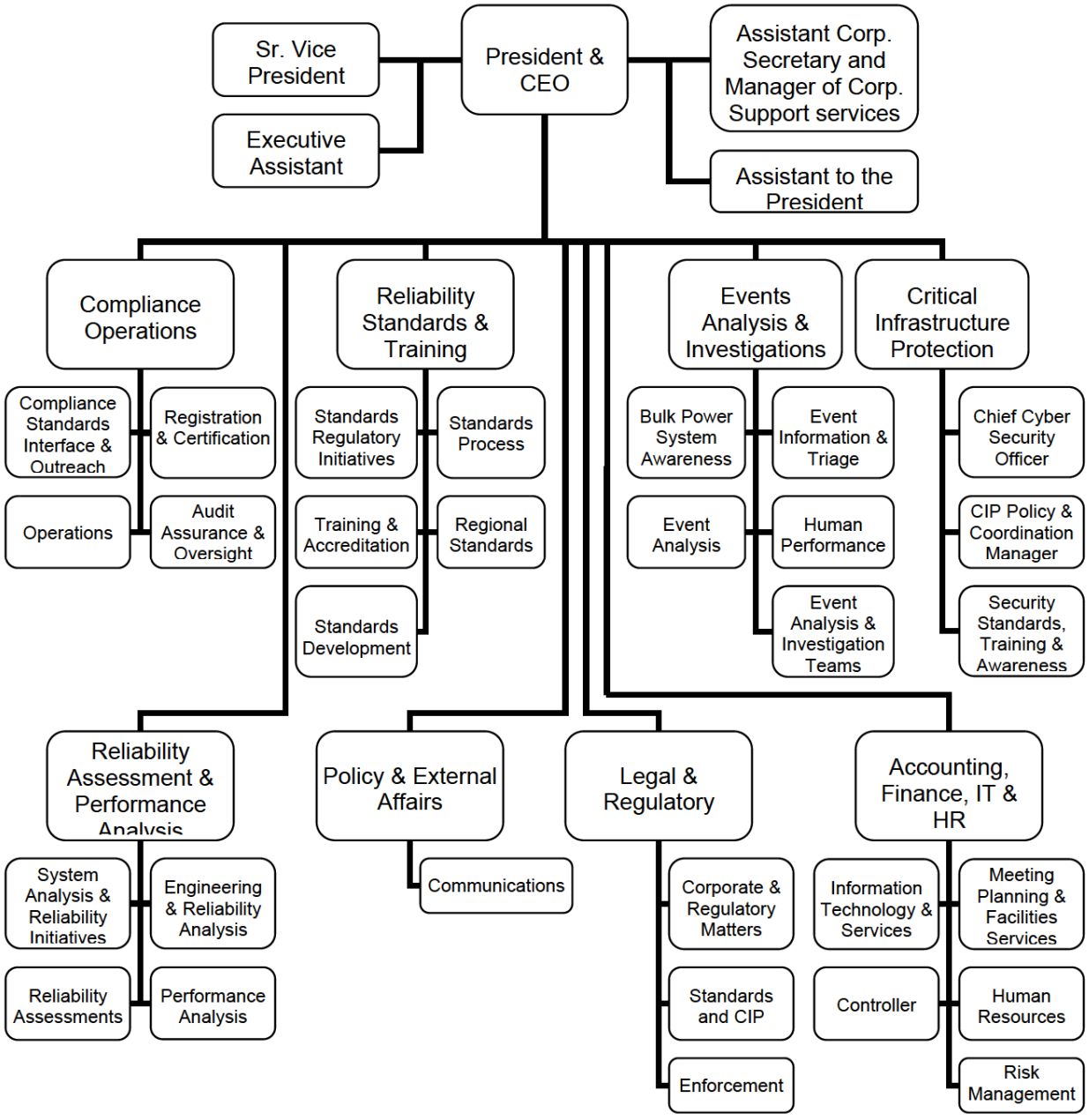


NERC's organizational charts have continued to generally reflect the broad functional categories initially approved by the Commission when it certified the ERO (i.e., operating divisions within NERC). ~~As such, they~~NERC does not view its organization as a matrix organization, but one in which resources from multiple departments support particular business needs requiring multidisciplinary support. However, in audit staff's view, the organizational charges do not clearly reflect the relationships that exist in the performance of particular tasks. Audit staff views NERC ~~operates~~as operating in a matrix

(i.e., cross-functional) environment with staff participating in specific programs that sometimes span operating divisions, ~~making~~which audit staff found made it difficult to discern lines of responsibility and authority.

Below is NERC's organizational chart effective February 2012:

2012 Organizational Chart



21 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

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

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III. Introduction

A. Objectives

The objective of this financial performance audit was to evaluate NERC's budget formulation, administration, and execution. This economy and efficiency audit focused on the costs and resources used to achieve program objectives. The audit covered the period from August 23, 2006 to March 15, 2012.

B. Scope and Methodology

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

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

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

- *Conducted Site Visits* – Audit staff conducted site visits to NERC facilities to gain a thorough understanding of NERC's processes, procedures, and operations. During the site visits, audit staff conducted extensive interviews, learned about NERC's operations, evaluated policies and controls, and sampled accounting records and supporting documentation. Audit staff interviewed the majority of NERC's executive management team, including ~~the~~but not limited to the President and Chief Executive Officer (CEO) and Chief Financial and Administrative Officer (CFO), as well as support personnel in the accounting, legal, and government affairs departments. Specific topics covered included:

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

23 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

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

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

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

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

Objectives of the ERO and NERC's Functional Organization

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

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

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

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

Budget Development, Administration, and Execution

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

- Reviewed NERC's process for compiling and submitting the annual budget and true-up filings for Commission approval;
- Discussed NERC's BOT involvement in the budget development and approval process;
- Interviewed ~~multiple~~three BOT members about their involvement in the budget development and approval process;
- Examined the controls in place to ensure adherence to the NERC budget, as well as the controls for overseeing the development, administration, and execution of the Regional Entity budgets;
- Interviewed the CEO and other executive management about their roles in developing and executing the annual budget; and
- Discussed how NERC budgets for particular programs and initiatives, as well as for day-to-day operations, contingencies, and other activities.

NERC's System of Accounts and Accounting for Expenses

- Examined the accounting system in place at NERC, including the associated policies, procedures, and controls;
- Evaluated the adequacy of the currently enabled functionality of the accounting system;
- Sampled travel and operating expenses and reviewed the supporting documentation;
- Interviewed the CFO and accounting staff about specific accounting treatments and activities, including NERC's headquarters relocation, working capital, line of credit, capital expenditures and depreciation, and interest income;
- Reviewed and discussed the lobbying activities and expenses of the legal, government affairs, and executive management staff;
- Discussed the role and responsibilities of the BOT Finance and Audit Committee (FAC); and
- Interviewed the chairperson of the FAC.

25 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

NERC Staffing and Organizational Responsibilities

- Discussed the alignment of NERC's staffing and resources to the responsibilities of the ERO;
- Examined the qualifications of NERC staff, including support personnel, executive management, and operational staff, as well as the qualifications of contractors;
- Examined the compensation of NERC staff, including benefits, bonuses, and other forms of incentive compensation;
- Evaluated the controls in place with respect to employee compensation;
- Reviewed the compensation studies and supporting documentation relied upon by NERC to determine employee base salary, bonuses, and other incentive compensation;
- Interviewed NERC Human Resources staff to discuss the NERC hiring process, including NERC's approach to succession planning for key staff and positions, employee qualifications, and employee retention and turnover;
- Discussed NERC's oversight of the Regional Entities' staff and contractors responsible for performing compliance monitoring and enforcement program (CMEP) activities;
- Discussed NERC's headquarters relocation, its effect on staffing, and the efforts taken by NERC to retain key employees;
- Discussed the compensation of NERC's BOT;
- Discussed the role and responsibilities of the BOT Corporate Governance and Human Resources Committee (CGHRC) in relation to employee and BOT compensation;
- Interviewed the chairperson of the CGHRC;
- Reviewed the employee performance evaluation process and discussed how it ties to the bonus allocation process; and
- Reviewed employment ~~contracts in place~~letters and written agreements with current and former employees.

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IV. Findings and Recommendations

1. NERC Budget Process

NERC's budget process ~~does not provide sufficient~~would benefit from additional transparency to allow the Commission, the BOT, and stakeholders to efficiently and effectively evaluate annual budget requests and subsequent ~~requests to change~~changes in the use of funds from the approved budgets. ~~This situation was due to a lack of~~These enhancements would include additional procedures and controls to:

- Address the use of ~~section 215 funds for unbudgeted activities as well as the redirection of~~ unused budgeted funds from approved ~~statutory~~budgeted activities ~~to~~for unbudgeted activities;
- Advise the Commission, BOT, and stakeholders of significant deviations from requested budgeted targets; and
- Develop budget filings with additional granularity ~~to~~at activity- and project-specific levels.

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

Pertinent Guidance

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

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

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

27 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

> annual Electric Reliability Organization budget shall include line item budgets for the activities of each Regional Entity that are delegated or assigned to each Regional Entity pursuant to § 39.8.[9]

18 C.F.R. § 39.4(d) further states:

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

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

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

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

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

[9] 18 C.F.R. § 39.4(b) (2011).

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

28 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

FERC and other Applicable Governmental Authorities having authority to approve the proposed budget.

The Commission has accepted each of the six annual business plans and budgets of NERC and the Regional Entities filed by NERC and the related assessments to U.S. LSEs to provide the funding for the statutory activities of NERC and the Regional Entities.

Background

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

Controls on Funding Unbudgeted Activities

Audit staff has concerns that NERC does not have sufficient procedures or controls to ensure~~: (1)~~budgeted section 215 funds are not used to pay for reliability activities that were not budgeted or approved~~, and (2) unused budgeted funds from statutory activities are not redirected to unbudgeted activities~~. NERC officials indicated during the audit that approved budgeted funds are at times seen as a cap on total spending ~~rather than as funds designated for accomplishing a specifically approved, statutory reliability activity. Such~~with management having discretion in how it elects to manage and utilize those funds within the context of the activities generally described in its business plan and budget. In audit staff's opinion, such practices erode the transparency of the budget, and cause the input and direction provided by the BOT, the Commission, and stakeholders through the budget review and approval process to be devalued or lost.

Audit staff believes that the manner in which NERC funded its recent office and data center relocations and the Washington, DC, expansion demonstrates NERC's ability to ~~redirect~~utilize a significant amount of unused funding without providing sufficient notice or transparency to the BOT, the Commission, and stakeholders. ~~Audit~~NERC management provided audit staff with an analysis of working capital ~~disclosed~~which showed that NERC's working capital reserves increased ~~by millions~~significantly over the projected working capital reserves for 2011. The significant increase in working capital reserves were generated primarily from unused funds, due to factors such as the inability to hire employees to fill unbudgeted positions by the dates assumed in the budgets, or the unexpected departures of existing employees, resulting in unfilled budgeted positions. NERC used these monies included in its working capital reserves to pay ~~for~~costs to

29 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

complete the relocations and expansion in 2011 in excess of the funds specifically budgeted for these purposes in the 2011 budget. While NERC stated in its 2011 business plan and budget that it would use working capital funds to fund the cost of the relocation in excess of funds specifically set forth in its budget, information regarding the total projected cost of relocation was not included in the 2011 budget since NERC could not project these costs at the time the budget was submitted to the Commission for approval.

In 2011 NERC relocated its corporate headquarters from Princeton, NJ to Atlanta, GA, expanded its office space in the Washington, DC area, and accelerated the relocation of its data center. ~~NERC accomplished these~~The plans to relocate NERC's headquarters from Princeton to Atlanta, and to expand the Washington, D.C. office, were justified internally, including Board approval, and the plans and the basis for the decisions were described in the 2011 Business Plan and Budget filing,[11] which was accepted by the Commission. The need for the relocation of the data center was due to the facts that the existing data center was outdated, did not contain back-up power or sufficient fire protection. NERC believed that once the headquarters relocation was announced, accomplishing it quickly would minimize disruptions to the operations of the organization, including having office space available for additional personnel which were budgeted but not yet hired and replacement of personnel for employees choosing not to relocate. NERC accomplished the three parts of the relocation almost entirely during 2011, though its final 2011 budget expressed only an intention to *begin* the process of relocating its corporate headquarters to a location suitable to effectively conduct its role as the ERO. ~~In the~~The 2011 budget filing~~, NERC stated the budgeted~~ included expenses for 2011 related to the relocation total~~ed~~ing $1,175,000, including $200,000 in moving expenses, $750,000 in unspecified relocation expenses, and $225,000 in startup costs for the data center relocation.[~~11~~] ~~In that filing, NERC also stated that it expected to incur further relocation expenses gradually in 2012 and 2013, and that it would end the relocation no later than May 2013.~~[~~12~~][12] NERC indicated that it would fund the balance of the relocation using working capital reserves. In that filing, NERC also stated that it expected to incur further relocation expenses in 2012 and 2013, and that it expected it would complete the relocation no later than May 2013, the date of the expiration of the lease for its headquarters space in

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

~~[11] North American Electric Reliability Corporation, Request, Docket No. RR10-13-000 (filed Aug. 24, 2010) (submitting its 2011 business plan and budget, for approval) at P 34 and P 86.~~

[12] ~~*Id.*~~North American Electric Reliability Corporation, Request, Docket No. RR10-13-000 (filed Aug. 24, 2010) (submitting its 2011 business plan and budget, for approval) at P ~~50.~~34 and P 86.

 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

Princeton, New Jersey.[13] Given that (1) the NERC Board approved the headquarters relocation in June 2010, a short time before the 2011 budget needed to be completed for filing with the Commission, and (2) NERC was in the early stages of implementation of its relocation strategy and was not able to project relocation costs with a sufficient level of certainty or develop more detailed cost estimates in time to include in the 2011 budget filed with the Commission, NERC did not include an estimate of the total costs of the relocation in its 2011 budget submission.[13][14] However, NERC spent a total of $6,540,000 on the relocation in 2011, completing

NERC completed the entire headquarters and data center relocation efforts and the majority of the Washington, DC, office expansion during that year. Audit staff's analysis of NERC accounting records revealed2011. NERC spent a total of $6,375,000 on the relocation in 2010, 2011 and 2012, including $747,000 of recorded rent expense that was abated and did not require a cash expenditure. Of this total amount, $1,953,000 was for the costs of the data center facility relocation. Additionally, NERC received significant rent abatement and tenant improvement allowances in 2011 and 2012 for its new office space in Atlanta under the terms of that lease, as well as access to significant furnished temporary space in the same building free of charge. NERC also negotiated free temporary space and a significant tenant improvement allowance in connection with its new space in Washington, D.C. which was need to accommodate NERC's additional Washington-based staff given limitations with its former Washington office space. Actual and projected budget impacts of the relocation were included in the quarterly variance reports that NERC posted in its website and reviewed at open meetings of the NERC Board's Finance and Audit Committee. Although NERC used working capital reserves in 2011 to fund a substantial portion of the office relocation costs, NERC did not find it necessary to include a component in its assessment to load-serving entities for 2012 to increase or restore its working capital reserve.[15]

NERC provided audit staff with an analysis that showed that approximately $3,278,000 of NERC's additional expenditures over the budgeted amount to fund the relocation came from unused funds redirected from other approved budgeted activities. Since NERC had no guidelines placing limits on the use of such available funds, audit staff believes that NERC elected to use them for its relocation.Audit staff believes that working capital should be usedhigher than projected balances of working capital reserves which, as noted, resulted primarily from under-runs in costs incurred for personnel expenses. Working capital reserves are maintained both to cover short-term operating cash flow

[13] *Id.* P 50.

[13][14] *Id.* P 50.

[15] *Request of the North American Electric Reliability Corporation for Acceptance of its 2012 Business Plan and Budget and the 2012 Business Plans and Budgets of Regional Entities and for Approval of Proposed Assessments to Fund Budgets*, Docket No. RR11-7-000, filed Aug. 24, 2011 ("2012 ERO Budget Filing"), at 53-54.

31 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

concerns due to timing differences between when expenses are paid and when funding is received~~.~~, and to provide readily available funds to meet unforeseen expenditures.[16] In interviews, NERC officers stated that working capital reserves are seen more as contingency funding, used for unexpected expenditures (e.g., an unanticipated event investigation) and for projects that were not finalized at the time of the budget filing but came to fruition during the operating year. Audit staff believes that a distinction needs to be made between reserves needed for continuing operations (working capital reserves) and reserves needed for contingencies (contingency reserves). Audit staff also believes that NERC should use the Commission-approved process set forth in section 39.4(d) of the Commission's regulations for requesting additional funding for projects that are initiated or completed outside of the budget cycle, where an additional or supplemental assessment to LSEs is needed due to insufficient funds or to maintain an adequate working capital reserve. This process exists not merely to provide NERC ~~funding for~~with the ability to collect an additional or supplemental assessment to fund an activity, but also to give the BOT, the Commission, and stakeholders a chance to evaluate ~~and~~the activity and for the BOT and the Commission to approve the ~~activity~~expenditure and the associated additional or supplemental assessment.

~~Significant~~ Deviations from Budgets

Audit staff identified some ~~significant~~ deviations between the budget formulation and execution phases of NERC's budget process that resulted in ~~divergence from budgeted expenditures~~funds being expended on items which were not specifically identified in NERC's budget. Audit staff believes NERC operates as if the approved budget sets a cap under which NERC ~~may redirect~~management may exercise considerable day-to-day discretion in the management of its budgeted resources ~~without disclosure to the BOT, the Commission, and stakeholders prior to expending such funds~~and activities. Rather than retain ~~these funds~~excess working capital to offset future assessments or seek approval to use these funds, NERC expended the funds as it ~~saw fit~~deemed necessary, either on activities or projects that were not specifically approved through the budget process, including activities or projects the need for which was identified or arose after the budget for the year was finalized, or on approved projects that were budgeted at levels significantly below what NERC actually ~~expended~~needed to expend on them.

For a variety of reasons during the operating years, NERC has been unable to expend funds according to the proposed expenditures it presented in its budget. Some of these reasons include: (1) an inability to use approved ~~fulltime~~funding for full-time equivalent (FTE) ~~funding~~positions because NERC is ~~unable~~operating in a tight market to attract ~~suitable~~qualified candidates in ~~a timely fashion~~the time frames assumed in the budget; (2) unanticipated resignation of staff members; and (3) fewer industry participants than projected when formulating the budget. Moreover, NERC must reprioritize its

[16] 2010 ERO Budget Order at P 24.

 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

planned activities to address unanticipated events that occur during the operating year after budget approval. While audit staff recognizes these possible disconnects between budget formulation and execution, we believe NERC should develop more robust procedures to allow the BOT, the Commission, and stakeholders to see, and the BOT and Commission to approve where appropriate, how unused funds are redirected during the operating year.

Increased Granularity of the Budget

NERC's budget filings are broken out into the functional categories that were approved by the Commission when NERC was certified as the ERO, and as amended in subsequent Commission orders. ~~While this~~This breakdown may be useful to examine cost trends over time; however, NERC's operational structure has notably evolved since it first became the ERO. NERC currently engages in reliability activities that span multiple functional areas ~~(i.e., a matrix environment). As a result, it is~~. While NERC tracks costs and provided audit staff with copies of monthly variance reports by department and Program Area, as well as publicly posts and reviews quarterly variance reports by Program Area with its Finance and Audit Committee, audit staff found it difficult to understand the amount and level of NERC's funding expended on general functional areas, much less on specific activities, taking into account cross departmental support. Audit staff believes that budget reporting at a more granular level would allow for a greater understanding and appreciation by the BOT, the Commission, and stakeholders of the reliability activities NERC is undertaking and the costs associated with them. For example, other sections of this audit report indicate specific areas that audit staff has identified as warranting a more detailed level of reporting than is currently provided in the budget process.[~~14~~17]

An example of an area that audit staff believes needs more granularity in budget filings is the manner in which the total cost of BOT oversight responsibilities is reported. While NERC separately reports Board of Trustee members' compensation, this is only a portion of the actual costs of providing BOT oversight to the ERO. Reporting the costs associated with holding periodic board meetings (e.g., hotel conference facility charges), the costs of the various BOT committee meetings that are convened, BOT travel expenses for attending BOT and Regional Entity board meetings, and other BOT-related costs as elements of total BOT expenses would allow greater attention to be focused on this important element of the NERC budget. (See Finding 5 below.) This level of granularity would provide greater opportunity to the BOT, the Commission, and stakeholders to

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[~~14~~17] For example, Finding ~~5 recommends that BOT entertainment expenses not be recorded as general business expenses, Finding~~ 7 deals with employee expenses that need to be separately reported and Finding 10 concludes that expenses for employee ~~entertainment~~rewards and recognition should be presented as a discrete line item in the budget.

33 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

review and comment on costs directly incurred by the ERO with an effort to increase efficiency and effectiveness.

~~Audit staff also found that NERC was directed to file true-ups~~In accordance with Commission orders, NERC files annual true-up reports with the Commission to provide the Commission and stakeholders with information that will help in analyzing the following year's budget.[~~15~~18] ~~Reviewing~~To date, all of NERC's annual true-up filings have been accepted by the Commission. However, reviewing these true-up filings, audit staff ~~discovered that~~experienced difficulty in following actual expenditures in the budget true-up filings ~~was difficult~~ because of the lack of granularity in reporting certain expenditures, the ~~redirection~~use of funds for other budgeted activities, and the funding of unbudgeted programs. This difficulty diminishes the usefulness of true-up filings for informing the following year's budgets. In line with improved transparency and granularity in the budget approval process, audit staff believes the annual budget true-up filings should be reported with a degree of granularity that is similar to the initial budget request. True-up filings should clearly ~~distinguish which projects came in under budget, which projects had funds redirected to other programs and the effect of those redirections, and which unbudgeted projects were funded~~explain variances in projected costs with the same level of detail contained in the budget or as otherwise specified by the Commission, including the use of funds for activities not specifically set forth in the budget.

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

Recommendations:

We recommend that NERC:

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

2. ~~Develop a transparent process that permits~~Continue to make improvements in budget transparency that informs the Commission, the BOT and stakeholders ~~opportunity for authorizing~~concerning the expenditure of funds approved for specific budgeted statutory activities ~~to be redirected to~~on unbudgeted activities, and develop and obtain Board approval of guidelines

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[~~15~~18] *North American Electric Reliability Corporation*, 121 FERC ¶ 61,057 at P 23 (2007).

34 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

governing such expenditures, including criteria for determining when Board approval is required;

3. ~~Request budgetary funds for activities initiated between budget cycles that were not included in the annual budget filing in accordance with section 1108 of the NERC Rules of Procedure (ROP);~~[Deleted];

4. Increase the granularity of the NERC budget filings by: (1) breaking out ~~significant cost categories in its expenses; (2) identifying proposed budgeted expenditures, at a minimum, on a project specific basis; and (3~~budgeted expenses, such as budgeted contractors and consultant expenditures, into more detailed cost categories; and (2) separating working capital reserves needed for operations from working capital reserves needed for contingencies and identifying those contingencies to the extent they are known during business planning; and

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

 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

2. NERC Oversight of the Regional Entities' Budgets

NERC's current process of reviewing Regional Entities' budgets ~~is inadequate and lacks appropriate~~would benefit from further qualitative procedures to efficiently and effectively assess Regional Entities' annual budgets. Greater qualitative oversight in this area may improve the efficiency and effectiveness of the ~~process, yielding savings for the ERO~~Regional Entity business plans and budgets, and may identify cost reduction possibilities in some areas while identifying the need for Regional Entities to budget and expend additional resources in other areas.

Pertinent Guidance

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

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

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

In addition, the Commission reiterated in Order No. 672 that the ERO may delegate its enforcement activities to the Regional Entities.[~~16~~19]

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

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

[~~16~~19] Order No. 672, 114 FERC ¶ 61,104 at P 23.

36 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

> Accordingly, the ERO must exercise budgeting oversight over the Regional Entities.

On April 4, 2006, NERC filed its Rules of Procedure with the Commission.[~~17~~20] The Rules of Procedure include a section on Submittal of Regional Entity Budgets to NERC (section 1104). In the filing, NERC's section 1104.2 stated NERC will presume each regional entity's budget is reasonable if their governing body has approved the budget for submission to NERC. However, a Commission order addressed the issue of the reasonable budget of the regional entity:

> NERC has not provided sufficient rationale for the provision that would establish a presumption of reasonableness by the ERO of a Regional Entity's budget if the Regional Entity's governing body has approved its budget. We believe that this proposed provision could hinder the ERO's ability to conduct a meaningful review of the proposed Regional Entity budgets as contemplated by Order No. 672 and is inconsistent with the overarching goal of establishing a strong ERO. Accordingly, we direct NERC to remove this provision from the *pro forma* delegation agreement…We agree with the California Commission that the budget should provide for performance and funding of reliability functions that are essential for maintaining overall reliability, that the way to accomplish this is by having the ERO review the budget and, where necessary, suggest or make changes and not presume the budget and thus the activities to be reasonable.[~~18~~21]

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

> We direct NERC and the Regional Entities to examine the various activities proposed by each Regional Entity to be performed under each statutory function, and to determine what activities need to be performed consistently across the Regional Entities. They should develop their budgets for 2008 to reflect the best practices found from this examination.[~~19~~22]

[~~17~~20] North American Electric Reliability Council and North American Electric Reliability Corporation, Application, Docket No. RR06-1-000, (filed Apr. 4, 2006) (requesting certification as the Electric Reliability Organization).

[~~18~~21] *North American Electric Reliability Corporation*, 116 FERC ¶ 61,062 (2006), *order on reh'g*, 118 FERC ¶ 61,111 at P 203 (2007), *order on compliance filing*, 118 FERC ¶ 61,257 (2007), *order on reh'g*, 119 FERC ¶ 61,257 (2007), *order on reh'g*, 120 FERC ¶ 61,260 (2007).

[~~19~~22] North American Electric Reliability Corporation, 117 FERC 61,091 (2006).

37 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

Background

NERC is responsible for ensuring that funds collected under section 215, including those funds allocated to the Regional Entities, are being used efficiently and effectively. ~~To~~Audit staff's observation is that, to date, NERC's review of the Regional Entities' budgets primarily consisted of ensuring that across the regions: (1) similar costs are reported in a uniform manner; (2) staffing (FTEs) and funding are consistently distributed between major program components; (3) increases and decreases in proposed budgets and staffing by program area compared to the previous year's budgets are adequately explained; (4) variances between regions appear reasonable; ~~and~~ (~~4~~5) stakeholder comments received from the budget review process are incorporated; (6) narrative explanation of programs, staffing and initiatives are reasonable and complete; and (7) where applicable, statutory and non-statutory costs are properly separated. Audit staff noted that NERC's method of review is in accordance with its Rules of Procedure, and that in recent budget cycles NERC has improved consistency by coordinating with Regional Entities to develop a common set of assumptions. However, with maturation of the ERO, audit staff believes, as discussed in greater detail below, that NERC should conduct more focused reviews to oversee Regional Entities adequately, and to ensure their budgets are sufficient to accomplish duties delegated under section 215 in an effective and efficient manner.

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

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

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would improve NERC's oversight of the Regional Entity CIP audit program budgets and promote consistency among Regional Entity execution of their delegated duties.

Audit staff further believes NERC should address the significant costs incurred by the Regional Entities for processing compliance violations. NERC's review of Regional Entity budgets for violations processing did not include: (1) a review of the policies and procedures used by Regional Entity staff or (2) examination of the training and qualifications of the staff processing the violations. ~~Without~~While audit staff recognizes that NERC oversight of Regional Entity processing of violations occurs on an ongoing basis through the Compliance Program rather than through the budgeting (Finance and Accounting) function, nonetheless, without considering these important aspects~~,~~ as part of the budget process, audit staff believes NERC was unable to provide effective guidance and oversight to the Regional Entities in the development of their business plans and budgets to ensure consistency across the regions and efficiency of this delegated responsibility. Greater qualitative oversight in this area may improve the efficiency and effectiveness of the process, yielding significant savings for the ERO.

NERC has recently taken steps to address the costs incurred and the amount of time spent by the Regional Entities for processing compliance violations, by implementing the "Find, Fix, Track and Report" (FFT) and the "Spreadsheet Notice of Penalty" enforcement alternatives to the development of a full NOP for every Alleged Violation.[23] In approving the proposal, the Commission stated that NERC's proposal "will be the first step to a more efficient and effective compliance and enforcement process"[24] and that "we believe that the FFT proposal may significantly reduce the time and resources needed to resolve minor possible violations of Reliability Standards and thereby permit NERC and the Regional Entities to reprioritize their compliance efforts toward more important violations and matters."[25] Earlier, NERC had adopted other approaches to improve the efficiency of violations processing and dispositioning, including an Abbreviated Notice of Penalty Format, a Deficiency Notice of Penalty Format, and an Administrative Citation Notice format. The Commission stated that the Abbreviated Notice of Penalty Format and Deficiency Notice of Penalty format "have been successful in increasing efficiency" and that it expected the Abbreviated Citation Notice Format "will be a successful tool in improving the efficiency of NERC's enforcement process, thereby reducing the time and

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

[24] *North American Electric Reliability Corp., Order Accepting with Conditions the Electric Reliability Organization's Petition Requesting Approval of New Enforcement Mechanisms and Requiring Compliance Filing*, 138 FERC ¶ 61,193 (2012) ("FFT Order"), at P 41.

[25] FFT Order at P 40.

39 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

resources expended by the Regional Entities, NERC and Commission staff while still achieving transparency and consistency in penalty determinations for violations that are appropriate for this format."[26]

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

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

Recommendations

We recommend that NERC:

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

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

8. Provide budget changes and recommendations to the Regional Entities during the ~~preliminary~~early stages of the Regional Entity budget processes

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

40 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

so there is sufficient time to incorporate NERC's recommendations prior to final review and approval of such business plans and budgets by the Board.

41 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

3. Time Reporting and Accounting System

NERC's historic systems and method for reporting and tracking employee time and expenses ~~failed~~had limited capability to~~:~~ track time and attendance on ~~a~~an activity- or project-specific basis~~, or properly classify expenses in its accounting system at a level that provided sufficient transparency to permit effective budget oversight. These deficiencies were due to NERC's lack of adequate procedures for reporting and tracking employee time and insufficient functionality implemented in its accounting system. These shortcomings resulted in inefficient and ineffective~~ within NERC's defined Program Areas, or allow for the accounting of expenses at an activity- or project-specific level. Enhancements to NERC's time reporting and accounting systems, if justified by cost-benefit analysis, would facilitate improvements in budget oversight, time and expense tracking, and control over cost.

Pertinent Guidance

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

18 C.F.R. § 39.4 sets out the requirements for funding an ERO. Specifically, section 39.4(b) addresses ERO annual budget requirements.[~~20~~27]

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

> "~~Proper charges of personnel expenses~~From a financial accounting and reporting perspective, the NERC System of Accounts provides a sufficiently detailed set of Functional Categories and Accounts to result in proper recording of income and expenses by function/activity and type. For example, each item of expense received or incurred by NERC or a Regional Entity (e.g., invoices received for services and products, disbursements for salaries, payroll tax payments and medical benefits, and so forth) must be coded by Functional Category and Expense Account and then recorded accordingly in the entity's general ledger. In addition, proper charging of Personnel Expenses (including Salaries, Payroll Taxes, Employee Benefits and Savings and Retirement expenses) incurred by employees whose activities involve more than one ~~f~~Functional ~~c~~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

[~~20~~27] *See supra* text accompanying note 9.

42 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

time spent during the reporting period on activities in each Functional Category."[21][28]

In that filing, NERC submitted for Commission review NERC's proposed System of Accounts and provided a detailed description of the NERC System of Accounts. The filing was accepted by the Commission with no directives for additional detail or further changes to the NERC System of Accounts.[29]

Background

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

Tracking of Employee Time

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

Audit staff noted that in an April 1, 2008 response to the Commission's 2008 ERO budget order, NERC indicated the existence and use of agenerically described the various time reporting systems used by NERC and the Regional Entities by stating that "proper charging 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 employees were "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

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

[21] North American Electric Reliability Corporation, Filling, Docket No. RR07-16-003 at P 7 (filed Apr. 1, 2008) (responding to the Commission's 2008 ERO Budget Order[29] *Order Conditionally Accepting Compliance Filing*, 123 FERC ¶ 61,282 (2008).

43 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

Functional Category~~.~~,." The "Functional Categories" NERC referenced were originally equivalent to the operating divisions, i.e., the statutory Program Areas existing when the order was issued. ~~Thus, audit staff understood that in this filing NERC committed to maintain a reliable contemporaneous record of the time spent by each staff member on each Commission-approved function. Tracking of hours to this~~In audit staff's view tracking of hours to the level of detail described in the April 1, 2008 filing would facilitate ~~more~~ accurate and effective budget formulation and oversight.

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

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

- ~~Evaluate the effectiveness and efficiency in achieving statutory goals;~~
- ~~Submit a budget with sufficient detail to show NERC's statutory projects and activities;~~
- ~~Assist the development of core competencies required for the hiring process;~~
- ~~Track the actual effort being expended on specific projects;~~
- ~~Track and evaluate individual employee performance;~~

 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

- ~~Analyze and report on differences between incurred costs and budgeted amounts; and~~

- ~~Facilitate the development of meaningful position descriptions reflecting actual work performed.~~

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

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

NERC Accounting System

Audit staff found ~~deficiencies~~opportunities for improvement in NERC's ~~implementation of its~~ accounting and expense reporting software. These ~~deficiencies~~opportunities for improvement became apparent during the audit as NERC expended an excessive amount of time and effort to respond to certain basic requests for

45 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

data. For example, NERC was unable to readily produce records of all expenses incurred for any given event, such as a BOT meeting, or travel for a specific audit. ~~These requests required NERC~~While BOT meeting costs are budgeted and tracked separately, employee travel, meal and lodging expenses to attend BOT meetings are not budgeted or tracked as part of BOT meeting expenses and are instead budgeted and tracked by department with other employee travel, meal and lodging expenses. In order to gather information regarding the total cost of BOT meetings, NERC was required to conduct an analysis of individual expense reports to aggregate the necessary data, as NERC had no software functionality in place to efficiently aggregate the costs of a given event. Audit staff believes that NERC ~~must improve its accounting software by using: (1)~~should conduct a cost-benefit analysis of implementing project-specific and business activity codes when recording expenses~~, and (2)~~. NERC should also implement improved automated flags to alert internal users, as well as reviewers, of possible data entry problems and violations of NERC's policies and procedures.

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

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

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Recommendations

We recommend that NERC:

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

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

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

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

13. ~~Implement functionality in the expense reporting software to allow the tracking of expenses on a project and activity basis;~~As part of its business plan and budget, in 2013 conduct a cost-benefit analysis of implementing project level budgeting and accounting systems;

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

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

47 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

4. Employee Compensation

~~NERC used studies to determine~~There were numerous weaknesses in the compensation studies conducted by NERC prior to the more recent compensation study conducted for NERC in late 2011-early 2012. This was in part due to the lack of adequate funding for these studies which in turn limited the scope and depth of the studies. At the direction of the Corporate Governance and Human Resources (CGHR) Committee of the NERC Board in 2011, NERC commissioned new, more comprehensive compensation studies, conducted by a nationally-recognized employee compensation consultant, regarding employee compensation levels ~~that did not have adequate support to justify the reasonableness of compensation NERC paid its officers and staff. Audit staff is concerned~~. These studies were completed in late 2011-early 2012. The new studies were designed to address a number of weaknesses which existed with prior studies which, as noted, were in part due to the lack of adequate funding for these studies. While the new studies are a significant improvement over the previous studies, audit staff believes that NERC should periodically update these studies. Audit staff also believes that NERC ~~has not systematically assessed~~would benefit from a more systematic assessment of its organizational staffing needs to determine the core competencies and skill sets required of employees. ~~This weakness occurred in part because NERC did not contract for an adequate compensation study. As a result, NERC incurred considerable personnel costs funded by end-users under section 215.~~

Pertinent Guidance

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

18 C.F.R. § 39.4 sets out the requirements for funding an ERO. Specifically, section 39.4(b) addresses ERO annual budget requirements.[~~22~~30]

Background

Since becoming the ERO, NERC grew from an organization with approximately 70 employees in 2006 to over 175 budgeted employees in 2012. Examination of NERC's budgets showed that ~~employee compensation~~Personnel Expenses (i.e., salaries, payroll taxes, employee benefits, and retirement) dramatically increased during this growth period.

[~~22~~30] *See supra* text accompanying note 9.

48 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

~~Employee compensation~~Personnel Expense is the largest cost category in the NERC budget, amounting to $30.1 million in 2012, representing 61.4 percent of the budget.[~~23~~31]

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

In November 2008, the BOT established and approved a process for determining compensation levels for the CEO, executives, and employees (Compensation Policy).[~~24~~32] This document outlines the process guiding the BOT's consideration of employee compensation levels. The essential element of this process is the need for reliable "comparability data" by which to measure remuneration.

During the ~~audit~~ period covered by this audit, NERC contracted ~~four~~three independent firms to conduct ~~eight~~a total of four compensation studies. NERC ~~meant~~'s intent was that the compensation studies ~~to~~would provide guidance on compensation levels and benefits for the CEO, executives, and employees. Given the nature of NERC's role as the ERO, audit staff believes that detailed compensation studies should take NERC's functional and operational responsibilities into consideration to determine the most applicable comparability data. However, NERC appropriated a relatively low level of funding to the ~~first six~~2011 staff and management compensation studies it commissioned, resulting in insufficient analyses and inadequate "comparability data." While audit staff does not believe that more funding would necessarily produce higher quality studies, nonetheless, in audit staff ~~believes the lack of sufficient funding is an indicator of the relative importance that NERC attributed to the studies. Audit staff is concerned that the low level of funding coupled with NERC's lack of attention and control over the assumptions used in the studies led to the inclusion of companies in the compensation studies that did not operationally correlate to NERC. These studies~~'s opinion, the 2011 studies prior to the more recent studies which were completed in 2012 provided limited

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[~~23~~31] North American Electric Reliability Corporation, Request, Docket No. RR11-7-000 at Attachment 2 at page 25 (filed Aug. 24, 2011)(submitting the 2012 business plans and budgets of NERC and Regional Entities for acceptance and Proposed Assessments to Fund Budgets for approval)

[~~24~~32] Process for Determining Annual Compensation of Independent Trustees, Chief Executive Officer, Other Officers, and Key Employees, November 13, 2008 (http://www.nerc.com/files/Process%20for%20Determining%20Annual%20Compensation.pdf).

49 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

relevance and usefulness as "comparability data" and lacked the substance needed to provide reasonable compensation comparators for NERC staff and BOT to make appropriate compensation decisions. ~~As one NERC executive characterized these efforts: "You get what you pay for."~~ The following table describes the compensation studies NERC undertook to establish a basis for CEO, executive, and employee compensation levels:

NERC Compensation Studies

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

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

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

~~*2011 Executive and Staff Compensation Study*~~

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

51 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

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

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

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

~~*More Recent Compensation Studies*~~

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

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

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

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

NERC was dissatisfied with the Executive and Staff Compensation study and benefits study conducted in early 2011, primarily because the consultant did not have data for, and therefore did not include, many representative companies that NERC was recruiting from or targeting to recruit from. NERC decided that there was no value to trying to improve these studies given the year-end timing of compensation decisions and the weakness of the relevant market data available in the studies. Therefore, NERC commissioned Mercer Group, Inc., an internationally-recognized compensation consulting firm, to conduct a new set of compensation studies. Mercer conducted separate compensation studies relating to NERC executive direct compensation, executive

retirement and supplemental benefits, and NERC staff total compensation. When the studies were completed, the NERC Board met with Mercer in a six-hour meeting, a portion of which was without management present, in February 2012 to review the studies, and then held a meeting with management to give specific direction on how the results of the studies should be implemented.

~~For the study of total compensation and rewards for NERC staff, the Mercer report found that total cash compensation was in line with or above market levels~~Audit staff had concerns with respect to the January 2011 Executive and Staff Compensation Study and the more recent Mercer Studies. With respect to the January 2011 study, audit staff believes that the study had several flaws, including treating companies from outside the electric sector as comparable and having limited supporting data. With respect to the Mercer study, audit staff also had concerns with respect to the companies that were treated as comparable, particularly with respect to the size (in revenue) of such companies. While audit staff has not ~~received and~~ evaluated all of the Mercer study's supporting materials, including the list of comparators used, audit staff notes that at the time the audit began NERC had only just begun to ~~a~~ systematically analyze staffing positions within NERC and rewrite employee job descriptions. Audit staff believes these elements are important in determining total staff compensation, as they are used to determine the necessary skills each position requires and ensures the descriptions reflect the necessary skills and competencies. Absent this process being completed, audit staff believes making appropriate comparisons of compensation would be difficult, even if appropriate comparables were applied.

Recommendations

We recommend that NERC:

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

17. ~~Contract for new~~Continue to perform routine and periodic updates to employee compensation studies ~~that use~~, using comparability data that target the required skill sets and competencies needed to carry out NERC's mission as the ERO~~. Submit the compensation studies with audit staff upon completion~~; and

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

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5. Standard for Determining the Reasonableness of Expenses

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

Pertinent Guidance

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

18 C.F.R. § 39.4 sets out the requirements for funding an ERO. Specifically, section 39.4(b) addresses ERO annual budget requirements.[~~25~~33]

Background

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

[~~25~~33] *See supra* text accompanying note 9.

55 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

Expenses Incurred by NERC Employees

During its review of NERC's accounting software and records, audit staff selected a sample of accounting records and reviewed the supporting documentation. Audit staff's sample identified various instances of noncompliance with NERC's policies and procedures, including missing documentation, misclassified expenses, and unusually expensive meals and hotels. These instances revealed inadequacies in the current practices and the need for improvement in NERC's existing cost controls over expense reporting, tracking, and accounting.

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

Meal Expenses

Audit staff's examination of meal expenses from meetings attended by NERC and Regional Entity staff and others found that NERC paid for ~~meals that were beyond what NERC considers reasonable.[26] For the sample period February 2011 through December 2011, audit staff analyzed documentation supporting meal expenses that were incurred at NERC meetings and in connection with travel, and observed that the cost of meals range up to $126 per attendee with numerous meals ranging above the $50 threshold trigger point.~~dinners that sometimes exceeded $50 per person.[34] During interviews, audit staff

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

[34] Although NERC's policies reference the term "reasonable" without defining it, based upon interviews and expense reporting practices a reimbursement request of $50 or more is a trigger for verifying that all attendees at the meal have been identified in the reimbursement request documentation. NERC's expense accounting software prompts the user to input a list of attendees for any meal expense entered into the system that exceeds $50 incurred. Additionally, an email dated November 2010 from the CEO to senior NERC

56 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

was informed that NERC sometimes rewarded its staff ~~by paying for high-priced meals. NERC approved these employee entertainment~~for additional or extraordinary efforts by taking the employees to dinner. An example given was that members of the IT staff who had worked additional hours over a period of time to complete the data center relocation were taken to dinner in appreciation of their efforts. Further, NERC recorded these dinner expenses as routine business expenses, which audit staff believes was inappropriate. When another employee dinner of this ~~topic~~type was discussed with the CEO, he was not aware of this matter and agreed that such costs were in excess of the guidance he provided and some of the costs should not have been ~~incurred. Therefore, it is clear~~occurred. In this particular instance, the CFAO stated that he counseled the manager who had taken his staff to dinner concerning the cost of the dinner. Therefore, the existing policies, procedures, and controls in place ~~were inadequate to~~did not prevent the costs of these ~~costs~~dinners from being included for ~~recovery~~reimbursement as approved business expenses~~. Due to this lack of formalized guidance, other~~, or incurred in the first place. Other senior management allowed the practice to occur and only "spoke to" employees incurring excessive costs without requiring assumption of personal responsibility for the excess cost. These admonishments were not documented, and audit staff questions their effectiveness. In further discussions about the matter, the CEO stated that employee rewards for performance ~~should~~could be made in more transparent categories, such as salaries or bonuses. Audit staff believes that the development of formalized guidance for the ~~entertainment~~recognition and reward of employees is necessary to ensure costs are appropriate and transparent.

Hotel Expenses

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

Audit staff believes it is very important for NERC to have a well-documented standard of reasonableness of costs in this area to achieve effective cost controls and provide guidance to its staff as to cost guidelines and limits, and the types of employee costs that are reimbursable from NERC. NERC can also benefit from additional policies, procedures and controls on travel-related hotel expenses.

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managers indicating that he would expect "staff would consider $50 to $60 per person to be a high-end dinner."

57 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

Review of Employee Expenses

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

Employee Recruitment

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

~~In discussions with NERC staff, audit staff learned that all NERC employee contracts were "at will," meaning NERC or the employee may terminate employment at any time, without cause. Rather than formal employment contracts, NERC detailed employment terms in offer letters or Memorandums of Understanding (MOUs). When audit staff inquired about the use of "at-will" contracts, NERC executives stated that NERC used this approach prior to certification as the ERO, and that these arrangements provided flexibility in the recruitment process. However, audit staff reviewed various offer letters and MOUs and noted significant accommodations offered to candidates. In discussions with NERC staff and its review of accounting records, audit staff was concerned by the lack of accountability for these costs exercised by NERC. Since these~~

costs are not required to be linked with any assurance that the candidate's services will be retained for any specific period of time such costs may not result in value being provided to the ERO. Therefore, maintaining NERC's accountability in incurring these costs to achieve a specific outcome (i.e. the recruitment and retention of the candidate) has not been done by NERC to date.

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

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

Employee Retention

In conjunction with its headquarters relocation in 2011, NERC gave certain support staff retention bonuses to incentivize them to remain at NERC through the relocation. The

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

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

Audit Staff reviewed several individual employee arrangements and had several concerns. For example, some employees were offered recruitment bonuses but there was no requirement that the employee remain with NERC for any set period of time. Also, with respect to retention bonuses associated with the relocation to Atlanta, staff was concerned that there was not sufficient transparency or documentation by which those bonuses were provided.

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

Recommendations

We recommend that NERC:

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

20. ~~Divide its process for approving expenses into two steps, leaving managers responsible for approving the purpose and rationale for incurring expenses, and designating accounting staff to be responsible for evaluating the reasonableness of expenses; and~~[This recommendation is deleted because it is subsumed in Recommendation 19]; and

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

61 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

6. Employee ~~Entertainment~~Reward and Recognition Expenses

NERC ~~did not have adequate~~should adopt additional policies and procedures ~~governing~~and provide increased budget transparency regarding employee ~~entertainment~~reward and recognition expenses. ~~These~~Existing policies and procedures ~~were~~are deficient ~~as follows~~in that:

- NERC did not have formal guidance for determining if ~~entertainment~~such expenses were reasonable and reimbursable; and
- NERC ~~paid approximately $74,000 and $109,000, respectively for office holiday parties~~incurred expenses for year-end employee dinners in December 2010 and December 2011 ~~(Holiday Galas)~~ that were neither fully nor transparently budgeted for~~; and~~
- ~~NERC did not properly account for employee entertainment expenses, including those of the Holiday Galas.As a result of these inadequacies, the Commission, stakeholders, and other interested parties did not have the necessary information to comment on and approve these expenses, and consequently NERC used budgeted funds for expenses not represented in NERC's budget~~.

Pertinent Guidance

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

18 C.F.R. § 39.4 sets out the requirements for funding an ERO. Specifically, section 39.4(b) addresses annual budget requirements.[~~27~~35]

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

> 62000 - Travel - This account shall include charges for expenses for employees, trustees, and contractors to travel to meetings and workshops in support of functional

[~~27~~35] *See supra* text accompanying note 9.

62 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

71000 - Telephone - This account shall include charges for telephone services (land lines and cellular)

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

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

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

Background

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

NERC ~~Holiday Galas~~Year-End Events

NERC incurred considerable expense for year-end meetings and employee ~~holiday parties~~dinners held in December 2010 ~~(2010 Gala)~~ and December ~~2011 (2011 Gala) (collectively referred to as the Holiday Galas). Audit staff's~~2011. NERC provided audit staff with an analysis ~~divided the Holiday Galas' costs~~dividing the costs of the year-end meetings and employee dinners into four main categories: travel costs ~~to and from the Holiday Galas~~, lodging ~~while at the Holiday Galas~~costs, the expenses of the ~~Holiday Galas~~dinner events themselves, and other expenses, as reflected in the following table:

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Expenses Incurred in Connection with ~~the Holiday Galas~~Year-End Meetings and Parties

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

~~Due to the way NERC accounted for these expenses, NERC was unable to readily identify the total cost of the Holiday Galas, which raised concerns about the way costs were recorded in NERC's books and records. For the 2010 Gala~~For the 2010 employee dinner, audit staff determined that NERC properly recorded in its books and records $35,127 of the ~~Holiday Gala~~dinner event expenses in Account No. 99000, Miscellaneous Operating Expenses under the General and Administrative function. However, NERC recorded the other costs ~~related to the Holiday Gala~~incurred during the same week as the employee dinner event, which included the travel, a portion of the lodging costs, gifts, and equipment, as approved business-related expenses in various operating expense accounts.[~~28~~36] Audit staff believes these ~~company-wide entertainment~~ costs should be recorded in Account No.

[~~28~~36] Travel Expenses: Travel – Account No. 62000; Office Costs: Telephone – Account No. 71000, Internet Expense – Account No. 71100; and Office Supplies – Account No. 71200

64 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

99000, Miscellaneous Operating Expenses. Additionally, audit staff believes NERC incorrectly recorded employee breakfast and award costs as travel expenses.

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

NERC's 2010 budget true-up filing stated that it was $65,954 over the $4,000 budget for Miscellaneous Operating Expenses under the General and Administrative function, and referenced a "provision for uncollected accounts receivable related to unpaid assessments and GADS Services" as the cause for the variance.[~~29~~37] NERC accounting records showed these items totaled $31,000. NERC ~~failed to mention~~'s explanation of the variance in this account did not include the variance resulting from the $35,000 of ~~Holiday Gala~~year-end employee dinner expenses, which appear to have accounted for ~~an even~~a larger portion of the variance. However, NERC did report a variance due to the 2011 year-end employee dinner costs in its 2011 Q4 variance report. Additionally, NERC's 2012 budget filing proposed to increase the budget for this account from $4,000 to $26,000 to account for "recent experience" without mention of funding for ~~its annual holiday party~~a year-end employee dinner event. Audit staff is concerned by the lack of transparency in NERC's budget and true-up filing for these expenses.

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

[~~29~~37] North American Electric Reliability Corporation, Report, Docket No. RR11-4-000, (filed May 31, 2011) (comparing budgeted to actual costs for 2010 for NERC and the Regional Entities).

65 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

dinner was in the midst of the training sessions that were held the day before, the morning of, and the day after.

Audit staff believes that for most public utilities regulated by the Commission, employee entertainment expenses as described in the above table are not generally recoverable from ratepayers but recorded as "below-the-line" expenses recovered from stockholders. However, NERC is a non-profit corporation with no shareholders and is subject to a cost recovery funding mechanism, and to protect ratepayers it is imperative that NERC not incur costs that have not been explicitly approvedthe electric industry entities that provide the funding, it is imperative that there be transparency with respect to any such expenses so that they may be considered appropriately in the budget review and approval process. For these reasons, audit staff believes employee entertainmentthese costs must be transparently presented in budgets and recorded in appropriate accounts, so the BOT, the Commission, and interested partiesstakeholders can review, and comment on, and the BOT and Commission approve whetherwhere necessary, such expenses should be incurred under section 215.

Recommendations:

We recommend that NERC:

22. Explicitly budget for employee entertainmentrewards and recognition expenses, if any, by including line items of sufficient granularity in the budget filings;

23. Use miscellaneous expense accounts to track entertainment expenses which are primarily social in nature, if any, separately from other business-related expenses in its accounting system;

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

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7. Board of Trustees Compensation and Entertainment

NERC ~~did not support its shift~~shifted to a ~~flat~~fixed-fee retainer plus expenses methodology of compensating its Board of Trustees (BOT), with ~~a time study based on actual~~the amount of the fixed fee dependent on the number of committees the Trustee sits on, whether the Trustee is a committee chair and whether the Trustee is also the chairman of the board. NERC's Board reviewed its proposed shift to a fixed fee retainer methodology at several open board meetings with stakeholders present. NERC also conducts annual surveys of the NERC Members Representative Committee (MRC) regarding BOT effectiveness. A consultant also reviewed and rendered an opinion in support of the fixed fee retainer methodology and associated Board compensation levels. Audit staff believes that in future compensation studies the Board should consider including a further evaluation of time spent by the BOT on BOT activities or a representative study of the ~~actual~~ time spent on these activities. Also, NERC incurred various expenses ~~to entertain BOT members outside the official BOT meetings. As a result, audit staff believes NERC's shift to a flat fee compensation methodology was not adequately supported, and the expenses incurred outside the official BOT meetings may have been improperly funded by end users under section 215.~~for dinners of BOT members during the evenings after BOT committee meetings and the evenings before BOT meetings. Audit staff believes these expenses should be more transparently set forth in NERC's annual budget to facilitate stakeholder and Commission review.

Pertinent Guidance

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

18 C.F.R. § 39.4 sets out the requirements for funding an ERO. Specifically, section 39.4(b) addresses ERO annual budget requirements.[~~30~~38]

Background

Board of Trustee Compensation

NERC compensated its BOT based upon a participation-based methodology from the inception of the ERO until January 2011. Beginning January 2011, NERC switched to a flat-fee plus expense methodology of compensating its BOT~~.~~, with the amount of the flat fee dependent on the number of committees the Trustee sits on, whether the Trustee is a

[~~30~~38] *See supra* text accompanying note 9.

67 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

committee chair and whether the Trustee is also the chairman of the board. In audit staff's opinion, NERC did not provide adequate support for the change in BOT compensation. In response to data requests and during onsite interviews, NERC staff stated that the BOT initiated the move to alter compensation and implied that the change was not initiated by or under NERC~~'s~~ control. NERC staff further indicated that it supported the change due to the administrative burden to NERC of providing compensation based upon meeting attendance. ~~Audit staff believes this burden was self-imposed by NERC's inadequate policies and procedures for tracking BOT time and meeting participation.~~ The study supporting the change in compensation methods consisted of a four-page report and two presentations to the BOT. The study was intended to deal with both the appropriate level of compensation and the manner in which compensation should be provided. The proposed change to a fixed fee retainer methodology was discussed at several open board meetings with stakeholders present. However, as discussed below, in audit staff's opinion, the study's report failed to accomplish either objective.

Level of Compensation

In November 2008, NERC's BOT established and approved a process for determining compensation levels, including levels for its BOT (Compensation Policy).[~~31~~39] The Compensation Policy outlined the process guiding the BOT's consideration of compensation at each level. Two elements of the trustee compensation process are the need for the BOT's Corporate Governance and Human Resources Committee (CGHRC) to~~:~~ evaluate the amount of work and level of responsibility the BOT is being asked to undertake, and examine comparability data of representative organizations as part of that review.

NERC commissioned an independent consulting firm in the spring of 2010 to conduct an Executive Compensation study based on data from other entities that it believed to be comparable with NERC. This consulting firm has an extensive compensation practice with the ISOs. However, in audit staff's ~~review of~~opinion, the data supporting the compensation study ~~revealed that it~~ did not address the first objective of the trustee compensation process and failed to meet the second. The data ~~supporting~~included in the study ~~were~~was sparse and ~~did not adequately address~~the report did discuss NERC's role in the electric industry, the complexity of the various entities' operations and structures, those entities' total budgets, and the degree of involvement (including actual hours worked or meetings attended) of those entities' trustees. Rather, the study's author included a list of comparators consisting of ISOs, RTOs, and Regional Entities to which surveys were sent. Only eight entities submitted data in response to the survey, with one of the responders not

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[~~31~~39] Process for Determining Annual Compensation of Independent Trustees, Chief Executive Officer, Other Officers, and Key Employees, November 13, 2008 (http://www.nerc.com/files/Process%20for%20Determining%20Annual%20Compensation.pdf).

68 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

providing compensation levels. The author relied on those eight responses and did not use publicly available data sources, such as IRS Form 990 annual filings that contain data on trustee compensation, to support the analysis. The author instead used ~~another~~the survey's results from ~~utility boards~~two nationally recognized compensation firms and its own ISO surveys to determine the baseline compensation recommendation.

In terms of competitive practice, the author concluded that the proposed total compensation retainers appear relatively conservative as compared to both utilities nationally and the ISO sector. The author concluded that the proposed 2010 NERC Level 1 trails the ISO median by 14% while the "Level 2" (serves on Compliance Committee, or serves as Committee Chair, or Serves on ESSG) and "Level 3" (serves on more than one of the Level 2 committees) and "Level 4" (Chairman of the Board) appear consistent with current practice for these additional responsibilities. In February 2012, the consultant performed a follow up study and reaffirmed its support for a flat fee board compensation structure, noting that in their 2010 review they cited research at that time showing that 20%-30% of companies were no longer paying meeting fees and that more recent surveys show this trend continuing. The author cited a 2011 survey of Director Compensation by The Conference Board found that 40% of non financial service firms (industrials) and 43% of financial service firms no longer pay meeting fees and that the 2011 survey by AonHewitt indicated that 51% of the organizations, across diverse industries, now use the retainer only approach .

~~When all of these factors are considered~~Despite the foregoing, audit staff questions the adequacy of the analysis supporting the compensation of NERC's BOT. NERC significantly increased the total and per-trustee compensation levels for the BOT despite the inadequacies in the analysis. This increase is depicted in the following table:[~~32~~40]

[~~32~~40] The 2008, 2009, and 2010 data is based on NERC's IRS 990 filings. The 2011 data is based on the new BOT flat fee structure in place for that year.

69 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

Average Compensation per Trustee

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

Manner of Compensation

As discussed above, in moving to the flat fee compensation approach in 2010, the Board obtained an evaluation from SMN Associates, a consulting firm on board compensation in the utility industry, which endorsed the annual retainer approach. Additionally, NERC staff provided audit staff a 2011 report by SpencerStuart, another leading executive search and compensation consultant, that reported that only 37% of boards are paid per-meeting fees, down from 72% in 2001 and 57% in 2006; and that 35% of companies pay fees for Board committee meetings, down from 68% in 2001 and 58% in 2006.[41]

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

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

70 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

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

~~Discussion with Compensation Firm~~

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

~~Audit staff believes the prior performance-based compensation method provided greater accountability by coupling compensation with participation in BOT activities. In the absence of accountability initiatives to support NERC's policy change, it appears switching to a flat-fee retainer reduced BOT accountability instead of reinforcing the appropriate role of the BOT. Audit staff notes that NERC has recently started working to integrate new software tools to better track, among other matters, BOT Committee meetings and the time and attendance of BOT members. This improved practice could greatly reduce the administrative burden of a participation-based compensation structure, a burden stated as one of the reasons NERC moved toward flat-fee retainers.~~

NERC stated that the Board compensation was changed to an annual flat-fee retainer because the objective of the Board compensation is to compensate the Board members for a full year's work attending to their responsibilities as Trustees, not to attend meetings. NERC also stated that considerable time is required of Trustees, and considerable work is performed by them, outside of the scheduled Board meetings and committee meetings, particularly in light of the considerable amounts of materials that the Trustees must read and review to prepare for meetings and to carry out their

responsibilities. Additionally, NERC has a process in place for surveys of members of the NERC MRC, which elects the Trustees, of the performance of the Board, to be conducted approximately annually. The assessment results are made available and are discussed at open meetings of the CGHR Committee and the Board. Additional reasons given for adopting the annual flat fee retainer method include: (1) To enable NERC to more accurately budget the annual expense for Trustee compensation, since each Trustee's projected compensation would be based on an annual fee. (2) To enable NERC to give potential candidates for current or upcoming Board vacancies a fairly accurate estimate of the compensation the candidate would receive as a Trustee, to help the candidate evaluate the Trustee position against other opportunities he or she may have. (3) To relieve NERC staff of the administrative burden of tracking each Trustee's attendance at meetings to keep track of the bases on which each Trustee's compensation would be based. (4) To remove the incentive inherent in the per-activity approach for more meetings or calls to be scheduled. (5) To eliminate the inequities inherent in the per-activity compensation system in which the same amount of compensation would be paid for a Board or committee conference that lasts 30 minutes as for one that lasts three hours or as for one that requires a full day. (6) To enable the Trustees to more accurately estimate their compensation, and therefore their estimated tax obligations, over the course of the year. In adopting the flat fee annual retainer approach, the Board committed to reviewing the approach (as well as the overall level of Board compensation) in one to two years.

BOT ~~Entertainment~~Meeting Meal Expenses

Audit staff sampled four months of BOT meetings by examining NERC's accounting records and found that NERC staff commonly hosted the BOT ~~at banquet-type dinner events that were separate and apart from the meals offered during normal business meetings~~dinners on the evenings between Board committee meetings and Board meetings, since the committee and Board meetings typically span a three-day period. Most of the costs involved with these events consisted of meal expenses (i.e., food and beverages) that ranged up to $146 per-person~~, which resulted in meal expenses well in excess of the "reasonable" level NERC provided as guidance to its employees.[33]~~. Also, these events included not only the BOT and NERC staff, but also on some occasions spouses or invited guests of attendees. NERC stated that the expenses for these dinners were appropriate travel-related expenses since, as noted, the Board meetings and related committee

~~[33] Audit staff notes that the term "reasonable" is not explicitly defined by NERC. However, the CFO stated that a cost of approximately $50 to $60 per person was the upper bound for a reasonable dinner meal, and NERC's expense reporting system triggers a prompt for a user to enter "additional attendees" if the meal cost entered is greater than $50.~~

72 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

meetings usually span more than one day, and depending on the schedules of events and meeting location, Board members may need to arrive in the city where the meetings are to be held on the evening prior to the first meeting. NERC also claimed that official business was ~~conducted at these events. However, audit staff found no evidence in NERC's board minutes or any other supporting documents showing that these events had a legitimate business purpose. In addition, audit staff examination revealed that some of the BOT members did not attend the events, and neither the Commission nor the public were invited to participate in these events if business was being conducted as NERC claimed~~discussed at these events. Audit staff believes that, while business may well be discussed at these gatherings, the primary purpose of the gatherings, as evidenced by the presence on occasion of spouses and guests, was social — to strengthen ties ~~between~~among the BOT members and among the BOT members and the senior management of NERC. Audit staff believes that such gatherings are within the discretion of NERC as a private corporation, but that funding for these activities must be clearly budgeted and approved ~~by the stakeholders~~ if it is to be paid from section 215 funds.

Audit staff notes that NERC did not record these meeting costs in any one particular account; rather NERC recorded the costs in various accounts as routine business expenses. ~~To~~In audit staff's opinion, to properly account for these costs in its books and records, NERC should have classified these costs in Account No. 99000, Miscellaneous Operating Expenses, instead of using several expense accounts to account for these costs. This accounting would also provide more transparency for these types of costs. NERC believes that the costs should be recorded in Account 62000, Business Travel Expenses.

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

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

only a small portion of NERC's budget, audit staff is concerned that the independence and integrity of the BOT members be carefully preserved.

Recommendations

We recommend that NERC:

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

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

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

28. ~~Conduct an analysis of BOT participation and effort based on a time study using actual time spent during BOT activities, or a representative study of the actual time spent and implement a compensation methodology that pays BOT members reasonably for performance of their duties;~~Continue to conduct periodic updates and review of the Board compensation model and compensation levels, taking into account Board time and participation on Board activities and market comparability data of appropriate comparator organizations;

29. ~~Estimate and include in its annual budgets an amount of funding to cover BOT entertainment expenses that it deems appropriate and seek approval for such funding;~~[Deleted – this recommendation is covered in Recommendation 30];

30. Track the ~~entertainment~~ expenses actually incurred for Board activities to the budgeted amounts for such expenses; and

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

74 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

8. ~~Pension~~Retirement Plans

~~NERC contributed 10 percent of salaries~~In connection with the conversion of NERC's defined benefit plan to a defined contribution 401(k) plan, which occurred prior to NERC becoming the ERO, NERC amended its 401(k) plan to provide for a contribution of 10 percent of compensation (salary and incentive) for each employee participating ~~in the pension plan, which is above energy sector norm~~. This 10 percent contribution was in addition to an up to 4.5 percent matching contribution for employees participating in NERC's 401(k) plan. Audit staff believes the 10 percent contribution component is above industry norms. NERC stated that the 10 percent contribution component was included because, as a nonprofit corporation, NERC cannot offer profit-based compensation components as can the for-profit entities with which NERC competes for employees. Also, NERC included bonuses as well as base salary in its determination of its ~~pension~~additional contribution obligations for employees. In addition, ~~NERC paid excess amounts above the allowable IRS limit for pension contributions to certain employees as additional compensation when it should have maintained these amounts in a tax-deferred account.~~to the extent a portion of the 10% additional amount could not be contributed to the participant employee's 401(k) account due to Internal Revenue Service (IRS) limits, NERC paid this excess portion to the participant as ordinary income, subject to current federal and state tax withholdings and taxation. Based upon a review of the recent employee compensation and benefits study and upon recommendation of NERC's Corporate Governance and Human Resources Committee, the NERC Board is scheduled to approve an amendment to NERC's 401(k) Plan and retirement polices in May 2012 to eliminate the inclusion of the bonus in the calculation of the additional contribution, as well as making the amount of the additional contribution a discretionary determination by the BOT. NERC has also established an employee funded 457(b) plan which allows employees meeting certain IRS eligibility requirements to defer additional amounts towards retirement. NERC does not provide any matching funding for 457(b) plan contributions, which are funded solely by the employee, in its discretion.

Pertinent Guidance

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

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

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

Background

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

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

In interviews, NERC senior management defended the practice, explaining that the 10 percent guaranteed contribution is NERC's alternative to a profit-sharing element. NERC cannot offer profit-sharing elements, such as stock options, as NERC is a non-profit entity and does not have profits to share with its employees or anyone else. NERC has fully budgeted for its ~~pension~~retirement contribution obligations as a cost included in its annual budget that is funded by ~~end-users~~statutory assessments. NERC senior management justified the additional compensation from a "total compensation"

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perspective, stating that it was a necessary element to stay competitive in the marketplace for skilled professionals. ~~However, former employees interviewed by audit staff did not state inadequate compensation as a primary factor for their departure.~~

In discussions with audit staff regarding this compensation element, the NERC CEO agreed that guaranteeing a 10 percent contribution lacked the appearance of the performance-based compensation of more traditional profit sharing programs ~~that NERC is attempting to emulate~~. The CEO also indicated that NERC would consider a different approach going forward, such as guaranteeing a smaller percentage and subjecting the remainder to annual review and approval by the BOT. This approach is in line with the benefits study that NERC commissioned, which recommends the guaranteed pension contribution component be lowered from 10 percent to 5 percent so that this amount, when coupled with the 4.5 percent matching 401(k) contribution, would equal up to "9.5 percent of pay, which is more in line with typical market practices."[~~34~~42] Audit staff noted that any changes in compensation, including changes to the guaranteed portion of the contribution, would not appear to violate any contractual entitlements to current employees, as all NERC officers and staff serve on the basis of "at will" arrangements.

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

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

[~~34~~42] The term "pay" used in the study is ambiguous in this context. The study report does not address whether bonuses should or should not be included when making ~~pension~~retirement contributions. The study itself indicates that a majority of capital accumulation plans do not count bonuses as compensation for determining contributions.

77 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

Based upon a review of the recent employee compensation and benefits study and upon recommendation of NERC's Corporate Governance and Human Resources Committee, NERC will be amending its 401(k) Plan and retirement polices in May 2012 to eliminate the inclusion of the bonus in the calculation of the additional contribution, as well as making the amount of the additional contribution a discretionary determination by the BOT. NERC has also established an employee funded 457(b) plan which allow employees meeting certain IRS eligibility requirements to defer additional amounts towards retirement. NERC does not provide any matching funding for 457(b) plan contributions.

Recommendations:

We recommend that NERC:

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

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

34. ~~Develop an alternative mechanism for addressing pension~~Continue to use the mechanism that has been adopted and consider additional mechanisms to allow employees to address tax deferred retirement saving of contributions in excess of the IRS cap ~~that maintains the payment as a retirement benefit and not as additional compensation to the employee~~on 401(k) contributions.

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9. NERC Critical Infrastructure Protection Program

NERC ~~inadequately staffed~~should further evaluate the sufficiency of its staffing for the needs of its critical infrastructure protection (CIP) program~~. NERC's senior management focused on a limited scope of activities that did not adequately address the CMEP needs of the ERO in the CIP program. This lack of attention to compliance-related activities led to insufficient staffing for this section 215 responsibility~~, in particular with respect to the resources needed for oversight of the Regional Entities' CIP auditing and other CIP compliance monitoring and enforcement activities. While NERC has significantly increased its CIP Program Area staffing over recent years, and has provided oversight through other means, audit staff believes that insufficient resources have been devoted to oversight of Regional Entity audit activities in the CIP area.

Pertinent Guidance

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

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

Background

As a program element under section 215, CIP has undergone significant changes since NERC was certified as the ERO. At the time NERC filed its 2007 Business Plan and Budget, the CIP program focused primarily on NERC's role as the US Department of Energy (DOE)-approved Information Sharing and Analysis Center for the electric sector (ES-ISAC). In its business plan and budget filing for 2007, NERC treated its role as the ES-ISAC as a situational awareness element under section 215, one of its purposes being to identify the need for mandatory standards to be developed in the CIP area.[~~35~~43] The CIP

[~~35~~ North American Electric Reliability Corporation, Request, Docket No. RR06-03-000, (filed Aug. 23, 2006) (submitting the 2007 business plans and budgets of

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standards were approved by the Commission in January 2008[36][44] and the first CIP standards became auditably compliant for high-priority "Table 1" entities (i.e., Reliability Coordinators, Balancing Authorities, and Transmission Operators) in July 2010. By late 2011, as the audit commenced, the ERO was tasked with ensuring compliance with the full slate of currently approved and applicable CIP standards for an expanded list of registered entities. The roll-outapplicability and enforcement of these new Reliability Standards resulted in a significant increase in reported possible violations, both in self-reports by registered entities but also more importantly in the initial CIP compliance audits conducted by Regional Entity staff. In 2010 and 2011, a total of 2,511 violations of the CIP standards were discovered, including 772 violations through compliance audits and spot checks. In 2010, eight of the ten most frequently violated standards were CIP standards, and in 2011, seven of the most frequently violated standards were CIP standards. Audit staff believes as NERC's responsibilities grew in this area, it failed to adequately budget and allocate resources to CIP. NERC should have established stronger oversight ofover the Regional Entities' programs for monitoring and enforcing compliance with thesse emerging CIP standards, ensuringin order to ensure consistency of auditing and commitment to establishment of a high-level of security for the BPS. Instead, audit staff believes NERC focused a disproportionate amount of its attention and limited budgeted resources on what it perceived were higher-priority demands in other program areas (e.g., dealing with Commission directives in the operating and planning standards), educating the electric industry on overall critical infrastructure protection and security concerns, and in expanding the functionality of NERC'sthe ES-ISAC.

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

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

NERC and Regional Entities for acceptance and Proposed Assessments to Fund Budgets for approval[43] 2007 ERO Budget Filing.

[36][44] Mandatory Reliability Standards for Critical Infrastructure Protection, Order No. 706, 122 FERC ¶ 61,040 (2008).

80 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

~~As indicated by~~Audit staff interpreted this organizational chart~~,~~ to mean NERC only had only two CIP staff dedicated to Regional Entity compliance oversight activities. Th~~is~~e low level of CIP staffing perceived by audit staff at NERC for compliance activities did not, in audit staff's opinion, allow for adequate oversight of the Regional Entities' enforcement of CIP standards across the entire BPS. Moreover, NERC's CIP staffing levels did not address the need for contingencies, succession planning, and other continuity of functions to be maintained.

Despite NERC's growing responsibilities in the CIP area, audit staff noted NERC's commitment and staffing levels for ~~its~~ CIP ~~compliance program~~oversight remained low throughout the audit period. In fact, NERC tasked only the two CIP Compliance FTEs (i.e., two auditors) with providing oversight to all eight Regional Entity CIP audit programs. ~~It was not until the current Commission staff audit commenced that~~ During the course of this audit, NERC began ~~the preliminary stages of~~ increasing its staffing and resources in this area. In addition to their Regional Entity audit oversight responsibilities, NERC's two auditors were also assigned to support NERC's duties as the Compliance Enforcement Authority (CEA), which oversees compliance with the CIP Reliability Standards for those Regional Entities registered to perform critical reliability functions (e.g., SPP, WECC, FRCC, and Texas Regional Entity). Furthermore, the two NERC auditors performed the following other duties: oversight of the Regional Entity program to implement Technical Feasibility Exemptions to CIP standards, routine meetings and calls to ensure consistency between regions and answer questions from FERC staff, communications with Commission staff on cyber-related incidents, participation in pilot programs to involve auditors in standards development, attendance at ERO auditor training workshops, and educational efforts at Regional Entity workshops. This was a significant amount of responsibility for two auditors, and given the difficulties encountered in implementing new reliability standards in this important area, audit staff believes the commitment of such a limited number of resources did not allow for a robust CIP compliance program to effectively and efficiently carry out NERC's CIP compliance-related activities.

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

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NERC CIP auditors attended a NERC auditor training workshop rather than perform their oversight obligations.

Audit staff noted in NERC's response to data requests that during 2010 and 2011 the NERC CIP auditors attended about half the number of compliance audits that FERC staff observed. Rather than taking the lead on providing oversight of the Regional Entity audits, NERC relied upon FERC's efforts to fulfill its oversight role.[~~37~~45] Audit staff believes that during the audit period NERC's ~~commitment to~~oversight of Regional Entity CIP auditing activities was weak primarily due to inadequate staffing levels and increased attention to other areas (e.g., ES-ISAC). As evidenced by interviews conducted by audit staff, significant attention, resources, and funding were devoted to expanding the NERC ES-ISAC capabilities under the tenure of the recently departed Director of NERC's Critical Infrastructure Division (CID), while attention to CIP compliance activities at the senior management level was minimal. CID leadership demonstrated limited knowledge of the state of compliance-related activities for CIP program elements at either the NERC or Regional Entity level. Senior management review of the Regional Entity CIP compliance programs was limited to a high-level budget check that lacked any substantive elements that might enable NERC to assist the Regional Entities in achieving improved performance in CIP compliance.

~~Despite the shortfalls in the NERC CIP program,~~ NERC senior management did not express any concern about the staffing levels for this program area in discussions with audit staff until late in the Commission staff audit ~~process. For example, when audit staff inquired how NERC selected the Regional Entity CIP compliance audits for which to provide oversight, NERC's senior management indicated that NERC had followed FERC's lead. However, NERC's senior management did not demonstrate that NERC had developed its own independent criteria to determine whether the risks in the Regional Entity CIP compliance auditing program were being addressed by the NERC oversight~~ process. Audit staff's review of the NERC CIP compliance program disclosed that NERC had not conducted any analysis to determine whether NERC or the Regional Entities had the appropriate resources to properly execute the CIP compliance program or whether NERC had developed a systematic process, plan, and schedule for conducting Regional Entity compliance audit oversight activities. Further ~~confusion in the direction of NERC's CIP compliance program was revealed during the audit period, when~~compounding these concerns, the recently hired Director of NERC's CID left NERC ~~in the midst of the Commission staff audit~~during 2011 and significant organizational changes in the CID thereafter took place.

[~~37~~45] Audit staff notes that the compliance audits of non-CIP (i.e., Order No. 693) standards had a much better initial track record in the early years, but dipped in 2011. However, audit staff noted a major staffing effort and recommitment to this important compliance area planned for 2012.

82 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

NERC indicated that the requirements for **c**ompliance with the CIP standards have been fluid and evolving with the rapid succession of revisions to the CIP standards: in 2010 three versions of the CIP standards were in effect; at the time the audit was being concluded, Version 4 of the CIP standards was pending at the Commission for approval, and the Version 5 CIP standards were under development. NERC stated that it therefore made a conscious decision to focus on education and training of the industry to understand, identify and respond to cyber threats. As a result, NERC stated that during 2010-2011, it focused on assistance, training and education to the industry on the broader CIP and infrastructure security concerns.

Since the Commission staff audit began, NERC has indicated that in 2012 it will make an effort to ~~reallocate~~further allocate resources into critical CIP compliance activities. NERC indicated its plan to hire an additional CIP auditor as well as a compliance manager, but the position descriptions and defined responsibilities for these proposed positions had not been completed and provided to audit staff when fieldwork concluded. Despite these changes, audit staff believes that NERC still does not appear to have conducted a rigorous assessment of the commitment that should be made in the CIP compliance activities. For example, CID management indicated that upwards of 21 CIP compliance audits were being planned for 2012, even if a third auditor were not hired. NERC's draft audit procedure guidelines outline the intensive efforts necessary to plan, prepare, and implement effective NERC oversight for a Regional Entity compliance audit. Audit staff believes that an adequate program of CIP oversight cannot be conducted by a staff of two auditors for that many audits, especially given their other assigned duties. NERC's failure to expand its compliance staff in a timely manner for CIP compliance activities contrasts markedly with efforts made on compliance to the operating and planning standards (i.e., Order No. 693). In this area, audit staff observed a significant growth in staffing for audits and other compliance-related activities~~.~~, although that growth has been occurring over a longer period of time since NERC began enforcing mandatory standards in 2007.

NERC also indicated that, in addition to the two CIP auditors, personnel in NERC's Compliance Operations Department are involved in overseeing the CIP audit reports, training CIP auditors, maintenance and revision of the Reliability Standard Audit Worksheets ("RSAWs") used by Regional Entity CIP auditors in conducting audits, development and issuance of Compliance Application Notices ("CANs," which provide guidance to auditors) relating to the CIP standards, and other activities to support NERC and Regional Entity CIP audit activities. NERC Legal staff also works closely with the Regional Entities with respect to the posting of Case Notes that pertain to the CIP standards. Further, personnel in NERC's Compliance Enforcement and Legal Departments provide support and guidance to the Regional Entities in CIP compliance monitoring, auditing and enforcement. For example, all Possible Violations, including Possible Violations of CIP standards, are processed and reviewed in the NERC Compliance Enforcement and Legal Departments. NERC staff works closely with the Regional Entities in the ultimate disposition of the CIP Possible Violations to ensure the records are complete and support

83 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

the ultimate disposition. NERC staff also fields questions and addresses issues that may arise in the context of compliance monitoring activities by the Regional Entities, including audits. NERC's Compliance Enforcement and Legal staffs also work closely with its CID staff in the review of violations and dismissals of CIP standards. NERC internal department meetings, as well as ERO working group meetings, are opportunities to provide ongoing guidance on CIP matters. NERC indicated that, as described above, it is continuing to make appropriate program adjustments for additional oversight of Regional Entity CIP audits. In NERC's 2012 Business Plan and Budget, two additional FTEs were approved for the CIP oversight team, consisting of one additional CIP auditor and one CIP Compliance Manager.

Recommendations

We recommend that NERC:

35. Conduct an assessment of ~~existing~~ CIP-related staffing levels to ensure ~~that NERC staff work aligns with section 215 activities, and that~~ there are adequate resources to accomplish CIP work, particularly with respect to Regional Entity CIP auditing and other Regional Entity CIP-related CMEP activities; and

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

84 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

10. NERC Activities

[NOTE: NERC recommends that this section be deleted, as noted above and discussed in the Response to the Draft Report.]

Neither the Commission nor NERC ~~did not~~ have established written criteria to determine whether specific activities NERC performs are statutory activities that should be funded under the Federal Power Act (FPA) section 215. ~~Audit staff is concerned that NERC's failure to develop written criteria to guide its decisions of what constitutes a statutory activity is directly related to its philosophy that all activities that promote the reliability of the Bulk-Power System (BPS) are statutory.~~ As a result, it was difficult for audit staff to determine whether all the ~~scope and extent of permissible~~ activities that ~~should be~~NERC performs are appropriately funded under section 215 ~~and NERC's method of prioritizing such activities to ensure the appropriate focus of activities undertaken as the ERO.~~

Pertinent Guidance

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

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

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

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

85 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

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

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

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

> On August 8, 2005, EPAct was enacted as law. New Section 215 of the FPA provides for a system of mandatory enforceable Reliability Standards. Under the new electric power reliability system enacted by the Congress, the United States will no longer rely on voluntary compliance by participants in the electric industry . . . [38][46]

> Section 215 of the FPA generally provides for Commission authorization of funding for statutory functions, such as the development of Reliability Standards and their enforcement, and monitoring the reliability of the Bulk-Power System. The Final Rule clarifies, however, that while the ERO or a Regional Entity is not necessarily precluded from pursuing other activities, it may not use Commission-authorized funding for such activities.[39][47]

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

> We generally believe that anything required of the ERO or a Regional Entity by the statute, Order No. 672 pursuant to the statute, or any subsequent Commission order pursuant to section 215 of the FPA is a statutory activity.[48]

> We agree with National Grid that NERC's funding proposal at a very high level seems appropriate, but lacks details. Consistent with Order No. 672, we direct NERC to submit in its compliance filing a list of budget principles for approval. These principles should include budget execution as well as budget formulation matters, including: (1) budget component justification based on statutory or other authorities; (2) how the budgeted activity lends

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~~[38] *Rules Concerning Certification of the Electric Reliability Organization; and Procedures for the Establishment, Approval, and Enforcement of Electric Reliability Standards*, Order No. 672, 114 FERC ¶ 61,104~~[46] *Order No. 672* at P 20 (2006)~~, *order on reh'g*, Order No. 672-A, 114 FERC ¶ 61,328 (2006), *modified*, 123 FERC ¶ 61,046 (2007).~~

[39][47] *Id.* P 34.

[48] ERO Certification Order at P 185.

86 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

> itself to the accomplishment of the statutory or other authorities; (3) methods of calculating budget estimates; (4) who prioritizes competing needs; (5) affordability, sustainability, and efficiency and effectiveness of expenditures; (6) implementation to meet international standards; (7) transparency; and (8) accountability and execution in accordance with operating plan, performance measures, and shifting priorities. Moreover, we expect NERC to submit its first detailed budget in the coming months that should answer many of these questions.[40][49]

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

> We find that NERC's proposed activities reasonably fall within the types of activities the Commission considers to be covered by FPA Section 215, i.e., the development and enforcement of reliability standards, and are entitled to receive funding under Section 215 of the FPA. As explained in the *ERO Certification Order*, anything required of the ERO or a Regional Entity by the statute, Order No. 672 pursuant to the statute, or any subsequent Commission order pursuant to Section 215 of the FPA is a statutory activity. NERC, in its budget filing and subsequent response, has provided an explanation for each of its program areas that relates to a function for which the ERO is responsible pursuant to section 215 of the FPA, Order No. 672 or the *ERO Certification Order*. Accordingly, we find acceptable NERC's designation of specific program activities as "statutory[.]"[41][50]

In the same order, the Commission stated in part:

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

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[40] ~~North American Electric Reliability Corporation, 116 FERC ¶ 61,062~~[49] ERO Certification Order at P ~~202 (2006).~~202.

[41] ~~North American Electric Reliability Corporation, 117 FERC ¶ 61,091 at P 28 (2006) (citing North American Electric Reliability Corporation, 116 FERC ¶ 61,062~~[50] 207 ERO Budget Order at P 28 (citing ERO Certification Order at P ~~185 (2006)).~~185.

87 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

> NERC should provide greater detail and justification for the criteria it uses to designate statutory activities.
>
> Accordingly, we require that, when NERC files its 2008 budget and business plan, it identify the general statutory activity, and which sub- activities, are covered by the 2008 budget and business plan. [~~42~~51]

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

> NERC will insert a new Section 1103.3 to its Rules of Procedure, as follows:
>
> The NERC annual budget submittal to governmental authorities shall provide for the following principles: (1) budget component justification based on statutory or other authorities; (2) how the budgeted activity lends itself to the accomplishment of the statutory or other authorities; (3) methods of calculating budget estimates; (4) who prioritizes competing needs; (5) how the budget meets the objectives of affordability, sustainability, and efficiency and effectiveness of expenditures; (6) implementation to meet international standards; (7) transparency; and (8) accountability and execution in accordance with operating plan, performance measures, and shifting priorities.[~~43~~52]

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

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

[~~42~~51] *Id.* P 30.

[~~43~~52] North American Electric Reliability Council and the North American Electric Reliability Corporation, Filing, Docket No. RR06-1-003, at P 5 (filed Oct. 18, 2006) (addressing non-governance issues).

88 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

> Specifically: (1) the Reliability Standards Program implements the statutory activity of development of reliability standards. (2) The Compliance Enforcement and Organization Registration and Certification Program implements the statutory activity of enforcement of compliance with reliability standards, including imposition of penalties and sanctions for violations of standards. (3) The Reliability Readiness Evaluation and Improvements Program supports the statutory activity of enforcing and achieving compliance with reliability standards and the statutory activity of conducting assessments of the reliability of the bulk power system. This program also provides information and feedback that supports the statutory activity of development of reliability standards. (4) The Training, Education and Operator Certification Program supports the statutory activity of enforcing and achieving compliance with reliability standards, and also provides information and feedback that supports the statutory activity of development of reliability standards. (5) The Reliability Assessment and Performance Analysis Program implements the statutory activity of conducting periodic assessments of the reliability and adequacy of the bulk power system in North America. This program also provides information and feedback that supports the statutory activities of development of reliability standards and achieving compliance with reliability standards. (6) The Situation Awareness and Infrastructure Security Program supports the statutory activity of enforcing and achieving compliance with reliability standards, and also provides information and feedback that supports the statutory activities of development of reliability standards and conducting assessments of the reliability and adequacy of the bulk power system.[4453]

In its order on NERC's 2008 business plan and budget filing, the Commission concluded:

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

[4453] North American Electric Reliability Corporation, Request, Docket No. RR07-16-000, at 45-46 (filed Aug. 24, 2007) (submitting its 2008 business plan and budget for acceptance).

89 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

672 pursuant to the statute, or any subsequent Commission order pursuant to section 215 of the FPA is a statutory activity.[54]

Similarly, in its order on NERC's 2009 Business Plan and Budget, the Commission stated:

> We find that NERC's 2009 Business Plan provides sufficient detail for us to determine whether NERC intends to pursue appropriate activities. NERC's proposed categories of activities for 2009 are the same as those approved by the Commission for NERC's 2007 and 2008 budgets, except for the proposed discontinuance of the Reliability readiness Evaluation and Improvement Program (discussed below), and reasonably fall within the types of activities the Commission considers to be covered by FPA section 215.[55]

In an order issued July 16, 2009 accepting in part a NERC compliance filing ~~on the 2009 NERC business plan and budget~~required by the Commission's 2009 ERO Budget Order, the Commission stated:

> The Commission accepts the ERO's proposal to terminate funding of the Reliability Readiness Program. As described above, documents provided in response to the Commission's data request indicate that the ERO engaged in a thorough vetting, both internally and with stakeholders, on the decision to eliminate the Reliability Readiness Program. The ERO's documentation provides in detail how, over time, the Reliability Readiness Program had become redundant of other ERO and Regional Entity activities. Further, the ERO's response to the data request indicates that the ERO considered alternative solutions before concluding that the best option was to eliminate funding for the program.[~~45~~56]

18 C.F.R. § 39.4 sets out the requirements for funding an ERO. Specifically, section 39.4(b) addresses ERO annual budget requirements~~.~~[~~46~~]:

> The Electric Reliability Organization shall file with the Commission its proposed entire annual budget for statutory and any non-statutory activities, including the entire annual budget for statutory and any non-statutory

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[54] 2008 ERO Budget Order at P 21.

[55] *North American Electric Reliability Corporation, Order Conditionally Accepting 2009 Business Plan and Budget of the North American Electric Reliability Corporation and Ordering Compliance Filing*, 125 FERC ¶ 61,056 (2008), at P 18.

[~~45~~56] *North American Electric Reliability Corporation*, 128 FERC ¶ 61,025 P 28.

[~~46~~] ~~*See supra* text accompanying note 9.~~

 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

activities of each Regional Entity, with supporting materials, including the ERO's and each Regional Entity's complete business plan and organization chart, explaining the proposed collection of all dues, fees and charges and the proposed expenditure of funds collected in sufficient detail to justify the requested funding collection and budget expenditures 130 days in advance of the beginning of each Electric Reliability Organization fiscal year. The annual Electric Reliability Organization budget shall include line items budgets for the activities of each Regional Entity that are delegated to each regional Entity pursuant to §39.8.

Background

Audit staff interviewed NERC senior management, staff, and various Board of Trustee (BOT) members to understand the criteria NERC used to determine whether its activities should be funded under FPA section 215. Audit staff believes such criteria are necessary because section 215 allows funding for: (1) development of mandatory standards; (2) enforcement of those standards; and (3) monitoring the BPS.[~~47~~57] NERC has organized each of its six annual business plans and budgets around the program Areas described in the 2007 budget filing, and the Commission has approved the budgeted activities in these Program Areas, as well as the related General and Administrative or overhead/indirect activities, as statutory activities to be funded through section 215, in each of the Commission's six annual ERO budget orders. Through these discussions, audit staff discovered that NERC has not developed any policies, procedures, processes, or practices (i.e., criteria) to guide its staff on the types of activities permissible under section 215. ~~These discussions also revealed that NERC adopted a philosophy that the development of criteria was unnecessary because all NERC activities promote reliability, and therefore should be funded under section 215.~~ Audit staff notes that the Regional Entities have undertaken efforts to determine activities performed that are non-statutory in nature and have transparently reflected these activities in their budget submissions to the Commission. However, audit staff found no evidence that the BOT undertook an independent review of NERC's activities as part of its oversight responsibilities to determine that all NERC activities are statutory. ~~As~~Although audit staff has not identified any specific NERC activities that fell outside of the scope of the NERC Program Areas that the Commission

[~~47~~57] In the Commission order certifying NERC as the ERO, the Commission interpreted the monitoring activities to include the periodic BPS reliability assessment activities that were ongoing at NERC prior to being approved as the ERO~~.~~ and which are expressly included in the ERO activities listed in Section 215. While these activities were approved during NERC's transition as the ERO, NERC has continued to be responsible for such existing assessments and has assumed even greater assessment responsibilities in other areas. ~~The degree to which such assessment and monitoring activities currently ongoing should be deemed statutory is therefore also an element that audit staff believes should be revisited.~~

91 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

has concluded are statutory activities to be funded under section 215, as described below, audit staff is concerned that the scope of some activities NERC undertook was not specifically required by the Commission in Order No. 672 or any subsequent order. ~~Also~~Further, although audit staff did not find any NERC activities that did not or do not contribute to and support the reliability and security of the bulk power system, audit staff questions whether some of these activities exceeded the functions of the ERO explicitly defined in section 215.

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

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

When the Commission reviewed NERC's application to become the ERO, and certified NERC as the ERO, it approved the ongoing programs but stated that "the funding proposal at a high level seems appropriate but lacks details" and directed NERC to "submit in its compliance filing a list of budget principles . . . including: (1) budget component justification based on statutory or other authorities; (2) how the budgeted activity lends itself to the accomplishment of the statutory or other authorities . . . "[~~48~~58]

NERC's compliance filing stated that each budget filing would provide for each principle.[~~49~~59] When reviewing the 2007 business plan and budget, the Commission stated that, "The 2007 budget provides sufficient information for the Commission to determine that the proposed designated activities are statutory," but in order to "provide greater detail and justification for the criteria [NERC] uses to designate statutory activities," the Commission required NERC to "identify the general statutory activity, and which sub-activities, are covered by the budget and business plan in the 2008 business plan and

[~~48~~58] *See* case cited *supra* note 40.

[~~49~~59] *See* pleading cited *supra* note 43.

92 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

budget filing."[50][60] In its 2008 business plan and budget filing, NERC vaguelycomprehensively addressed this requirement by stating that each of its program areas "carries out or supports implementation of one or more of the statutory activities."[51] to the Commission's satisfaction, as shown above. Although many of the ongoing activities NERC performeddescribed were consistent with this Commission determination that additional details were required in order to clarify theire status as statutory activities, audit staff has concerns that the manner in which NERC addressed the Commission's requirement for greater detail was insufficient to allow NERC itself, or the Commission audit staff, to verify that specific NERC programs and activities should be funded as section 215.in subsequent years' business plan and budget filings, NERC has not provided sufficiently specific details on each of its planned activities within the Program Areas that the Commission has found to be statutory, to enable the Commission to verify that all activities fall within the scope that the Commission has defined as statutory.

The Commission order certifying NERC as the ERO outlined the process NERC would follow to pursue reliability-related activities other than those specified in section 215. The Commission also recognized that the ERO is not precluded from pursuing these activities as long as the funding comes from non-section 215 sources,[52][61] and as long as the non-statutory activities are included in its business plan and budget. If NERC had followed this process, it would "provide the Commission with necessary information about any non-statutory activities, the source of their funding, and whether the pursuit of such activities presents a conflict of interest for the ERO."[53][62] However, to date, NERC has not usedmaintained a policy of not engaging in any non-statutory activities, and therefore has not sought to use the Commission's process for seeking approval of non-statutory activities.

Since becoming the ERO, NERC has embarked on new or expanded programs it believes maintain and improve the reliability and security of the BPS. Audit staff questions whether some of these programs fall outside the explicit scope of the ERO under section 215, which is the development and enforcement of mandatory reliability standards and monitoring of the BPS[54], but are more consistent with how NERC historically pursued its mission prior to its certification as ERO (i.e., the pursuit of reliability and security through voluntary programs)scope of what the Commission has previously approved as statutory programs and activities. Audit staff understands that NERC has the authority to perform any activities that do not conflict with its role as the ERO; however, itif any such activities

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[50][60] North American Electric Reliability Corporation, 117 FERC ¶ 61,091 at P 30 (2006).

[51] See pleading cited supra note 44.

[52][61] Order No. 672, 114 FERC ¶ 61,104 at P 202.

[53][62] *Id*. P. 198

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

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are non-statutory, NERC must designate them as non-statutory and fund them separately and apart from the permitted section 215 activities. Several of the Regional Entities have adopted this approach and continue to pursue their historic missions as well as undertaking their responsibilities and duties under section 215.

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

~~Audit staff sampled~~After exhaustively reviewing NERC's current activities ~~and~~over a period of many months, audit staff found three activities that it questions whether ~~several~~they are, in whole or in part, appropriate under section 215 because NERC presented ~~little to no documentation~~insufficient explanation, in audit staff's opinion, explaining how ~~some~~these three activities link to section 215. ~~However~~

With respect to the three activities that audit staff questions as being statutory, NERC presented ~~only verbal~~information and arguments defending the value of each activity and how each contributes to BPS reliability and security. While audit staff recognizes the~~se~~ facts~~, it~~ presented by NERC, audit staff remains unconvinced that ~~an~~NERC adequately explained why each activity's admitted contribution to BPS reliability and security ~~is an adequate criterion to determine whether an~~adequately establishes that the activity should be funded under section 215. To facilitate such determinations in the future, audit staff believes that NERC should develop clear written criteria by which to demonstrate activities undertaken are statutory in nature within the scope of the Program Areas previously approved by the Commission and therefore are allowable as activities to be funded under section 215. ~~Sampled~~

The three activities ~~that fall into this category~~questioned by audit staff, as detailed below, include:

- Conducting presentations and speeches at universities encouraging students to seek electric power industry careers (an activity that was initiated because NERC's assessments of the reliability of the BPS have identified the electric

industry's aging workforce, and the apparent lack of younger individuals seeking and training for careers in the industry, as a potential problem for the reliability and adequacy of the BPS);

- Conducting the GridEx exercise; and
- Hosting a grid security conference;

In addition, activities NERC itself termed "non-compliance" in nature are of concern to audit staff. These activities are pursued as part of NERC's function as the Electric Sector – Information Sharing and Analysis Center (ES-ISAC). The audit report deals with these concerns in a separate finding, Finding 11 in section IV of the audit report.

Aging Workforce

NERC's concerns about the electric power industry's aging workforce began before it became the ERO. NERC's Long-term Reliability Assessment identified the issue in 2006, and again in 2007 and 2009. In its first year as the ERO in 2007, NERC developed an initial action plan that involved coordination with the National Science Foundation in which NERC would take an active role in facilitating an industry action plan addressing the aging workforce issue. In November 2007, the two organizations hosted an industry workshop to develop a nationwide action plan with collaborative industry effort. This plan included action items, best practices, and recommendations for recruiting new talent, supporting university programs, and raising awareness.[~~55~~63]

NERC continued to support the initiative, hosting an Aging Workforce Webinar in July 2008. In addition, a senior NERC staff member continued to engage in activities addressing the issue, including travel to U.S. and Canadian universities to give presentations and speeches encouraging greater interest in electric power industry careers among students. Those efforts began under a plan developed by NERC's former CEO, starting with a May 2007 meeting. The staff member has continued to execute the plan under the new CEO, and in total has participated in five activities hosted at universities between 2007 and ~~2011.~~2011, or one such activity per year on average.

NERC believes that this activity is a logical component of its statutory responsibility to assess the reliability and adequacy of the bulk power system. In its Three-Year ERO Performance Assessment Report, which the Commission accepted, NERC described this program as "Develop[ing] Independent Short- and Long-Term Assessments of the Reliability and Adequacy of the Bulk Power System and Focus[ing] Attention on Emerging Issues Important to Reliability."

[~~55~~63] North American Electric Reliability Corporation, *NERC & National Science Foundation Partner with Industry to Create Action Plan on the Aging Workforce*, NERC News, (Sept. 18 2007), *available at* http://www.nerc.com/fileUploads%5CFile%5Cnewsletters/NERCNews-2007-09.pdf.

95 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

Audit staff believes that conducting a reliability assessment to identify this issue as a reliability concern was appropriate under section 215, but has no clearly articulated criteria upon which to assess undertaking non-mandatory corrective actions in response to any needs identified. NERC's response to the concern identified ~~concern~~by audit staff did not seek to directly address any staffing needs of NERC itself. Rather, NERC acted on behalf of the electric power industry through an activity ~~with no~~whose only linkage to ERO functions~~. Absent having written criteria linking the activities to ERO functions, audit~~ appears to be that they were identified in the course of performing one of the ERO duties specified in section 215, performing assessments of the reliability and adequacy of the BPS. Audit staff questions whether NERC's activities to address the issue have not been appropriate activities under section ~~215.~~215 within the scope of the statutory Program Areas previously approved by the Commission.

GridEx

In November 2011, NERC's Critical Infrastructure Division (CID) planned and hosted a cyber security incident readiness exercise, known as GridEx. During the entire development process, NERC did not seek to involve FERC staff in any oversight of this project. Participants in the exercise consisted of 75 U.S. and Canadian organizations, including 48 utilities, 21 government and academic organizations including FERC, and six Regional Entities. NERC designed the exercise to test participants' readiness to respond to a cyber incident, strengthen registered entities' crisis response functions, and provide input for internal security program improvements.

NERC stated that GridEx was consistent with NERC's Situation Awareness and Infrastructure Security Program, as set forth in §1003 of its Rules of Procedure, which provides that:

- NERC shall encourage and participate in coordinated Critical Infrastructure Protection exercises, including interdependencies with other Critical Infrastructure sectors.

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

NERC indicated that the findings and recommendations from the exercise were designed to strengthen the readiness of NERC and the industry to identify, defend against and respond to a cyber attack or incident that threatens the security and reliability of the Bulk Power System – including, where appropriate, through development of new Reliability Standards and modification of existing Reliability Standards.

Audit staff's review of the materials supporting the exercise ~~revealed no indication that it was designed to result in any changes to, or the development of, reliability standards.~~

96 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

~~Instead, the exercise~~indicated that it related primarily, in audit staff's opinion, to NERC's role as the ES-ISAC, a function that it carried prior to becoming the ERO~~.~~, and which the Commission has, in its budget orders, accepted as a statutory activity that should be funded through section 215. While audit staff believes the exercise may be helpful, audit staff is concerned that the exercise was contemplated and designed without ~~criteria in place to ensure~~establishing that it was an appropriate activity under section 215.

In addition, NERC had not included or described this exercise in its 2011 budget, approved in 2010, and therefore it was not subject to ~~approval~~consideration by the Commission, the BOT or the stakeholders, or approval by the BOT or the Commission, during the budget process. NERC's CEO authorized the CID to conduct GridEx ~~despite~~, although no similar activity ~~having~~had ever been approved or conducted in previous years at NERC. Moreover, NERC neither presented any cost/benefit analysis to the Commission or the BOT nor did it present to audit staff with any meaningful degree of specificity the exercise's justification as statutory under section 215. In the absence of adequate criteria and a process to implement them, audit staff questions whether GridEx is an appropriate activity under section 215.

Grid Security Conference

In October 2011, NERC held its first grid security conference, a two-day event known as GridSec. GridSec consisted of speakers from NERC, government agencies, security agencies, registered entities, vendors of consulting services and software/hardware products, and other parties involved in cyber security issues. More than 260 industry and government security professionals attended the conference, including representatives from the Commission. NERC stated that the conference focused on security threats to Bulk Power System reliability, including threats to industrial control systems, hacker exploits, facility threats and violence, and how the CIP standards support Bulk Power System reliability, and was consistent with the requirements in NERC's Situation Awareness and Infrastructure Security Program, as set forth in Section 1003 of its Rules of Procedure, which include requirements to strengthen relationships with government agencies and the industry in support of critical infrastructure matters and engage in education and outreach to increase awareness of these matters.

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Audit staff's review of the costs associated with GridSec showed that commercial vendors contributed approximately $50,000 toward the event by sponsoring some meals and refreshments for attendees. While Critical Infrastructure Protection (CIP) standards were discussed during one half-hour presentation and the ES-ISAC was the subject of another half-hour talk, the bulk of the conference dealt with cyber security ~~from a primarily non- compliance context (i.e.~~ without any linkage to the identification of the need for new or revised standards~~)~~ or to specific compliance issues with respect to existing Reliability Standards. Audit staff notes that during the Commission staff audit of NERC, NERC staff informed FERC staff that in future years greater inclusion of CIP compliance issues in such conferences will be planned.

NERC believes that hosting this conference ~~falls under~~, in addition to being within the scope of its ~~Commission-approved training function. However, NERC made no showing that the budget for the training function contemplated the costs of hosting this event~~Situation Awareness and Infrastructure Security Program as described in its Rules of Procedure, also provides important training for industry. NERC did not document this event in any context during the 2011 budget review process, and therefore did not provide an opportunity for stakeholder review, or seek Commission~~,~~ or BOT~~, or stakeholder~~ approval, for its funding in the 2011 operational year by means of the budget process. Audit staff reviewed the materials associated with GridSec and believes that the education provided was at best only tangentially related to the statutory duties of NERC as the ERO, within the statutory program scopes as previously accepted by the Commission. On this basis, audit staff questions the appropriateness of funding this activity under section 215.

Summary

While each of the above examples promotes reliability and has reliability or security aspects (to a greater or lesser extent), audit staff believes that these alone are not appropriate criteria upon which to assess their statutory nature. NERC needs to establish and operate under formal criteria that ensure all of its program activities that are funded pursuant to FPA section 215 are statutory. ~~By having engaged in the activities described above without written criteria~~In the opinion of audit staff, NERC did not provide adequate support ~~for engaging in~~during the audit that these activities were statutory. If NERC embarks on new projects within an operating year that were not budgeted and approved through the budget process, NERC needs clear guidance to ensure that the funds expended are for statutory purposes.

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Recommendations

We recommend that NERC:

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

38. ~~Identify all ERO activities funded under section 215, detailing at a minimum: the purpose of the activity, a description, and the justification for using section 215 funding. Submit all documentation to audit staff for these reliability activities.~~In its annual business plan and budget filings, provide an explanation as to why the proposed activities to be undertaken by each Program Area for the budget year are statutory, including, at a minimum: a description and the purpose of the major activities to be undertaken by each Program Area and an explanation for why the activity is a statutory activity.

99 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

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

NERC's dual role as the Electric Sector-Information Sharing and Analysis Center (ES-ISAC) and as the ERO raises significant challenges. NERC ~~has continued functioning in both roles, resulting in internal confusion and confusion among the Commission and stakeholders~~should continue to address these challenges through appropriate separations and additional transparency.

Pertinent Guidance

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

> Section 215 of the FPA generally provides for Commission authorization of funding for statutory functions, such as the development of Reliability Standards and their enforcement, and monitoring the reliability of the Bulk-Power System. The Final Rule clarifies, however, that while the ERO or a Regional Entity is not necessarily precluded from pursuing other activities, it may not use Commission-authorized funding for such activities.[~~56~~64]

~~Commission Order No. 672 Certifying~~In its order certifying NERC as the ERO ~~states~~, the Commission stated, in part:

> The Commission finds that NERC has met the requirements of Order No. 672 and we hereby certify NERC as the ERO for the United States.[~~57~~65]

Section 1000, Situation Awareness and Infrastructure Security, of the NERC Rules of Procedure ~~include~~, which have been approved by the Commission pursuant to section 215 and Part 39 as ERO Rules, includes a section on the Electric Sector Information Sharing and Analysis Center (Section ~~1003.1). Subsection 1003.1.1 states:~~1003), which states in part that "NERC shall coordinate electric industry activities to promote Critical Infrastructure protection of the Bulk Power System in North America by taking a leadership role in Critical Infrastructure protection of the electricity sector so as to reduce vulnerability and improve mitigation and protection of the electricity sector's Critical Infrastructure" and further that "NERC shall serve as the electricity sector's sector coordinator and operate its Information Sharing and Analysis Center to gather information and communicate security-related threats and incidents within the sector, with United

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[~~56~~64] Order No. 672, 114 FERC ¶ 61,104 at P 34.

[~~57~~ North American Electric Reliability Corporation, 116 FERC ¶ 61,062[65] ERO Certification Order at P ~~3 (2006).~~3.

100 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

States and Canadian government agencies, and with other Critical Infrastructure sectors.[58],,[66]

Background

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

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

NERC's role in connection with the ES-ISAC is set out in §1003 of its Rules of Procedure as one of the functions through which NERC will accomplish the goals related to the Infrastructure Security Program. In the order accepting NERC's 2007 Business Plan and Budget, FERC considered commenters by intervenors who questioned the statutory nature of several of NERC's activities. In that order, FERC expressly found that NERC's proposed activities, including those related to the Infrastructure Security Program, are "covered by FPA section 215, i.e., the development and enforcement of reliability standards, and are entitled to receive funding under section 215 of the FPA."[67]

Under the ISAC program, NERC, as the ES-ISAC, receives physical security, cyber security, and operational security event and incident reporting from the electricity sector and Bulk-Power System entities. This reporting requirement is reflected in the current CIP

[58] North American Electric Reliability Council and North American Electric Reliability Corporation, Application, Docket No. RR06-1-000, (filed Apr. 4, 2006). (requesting certification as the Electric Reliability Organization).[66] NERC's Rules of Procedure are available at: http://www.nerc.com/fileUploads/File/Rules_of_Procedure/NERC_ROP_Effective_20120315_without_appendices.pdf

[67] 2007 ERO Budget Order at P 28.

101 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

standards under CIP-~~008 security incident reporting~~008, Incident Reporting and Response Planning. Requirement ~~1.3.~~1.3 reads: "The Responsible Entity must ensure that all reportable Cyber Security Incidents are reported to the ES-ISAC either directly or through an intermediary." The required reports are ~~filed~~the DOE OE-417 reports, and are subject to the applicable rules and regulations of the DOE reporting system.

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

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

Audit staff noted that ~~at~~, coinciding with the conclusion of ~~its~~the audit fieldwork, NERC proposed a significant organizational change to its CID to its BOT. This proposal was reflected in a policy statement presented to, and approved by, NERC's BOT at its February 2012 meeting. The proposal would define the operation of the ES-ISAC as a "non-compliance obligated function" to, in effect, "wall off" certain staff within its CID from compliance- related activities. In interviews, NERC staff stated the primary motivation for the change was to increase industry participants' use of ES-ISAC and encourage information sharing. NERC believed industry's use of the site would increase if ES-ISAC staff were perceived and accepted by industry participants as "non-compliance obligated." In particular, NERC believed the industry would more readily report to the ES-ISAC site non-mandatory high-frequency/low-risk incidents. While NERC said it

might at some unspecified date in the future be able to use these incident reports to identify activity patterns that pose security threats to the electric grid, this provided, in audit staff's opinion, a very weak linkage to the standards development function of the ERO.

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

Additionally, audit staff noted that the Commission's approval of NERC's ES-ISAC role for funding under section ~~215 was~~215, which the Commission has provided in accepting each of NERC's six annual business plans and budgets from 2007 through 2012, was initially, at least in part, based on NERC's 2007 Business Plan and Budget. In that budget filing, NERC stated the ES-ISAC was a statutory, compliance-related program to the extent that "performance of the function included in this program will assist NERC in identifying areas for which new or revised reliability standards may be required."[~~59~~68] NERC's proposal sought to maintain a link between the ES-ISAC and compliance-related activities by flowing "sanitized trends" in security-related matters to assist in the development of reliability standards. This process would involve removing all identifiable information from collected data in order to maintain anonymity prior to conducting trend analysis. Audit staff believes this could present issues regarding the Commission's oversight responsibilities for NERC's performance in this process. NERC's proposal must address, at a minimum, the Commission's mandate to oversee all programs funded under section 215, and sufficiently show how the ES-ISAC continues to fall within the rubric of NERC's statutory activities and the Commission's oversight responsibilities.

[~~59~~68] North American Electric Reliability Corporation, Request, Docket No. RR06-3-000 at Attachment 2 at page 25 (filed Aug. 23, 2006)(submitting the 2007 business plans and budgets of NERC and Regional Entities for acceptance and Proposed Assessments to Fund Budgets for approval).

103 DeltaView comparison of pcdocs://wassr02a/1028137/1 and pcdocs://wassr02a/1028608/1. Performed on 4/25/2012.

Recommendations

We recommend that NERC:

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

39. ~~40. Evaluate the impact on~~Provide additional information in NERC's 2013 business plan and budget regarding NERC's role as the ES-ISAC and provide opportunities for stakeholder input regarding NERC's role as the ES-ISAC during the 2013 business plan and budget process. This should also include: (1) an evaluation of the impact, if any, on NERC's compliance-related activities of "walling off" certain staff from these activities~~, and modify NERC's current proposal for redefining the operation of the ES-ISAC to include clear guidance on how the "walled-off" sub-division will interact with the ERO~~; and (2) clarification of the flow of information between the ES-ISAC and the Commission staff for situational awareness and compliance purposes;

40. [This recommendation is incorporated in Recommendation 39];

41. ~~Clarify the flow of information between the ES-ISAC and the FERC staff for situational awareness and compliance purposes; and~~[This recommendation is incorporated in Recommendation 39]; and

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

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Deletions	751
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Style change	0
Format changed	6
Total changes	1610

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May 4, 2012

Commissioner Philip D. Moeller

STATEMENT

FEDERAL ENERGY REGULATORY COMMISSION

Docket No. FA11-21-000

Statement of Commissioner Philip D. Moeller on The NERC Audit Report

"Today, a delegated letter order announced the Office of Enforcement's audit findings and recommendations of the North American Electric Reliability Corporation (NERC), the nation's Commission-certified Electric Reliability Organization. The Commission's audit staff has extensive experience conducting financial performance audits. However, this is staff's first financial performance audit of NERC, an enterprise that is set apart by its responsibility under Section 215 of the Federal Power Act to develop and enforce reliability standards for the bulk-power system. In the report, Commission staff found eleven areas where performance could be enhanced, which resulted in forty-two audit recommendations. NERC's objections to these findings and recommendations are substantial. Should NERC determine that some of these matters would benefit from Commission review, they now have 30 days to request such review. I look forward to receiving additional insight from this report, now that it has been released, and receiving any further information and feedback from NERC on the outcome of staff's audit."

Document Content(s)

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May 4, 2012

Commissioner Cheryl A. LaFleur

STATEMENT

FEDERAL ENERGY REGULATORY COMMISSION

Docket No. FA11-21-000

Statement of Commissioner Cheryl A. LaFleur on The NERC Audit Report

"Today, Commission staff issued a performance audit of the North American Electric Reliability Corporation (NERC). The audit sets forth numerous concerns regarding NERC's operation and focus. As described in the audit, NERC has expressed strong disagreement with some of the audit findings.

I have a high degree of confidence in FERC audit staff. However, I believe the issuance of this audit without a Commission vote was inconsistent with Commission regulations. Given the importance of NERC's role as the Electric Reliability Organization charged with overseeing the reliability of the bulk power system, and the scope and significance of today's audit, I believe the audit report as presented by staff should have been subject to a vote of the full Commission prior to issuance."

Document Content(s)

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Getting Even on Reliability

The feds retaliate against an advisory board for doing its job.
Opinion

Imagine if some obscure trading desk within J.P. Morgan had tried to warn Jamie Dimon about corporate malfeasance—or perhaps a risky investment—and it turned out he tried to shut up the whistleblower. We'd never hear the end of it. Somehow the same norms don't apply in government, as shown by a federal energy regulator's reprisals against an independent advisory body.

The target is the North American Electric Reliability Corporation, or NERC, and its crime is scrutinizing the Obama Administration's anticarbon agenda. This highly respected nonprofit has monitored the power system since the 1960s and establishes best practices to keep the lights on. In 2005, Congress gave NERC a formal role as adviser. But now it may be defrocked for questioning the "pace and aggressiveness" of the Environmental Protection Agency's regulatory wave in a 2010 report.

NERC's position is that the EPA goal of mothballing many or most coal-fired power plants could endanger the security of the electric-power grid, with possible blackouts and much higher energy costs. In a follow-up report last year it found that "Environmental regulations are shown to be the number one risk to reliability over the next one to five years."

Apparently that was too honest for Washington. Earlier this month the Federal Energy Regulatory Commission disclosed that it has spent months conducting a highly unusual audit of NERC. The commission oversees NERC under the 2005 law, so it has every right to check its practices. But this probe exceeded normal auditing standards and was a freefloating investigation into NERC's "economy and efficiency," whatever that means. It didn't find any rule-breaking.

Instead, the auditors question NERC's focus and statutory responsibilities, concluding that it "may have exceeded the functions" Congress intended for a reliability organization. Never mind that NERC has been doing the same job for decades and its integrity hasn't been questioned. The feds also complain about NERC's "periodic reliability assessments," otherwise considered the gold standard. They say this role "should be revisited."

In other words, the energy G-men think NERC should help protect reliability without studying the actual threats to reliability. This may be intimidation to get NERC to tone down its candor, or it could be a prelude to decertifying NERC to silence a troublesome critic. NERC tried to compromise on some of the audit's proposals while protecting its core duties, but the feds are now litigating to impose them.

The back story is that Federal Energy Regulatory Commission Chairman Jon Wellinghoff is an EPA wingman and President Obama ally. He has told the trade press that he has "some real, real, real serious issues with respect to the functioning of NERC," without details, and he launched the audit on his own personal authority as boss. It's especially notable that Commissioner Cheryl LaFleur—an Obama appointee—attacked the move as "inconsistent with Commission regulations" and said it should have been put to a vote.

Bureaucratic infighting is an eternal reality of government, but Congress should ask Mr. Wellinghoff what he has to fear from honest counsel.

A version of this article appeared May 21, 2012, on page A14 in the U.S. edition of The Wall Street

NERC
NORTH AMERICAN ELECTRIC RELIABILITY CORPORATION









Announcement

Board Adopts 5 Standards; Highlights Strategic Milestones Accomplished by the ERO

May 11, 2012

ARLINGTON, VA -- The North American Electric Reliability Corporation's (NERC) quarterly Board of Trustees meeting took place on May 9 in Arlington, Va. Board Chair John Q. Anderson opened the meeting, welcoming FERC Commissioners John Norris and Cheryl LaFleur, and U.S. and Canadian industry participants.

NERC President and Chief Executive Officer Gerry Cauley commended the cooperation and collaboration between NERC and the Federal Energy Regulatory Commission (FERC) on the September 2011 Southwest outage inquiry report. The thoroughness and detail of the report lay important groundwork for how the industry can better ensure the reliability of the bulk power system.

"The joint outage report allows us to look at events from a broader perspective and see commonalities across the system, not just in one interconnection," Cauley said. "We need to look at underlying issues *before* events happen to make sure we have adequate programs in place. This introspection can be accomplished through a risk-based approach of testing and evaluating."

Cauley also highlighted three strategic milestones achieved to date in 2012 by the electric reliability organization (ERO):

- **Standards Process Input Group.** The high-level Member Representatives Committee working group was formed to provide policy input and recommendations on key issues in the standards area, including quality of process and product, timeliness, efficiency and effectiveness, and significance of American National Standards Institute requirements.
- **State of Reliability report.** This report follows the 2011 foundational report that reviews and assesses the state of reliability based on trends identified through data combined with root cause analysis of events. The key findings

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serve as technical input to NERC's Reliability Standards and project prioritization, compliance process improvements, event analysis, reliability assessment and critical infrastructure protection.

- **Severe Impact Resilience and Cyber Attack Task Force reports.** These two reports are the final of four task force reports that address high-impact, low-frequency events. The reports provide guidance to industry on enhancing and protecting the resilience of the bulk power system against debilitating grid events. Previous task force reports addressed geomagnetic disturbances and spare equipment.

During this meeting, the board adopted five reliability standards: FAC-003-3 – Transmission Vegetation Management Program; PRC-005-1.1b – Transmission and Generation Protection System Maintenance and Testing; TOP-001-2 – Transmission Operations; TOP-002-3 – Operations Planning; and TOP—003-2 – Operational Reliability Data Real-Time Operations. One interpretation, 2010-05 of CIP-002-1 for Duke Energy, also was adopted.

FERC Commissioners Cheryl LaFleur, John Norris and Philip Moeller attended the Member Representatives Committee meeting on May 8. The next NERC Board of Trustees meeting is scheduled for August 16 in Quebec City, Canada.

###

The North American Electric Reliability Corporation's mission is to ensure the reliability of the North American bulk power system. NERC is the electric reliability organization (ERO) certified by the Federal Energy Regulatory Commission in the United States to establish and enforce reliability standards for the bulk-power system. NERC has equivalent relationships with provincial and federal authorities in Canada. NERC develops and enforces reliability standards; assesses adequacy annually via a 10-year forecast, and summer and winter forecasts; monitors the bulk power system; and educates, trains and certifies industry personnel. Learn more at www.nerc.com

From: Tina McClellan
To: Tina McClellan
Subject: NERC: POSTED: Supplemental Documents to May 2012 Meetings - Arlington, VA
Date: Thursday, May 03, 2012 5:56:15 PM

Posted — Supplemental Documents to May 8-9, 2012 Meetings, Arlington, VA

The following documents can now be found at the following link:
SUPPLEMENTAL DOCUMENTS

- Policy Input
- Schedule of Events
- UPDATED Board of Trustees Agenda Package
  - *ADDITION of Agenda Item 6h* -- Supplemental Item -- Request to Shorten Comment Period for Proposed Data Request Under Section 1606 of the NERC Rules of Procedure
  - *ADDITION of Agenda Item 10 – Attachment 1* – State of Reliability DRAFT Report
  - *ADDITION of Agenda Item 16d* – North American Generator Forum Report

For more information or assistance, please contact Tina McClellan (via email) or 404-446-2564.

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Reliability Standards

Herb Schrayshuen, Vice President and Director of Standards and Training
Board of Trustees Meeting
May 9, 2012

RELIABILITY | ACCOUNTABILITY






Generator Requirements at the Transmission Interface (GO/TO)

- Approve standards and supporting documents; direct staff to file with the applicable authorities
  - Reliability Standard FAC-003-3 – Vegetation Management
    - Two versions – one for the currently effective version and one for the prospective standard
  - Reliability Standard PRC-005-1b – Transmission and Generation Protection System Maintenance and Testing
  - Implementation plans for FAC-003-3 and PRC-005-1b

Purpose and Results

- Ensure that the responsibility for generator interconnection facilities is appropriately assigned
- Ballots for the project will close on May 6, 2012
  - Ballot results will be provided at the Board of Trustees meeting

Interpretation of CIP-002-1 for Duke

- Approve – The interpretation of Requirement R3 of CIP-002-1—Cyber Security—Critical Cyber Asset Identification and direct staff to file with applicable regulatory authorities

Highlights

- Duke is seeking:
  - Clarification of the “List of Examples” in the standard
  - Meaning of the phrase "essential to the operation of the Critical Asset"
- Conclusion
  - Examples listed in the standard are simply examples and not an exclusive list
  - The word “essential” is not defined in the Glossary of Terms

Ballot Results

- Recirculation ballot conducted on April 20, 2012 – April 30, 2012; the interpretation was approved by stakeholders
  - Quorum – 93 percent ; approval – 95 percent

Real Time Transmission Operations TOP-001, 002, 003

- Approve the following standards and related materials and direct staff to file with applicable regulatory authorities:
  - TOP-001-2 — Transmission Operations
  - TOP-002-3 — Operations Planning
  - TOP-003-2 — Operational Reliability Data

Purpose

- Clarify requirements for real-time operations of the Bulk Electric System
- Consider stakeholder comments received during the initial development of the Version 0 standards
- Respond to directives in FERC Order 693

Highlights and Results

- Extensive development history is described in the approval package
- Key points are:
  - Issues related to System Operating Limits (SOL) resolved through the time standard for action T_V
  - Issues raised in operations planning were resolved through the definition of Operational Planning Analysis
- The standards are posted for recirculation ballots closing May 6, 2012
  - The results of the recirculation ballots will be made available at the Board of Trustees meeting

VAR-001-3 Variance for WECC

- Approve and direct staff to file with applicable regulatory authorities
  - Automatic Voltage Regulators operating in automatic voltage control mode are needed to stabilize voltage
  - Transmission Operators are responsible for determining the voltage levels

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Frequency Response Project

Mark Lauby, Vice President and Director Reliability Assessment and Performance Analysis
Herb Schrayshuen, Vice President and Director of Standards and Training
Board of Trustees Meeting
May 9, 2012

RELIABILITY | ACCOUNTABILITY






Completed Analyses

- *Interconnection Criteria for Frequency Response Requirements – Determination of Interconnection Frequency Response Obligations* – Planning Committee approved September 2011
  - Frequency variation in interconnections
  - Relationship between nadir and recovery point
- Resources Subcommittee's Position Paper
- ERAG/NERC: *Analysis of Eastern Interconnection Frequency Response*
- Governor Survey – In August 2012 Report

Ongoing Analysis: Obligation

- Validate interconnection frequency response needs
- Analysis of frequency response variability
  - Assess ongoing trends using probabilistic measures
  - Incorporate event and nadir concerns
  - Avoid layering of margins
  - Interconnection resource contingency requirements
- Simulation of Eastern Interconnection UFLS setpoint – 59.5 Hz versus 59.7 Hz
- Vet frequency response needs through simulation

Standard Development

- In 2009, work was stopped
- Restarted and refocused in 2010
- Standard BAL-003 drafted and posted:
  - 1st draft standard posted for comment on February 4, 2011
  - 2nd draft posted for comment, with initial ballot on October 23, 2011
- 31 percent approval on 2nd draft

BAL-003 Standard: Status

- Addressing concerns for a number of years
  - Targeted technical and standards work by May 2012
- Technical work ongoing, initial ballot unsuccessful
- Request FERC grant relief from May 2012 filing deadline
- Two technical conferences planned for May 2012

Standards: Next Steps

- Continue standards development and technical work
- Complete technical work by August 2012
- Post next version of draft BAL-003 standard by December 2012

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State of Reliability 2012

Mark Lauby, Vice President and Director,
Reliability Assessments and Performance Analysis

Bill Adams, Chair, Performance Analysis Subcommittee,
System Operations Manager, Georgia Power

Board of Trustees Meeting
May 9, 2012

RELIABILITY | ACCOUNTABILITY






2012 State of Reliability Report

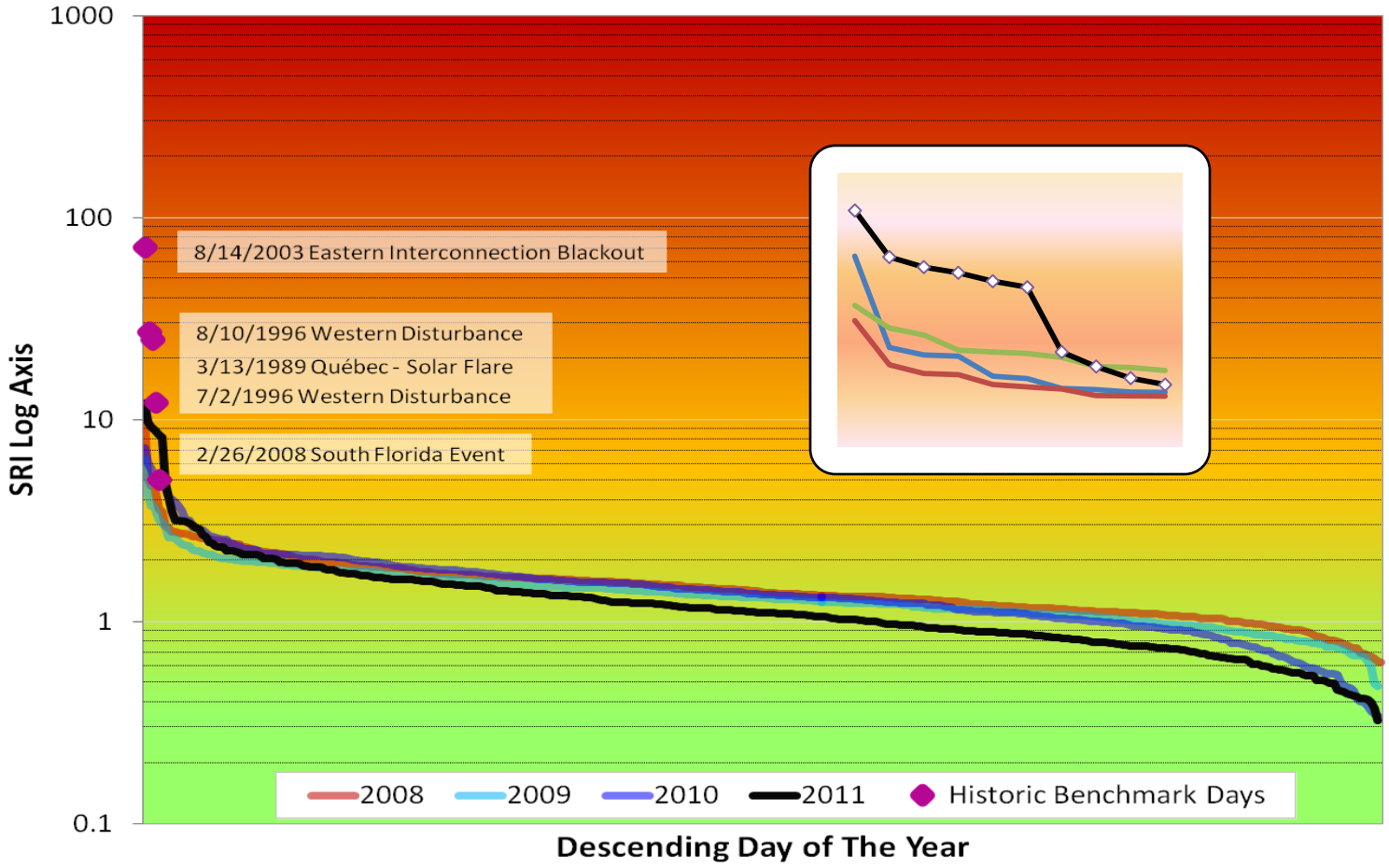
- Purpose – Objectively provide an integrated view of reliability performance
- Serve as risk-informed input to:
  - Standards and project prioritization
  - Compliance process improvement
  - Event analysis, reliability assessment, and CIP
- Reference for trends risks to reliability
- Offer analytical insights towards actionable risk control
- Prepared by NERC with input from the Performance Analysis Subcommittee (PAS)

2012 State of Reliability Report

- Build on *2011 Risk Assessment of Reliability Performance*
- Prepared by PAS and NERC with input from:
  - Operating Committee (OC)
    - Resources Subcommittee (RS)
    - Frequency Working Group (FWG)
    - Event Analysis Working Group (EAWG)/Events Subcommittee (ES)
    - Operating Reliability Subcommittee (ORS)
  - Planning Committee (PC)
    - Reliability Assessment Subcommittee (RAS)
    - System Protection and Control Subcommittee (SPCS)
    - Transmission Availability Data System Working Group (TADSWG)
    - Generating Availability Data System Working Group (GADSWG)
    - Demand Response Availability Data System Working Group (DADSWG)

Bulk Power System Reliability Remains Adequate

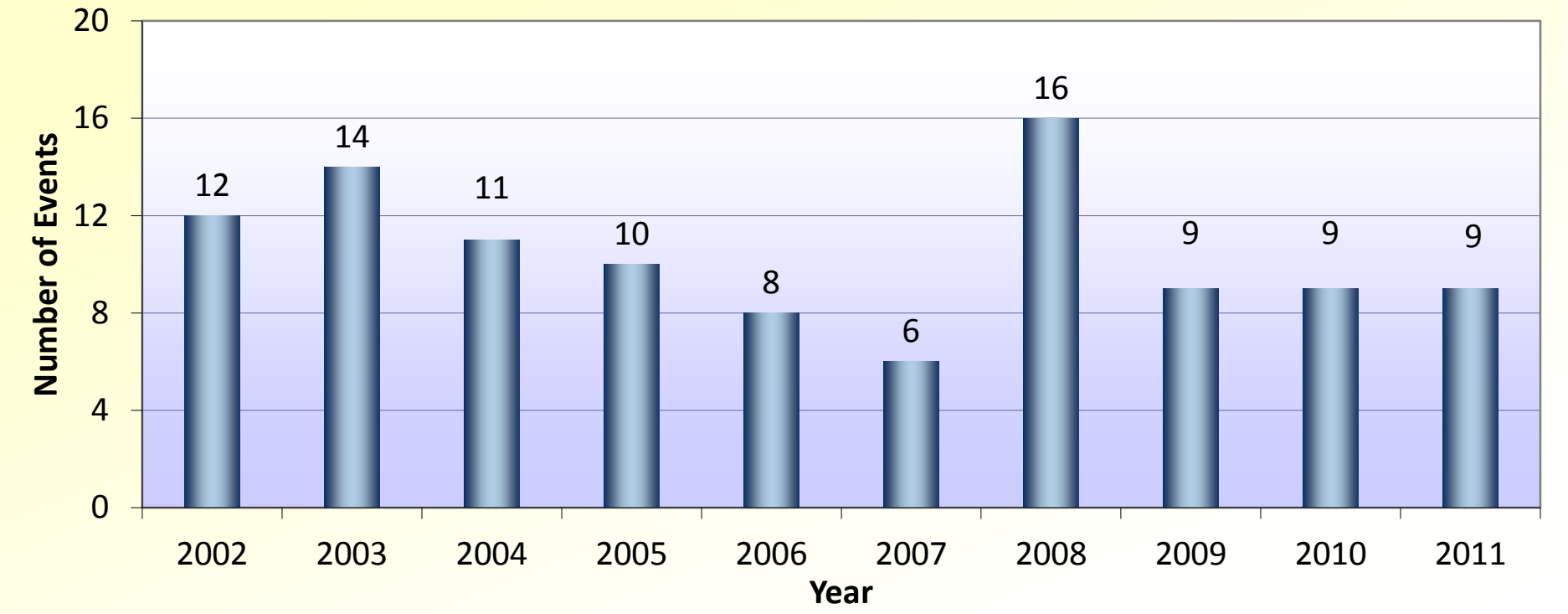
NERC Annual Daily Severity Risk Index (SRI) Sorted Descending with Historic Benchmark Days



Bulk Power System Reliability Remains Adequate

- Bulk power system reliability stable within ALR conditions
  - For 2008 to 2011, no significant upward or downward trends
  - Consistent 98% AC circuit availability

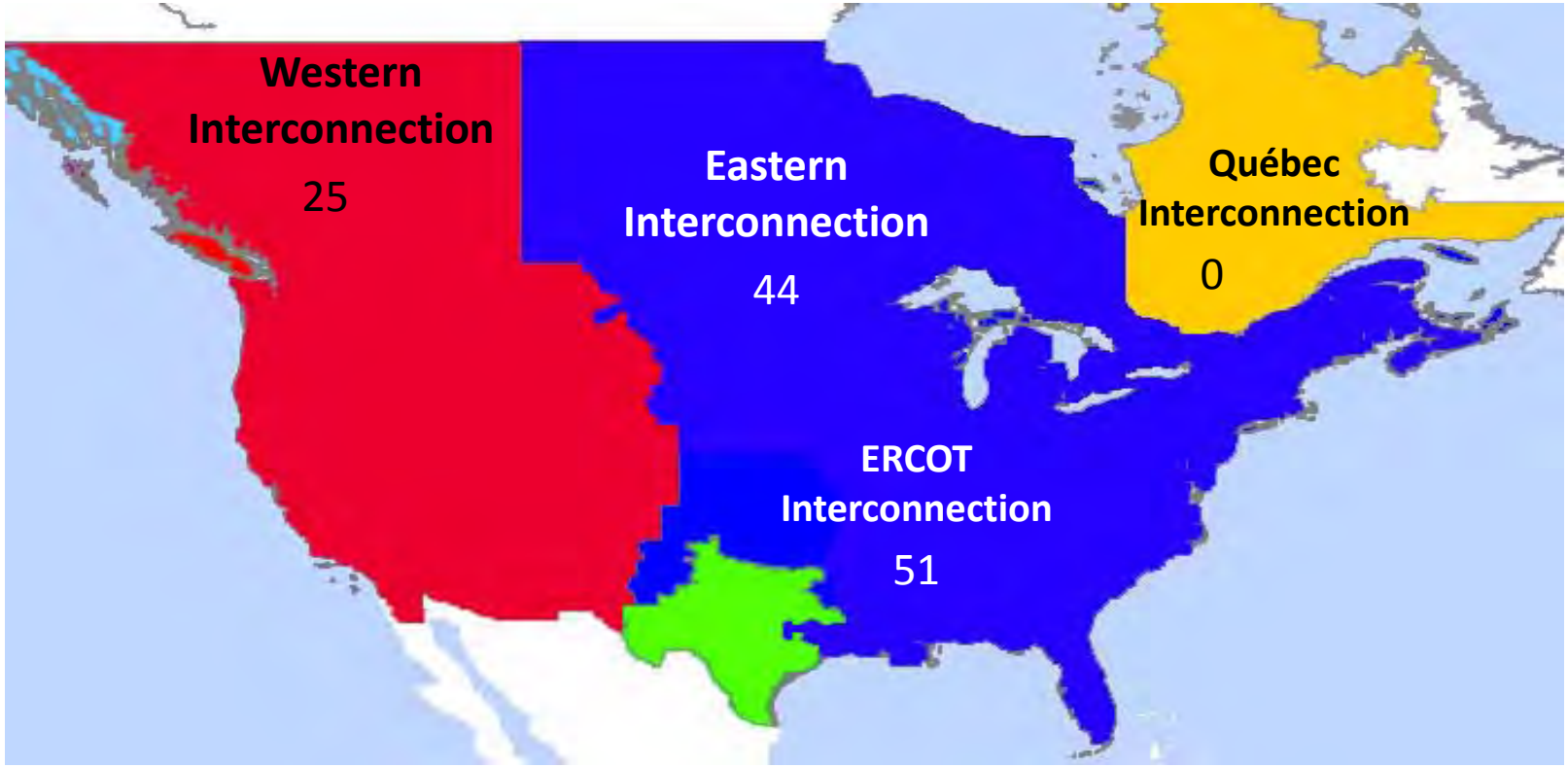
BPS Transmission Related Events Resulting in Load Loss



Frequency Response (FR) Stable

- Consistent data collection/procedures implemented in 2011
- Further analysis for EI FR events with less than 1,500 MW/0.1Hz

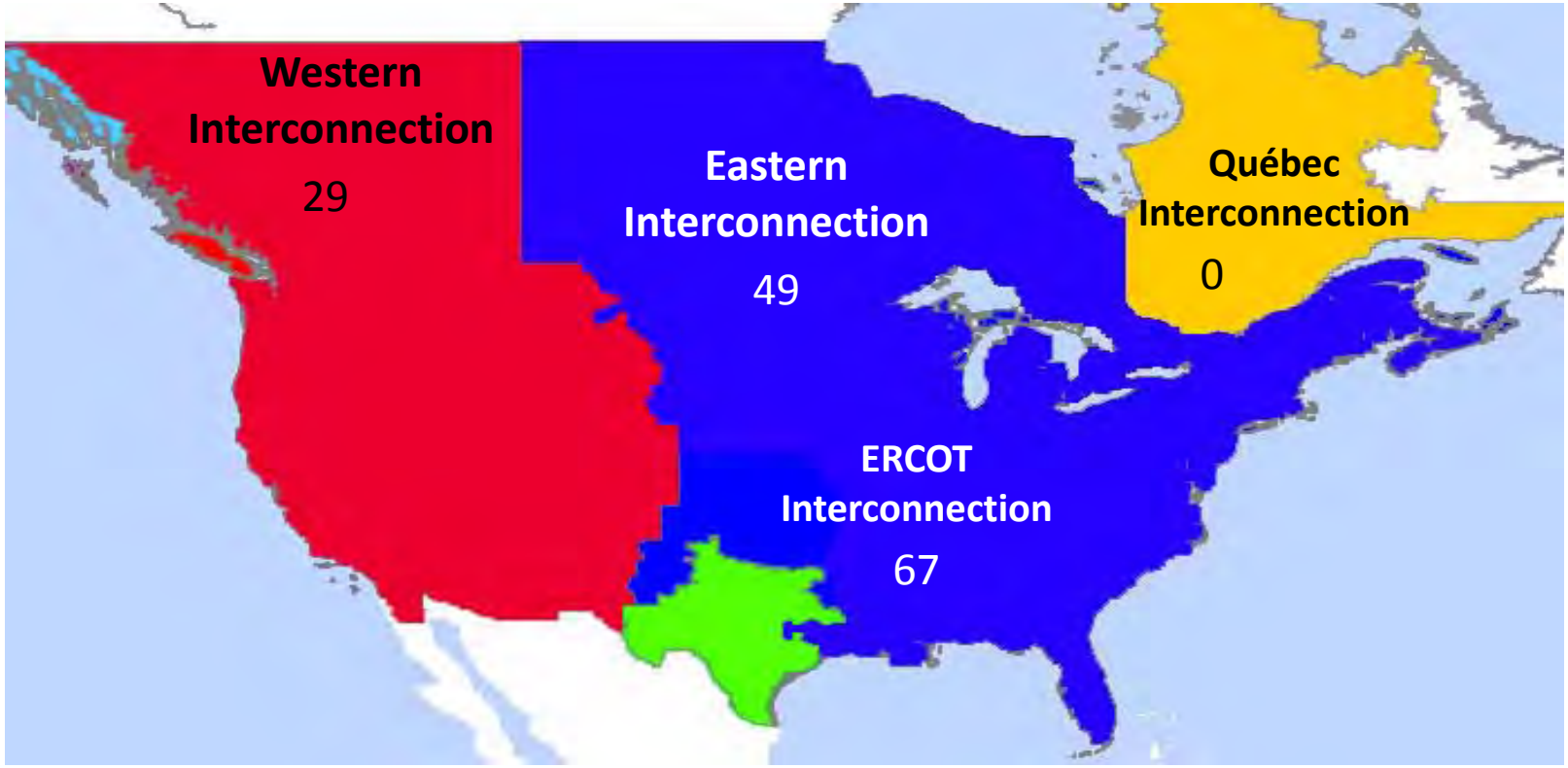
2009 Frequency Response Events Captured



Frequency Response (FR) Stable

- Consistent data collection/procedures implemented in 2011
- Further analysis for EI FR events with less than 1,500 MW/0.1Hz

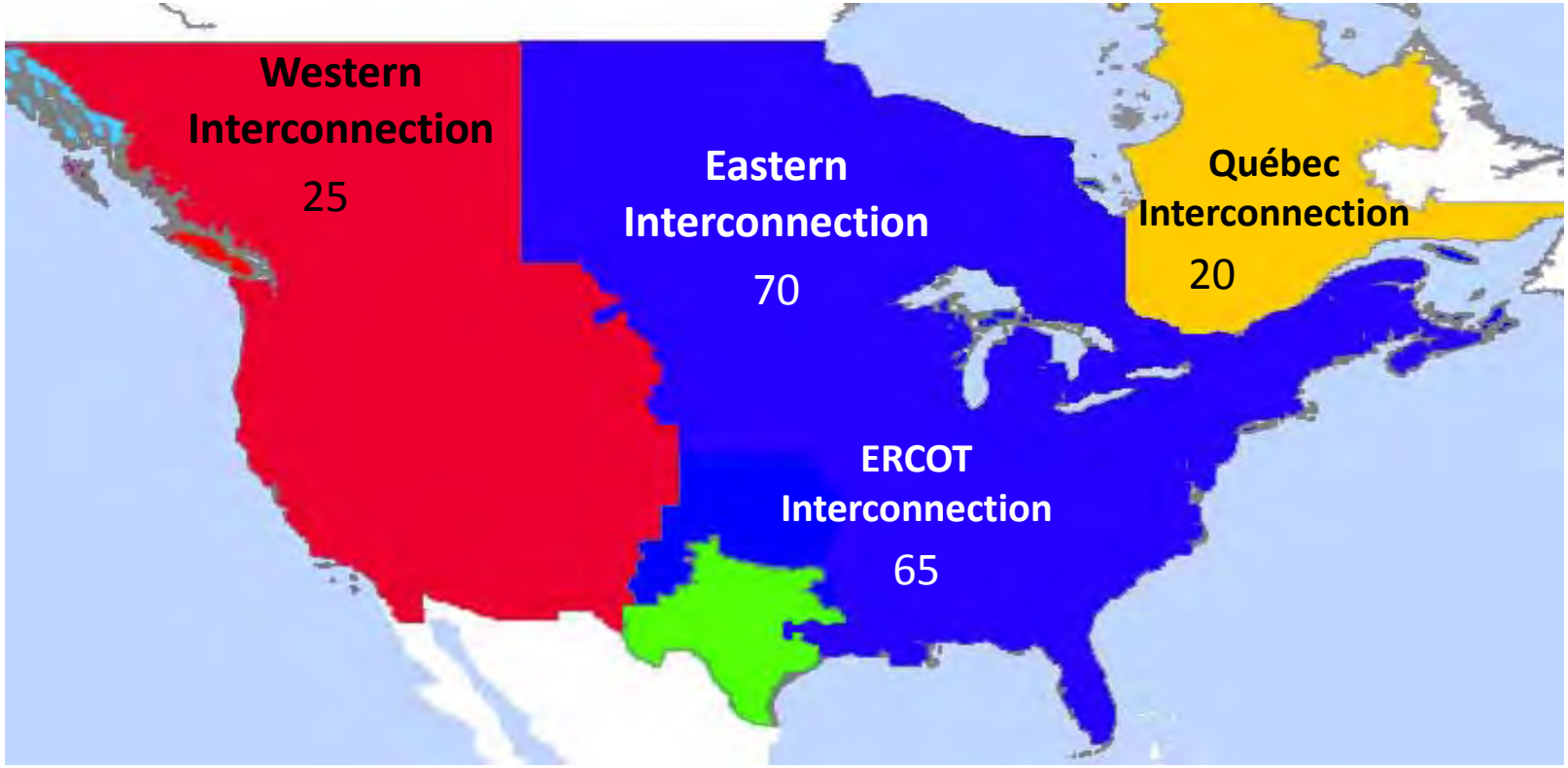
2010 Frequency Response Events Captured



Frequency Response (FR) Stable

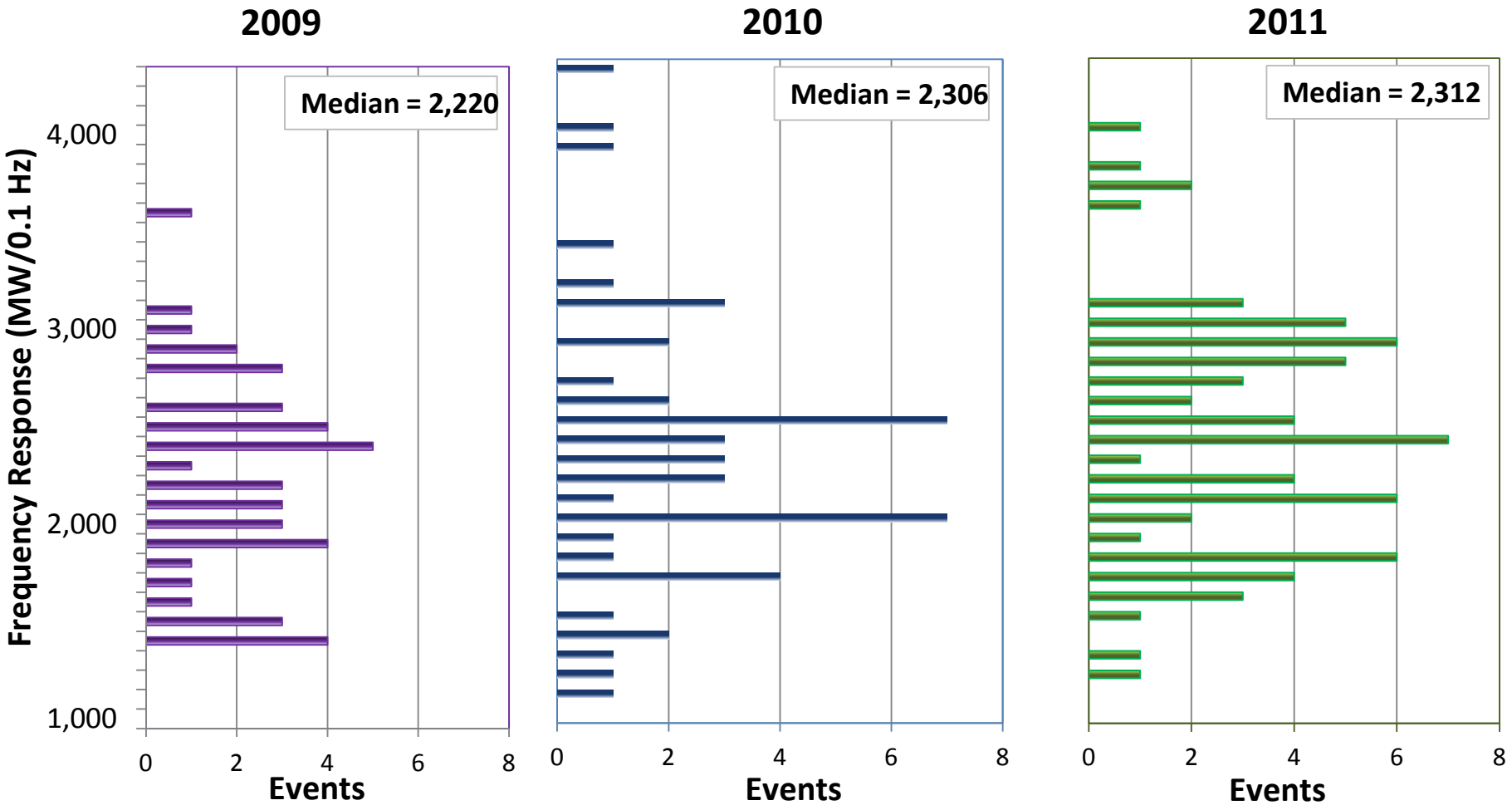
- Consistent data collection/procedures implemented in 2011
- Further analysis for EI FR events with less than 1,500 MW/0.1Hz

2011 Frequency Response Events Captured



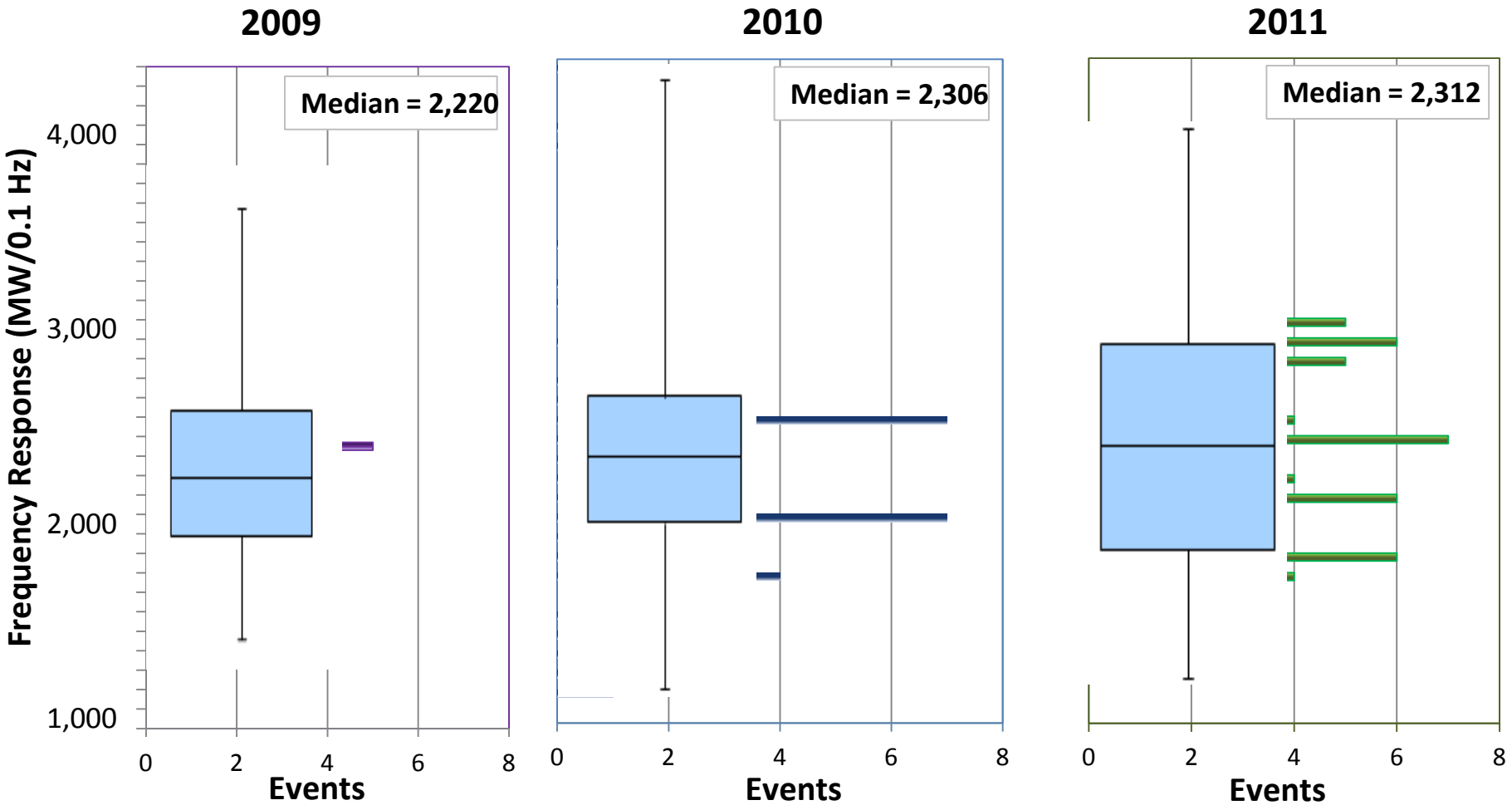
Frequency Response (FR) Stable

Eastern Interconnection Frequency Response by Year



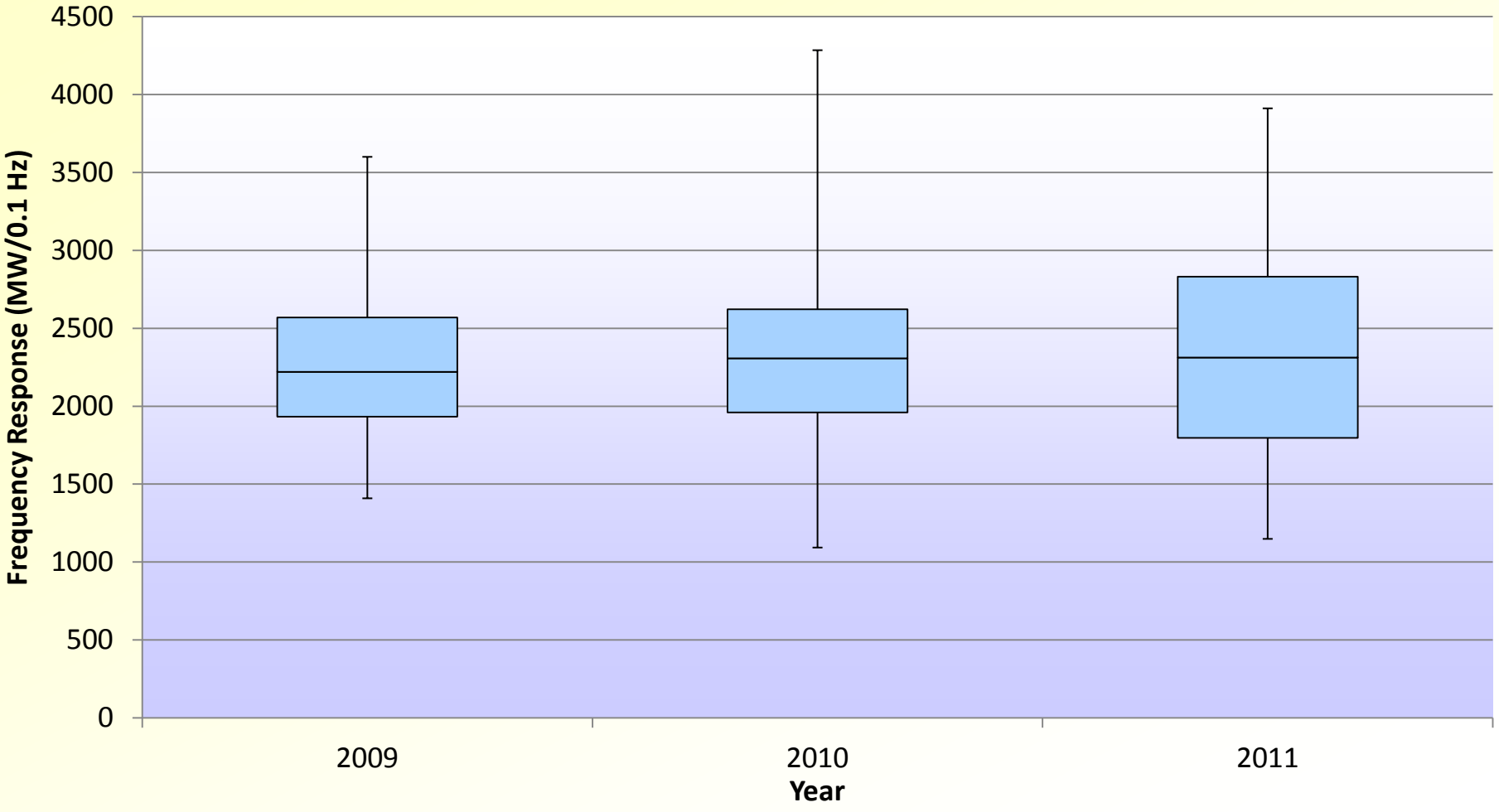
Frequency Response (FR) Stable

Eastern Interconnection Frequency Response by Year



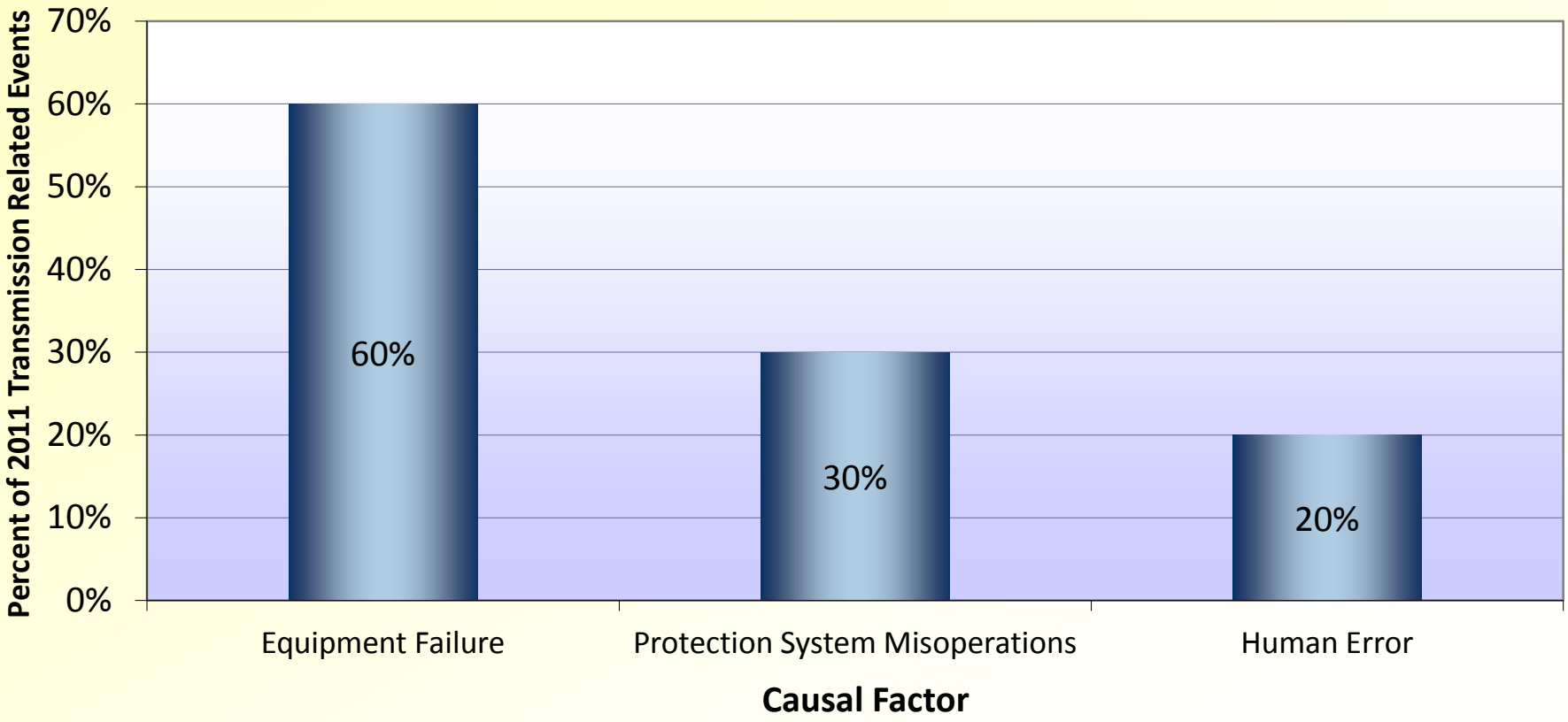
Frequency Response (FR) Stable

Eastern Interconnection Frequency Response by Year



Protection System Misoperations a Reliability Issue

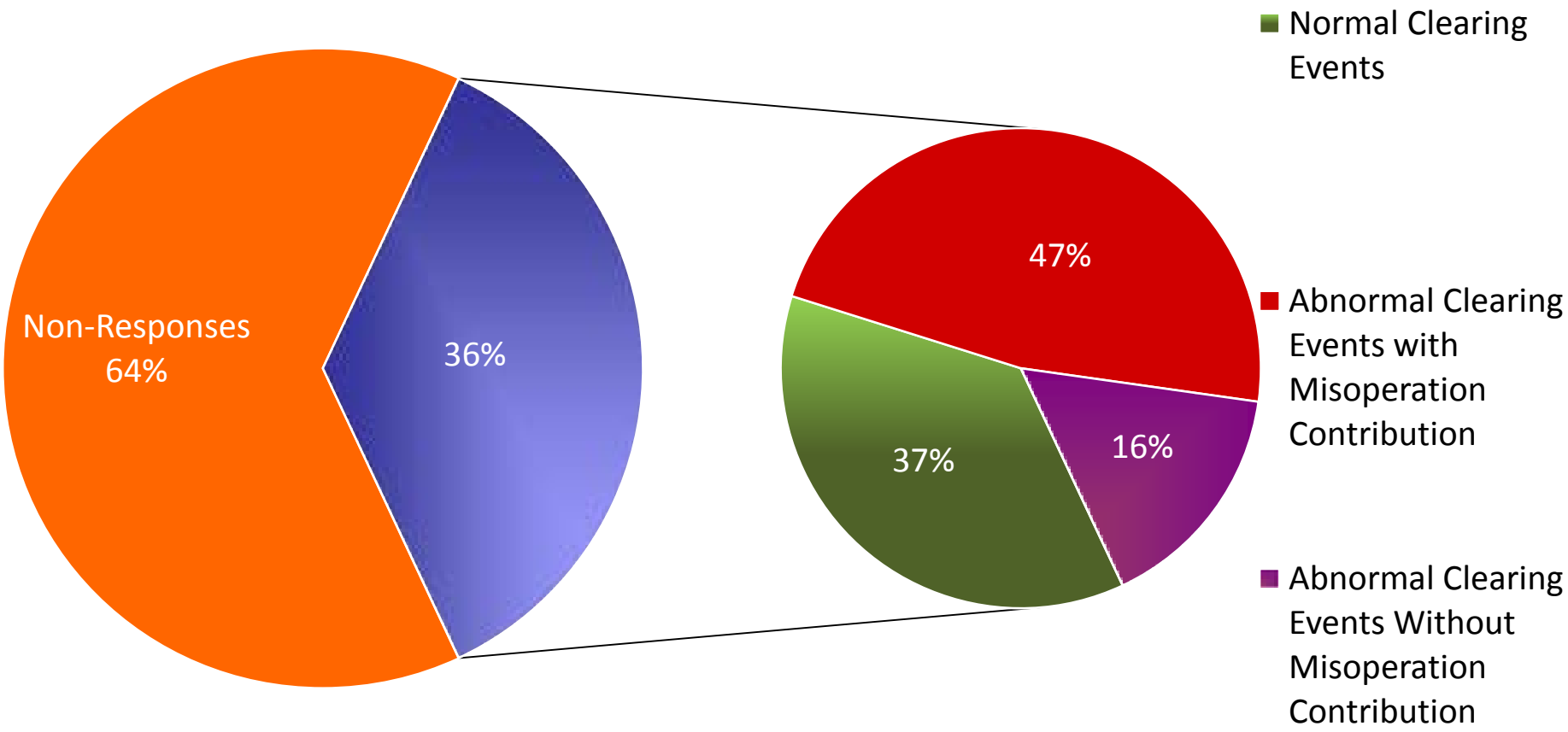
Percentage of 2011 Transmission Related Events by Causal Factor*



* The September 8, 2011 event analysis was underway during preparation of the report and is not included. Events may have multiple causal factors.

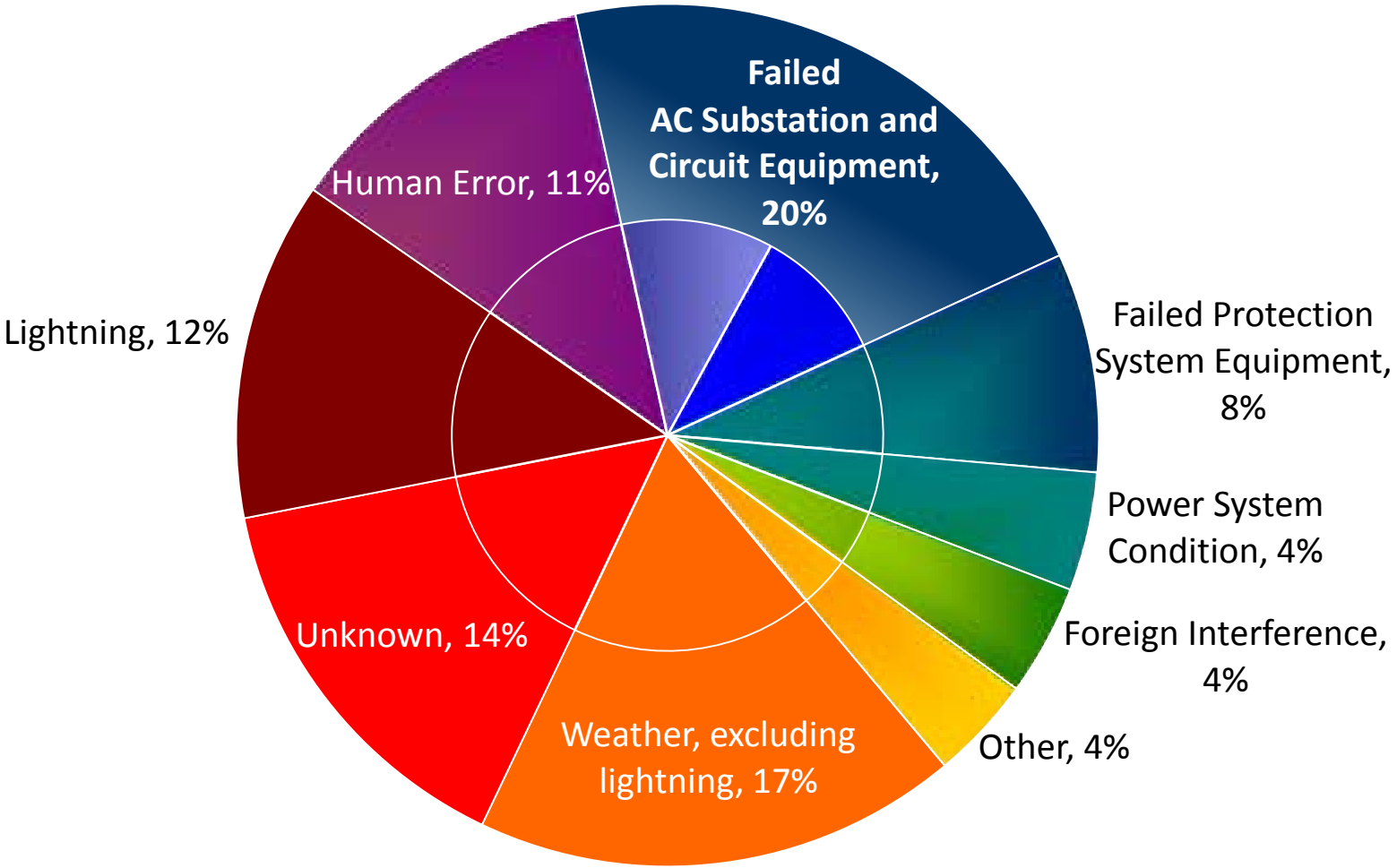
Protection System Misoperations a Reliability Issue

Survey Summary – TADS Events with Greater Than Three Outages



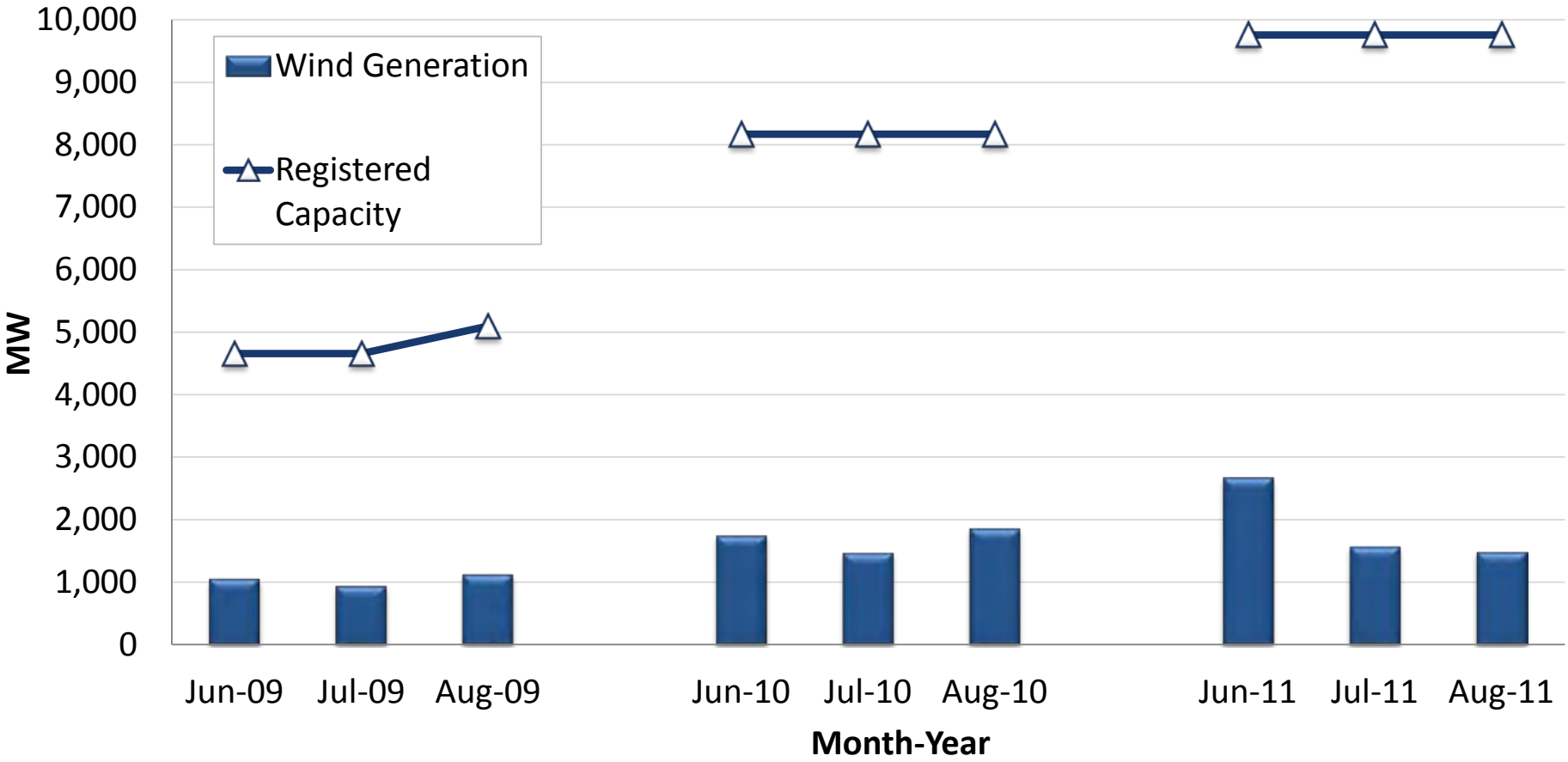
Equipment Failure Warrants Analysis

AC Circuit Sustained Automatic Outages by Initiating Cause Code



Resource Mix Changes Necessitate Metrics

MISO Average Wind Generation and Registered Wind Capacity (2009-2011 Summer)



More Data and Research Needed

- Datasets and analysis need to mature
- Identify data and metric limits — enhancements
- Data enhancement may be required

Future Advancements

- Model for risk cluster and statistical analysis
  - Link reliability to initiating events measuring reliability impact
- Model would characterize and monitor reliability, and develop cause-effect relationships
- Include integrated indices in future reports
- Include cyber and physical security metrics



Questions and Answers

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Risk-Based Reliability

Scott Halleran, Manager of Reliability Risk Controls
Board of Trustees Meeting
May 9, 2012

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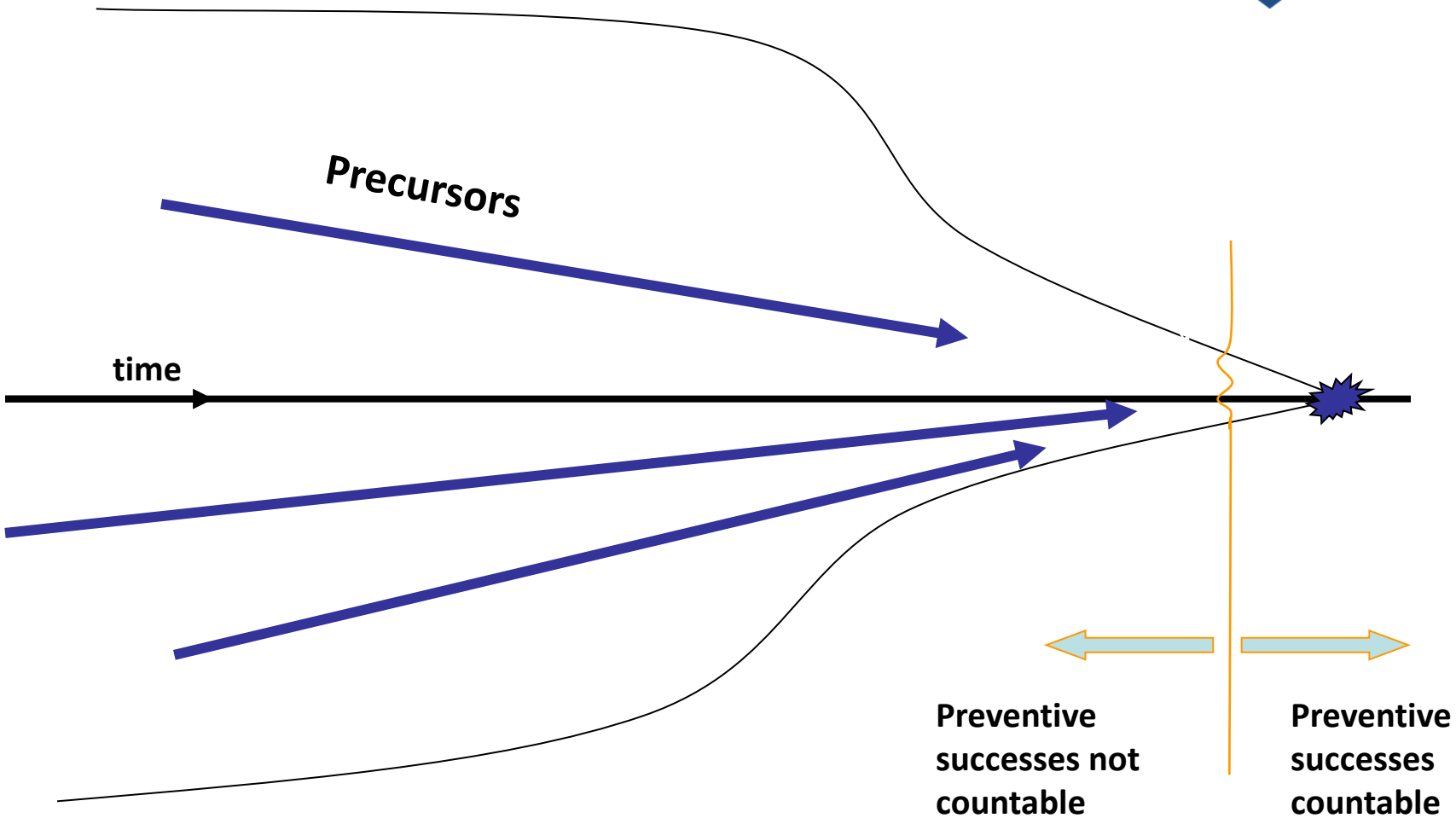

ERO Vision: Risk Control

- Framework to identify, document, and prioritize key risks to reliability
  - Develop solutions that address key risks
  - Close collaboration with industry:
    - Coherent approach to address problem solving
    - Organize and manage technical teams
- Refine existing risk-based approaches

Risk Control is a Process

- Nomination process
- Problem definition
- Determine impact measurement
- Develop solution(s) and plans
  - Deploy plan(s)
  - Monitor and measure
- Close project, long-term monitoring

Chronology of Failure Events

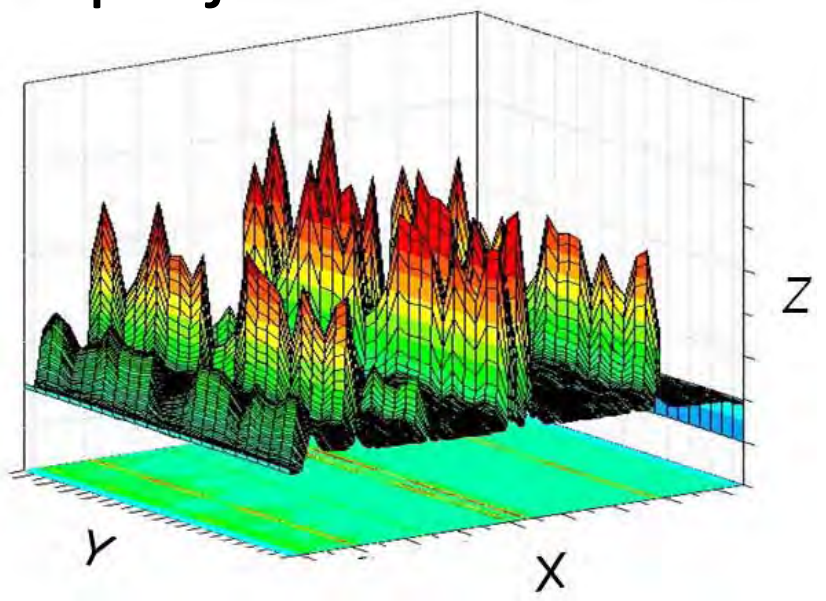


Malcolm K. Sparrow (adapted)

John F. Kennedy School of Government, Harvard University

Next Steps for Risk Control

- Communicate the nomination process
- Identify and define key risks
- Establish an ERO-wide risk portfolio
- Initiate multiple risk control projects





Questions and Answers

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Special Report: Severe Impact Resilience: Considerations and Recommendations

Tom Bowe, PJM
Chair - Severe Impact Resilience Task Force (SIRTF)
Board of Trustees Meeting
May 9, 2012

RELIABILITY | ACCOUNTABILITY





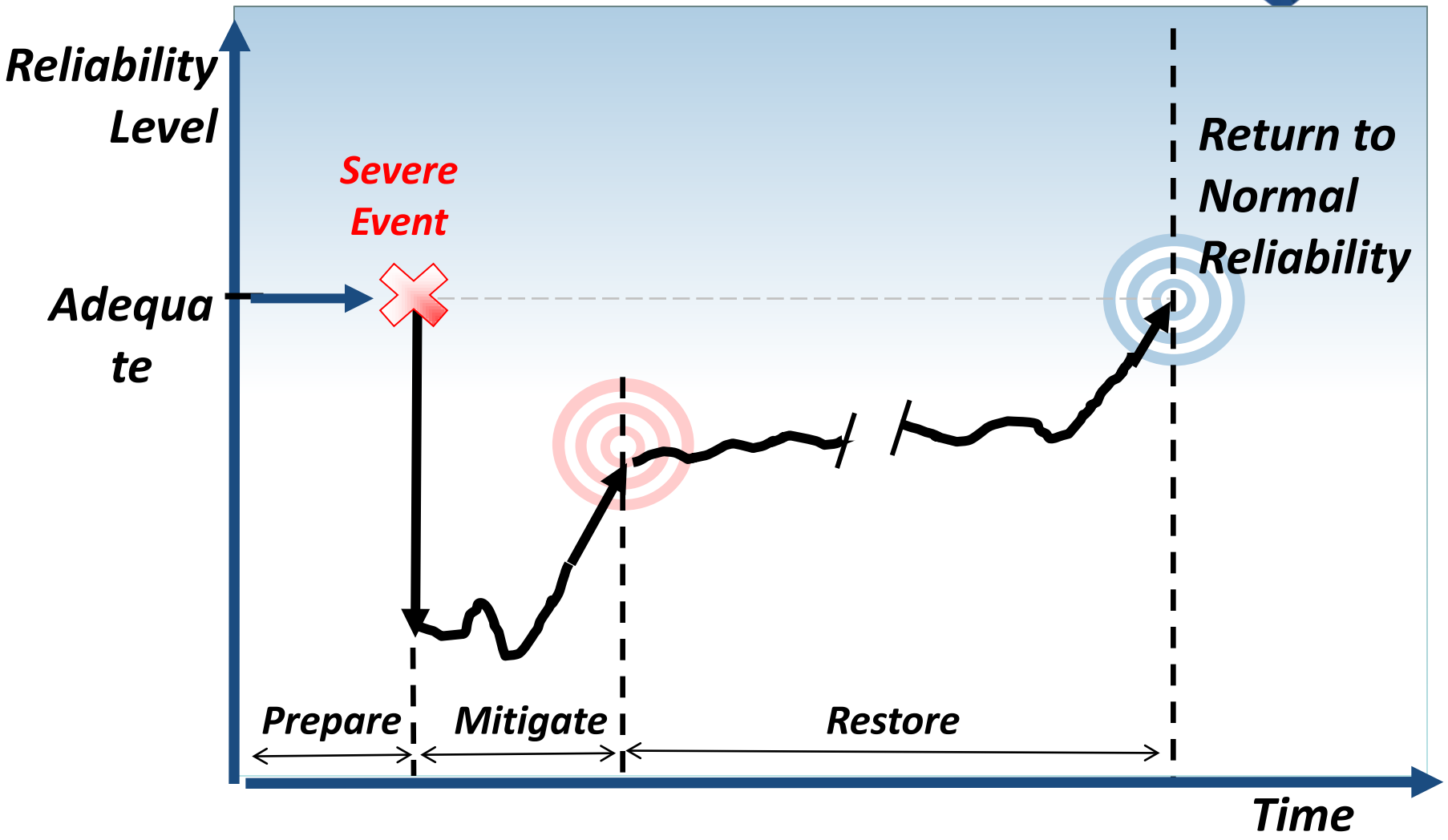

Purpose

- Highlight major conclusions of the Severe Impact Resilience Task Force report
- Overview possible Operating and Planning Committees' follow-on initiatives
- Accept the report and endorse recommendations

Resilience Definition



Operating in the New Normal



SIRTF Report's Conclusion

Entities…

- Develop **approaches and flexible plans** for a wide variety of circumstances
- **Consider what else is required** to manage restoration and operations during a severe event

SIRTF - Conclusion - Compliance

Entities…

- **Do not need guidance** on the applicability of standards during a severe event
- **"Do the right thing"** for reliability and public safety, and self-report

Operating Committee's Future Work?

- **Key Recommendation #1 |** Operations
  - Degraded communications - **which entities take independent actions to stabilize islands**

- **Key Recommendation #3 |** Operations
  - Consider - **"critical load"** and **"priority load" term adoption**

OC's Future Work?

- **Rules of thumb** for "block of load" that can be safely added to an island
- **Variable generation** policies during islanded operation
- Enhance Appendix 3 worksheet and 4 checklist
- **RESILIENCE DRILLS or Seminars**

PC's Future Work?

- **Key Recommendation #16**| System Planning – Guidelines for . . .
  - Selected studies (e.g., equipment interchangeability) that speeds restoration
  - Severe events – Island identification and sources of generation

Request for Approval

Severe Impact Resilience:

Accept the report and endorse the recommendations



Questions and Answers

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Special Report: Cyber Attack Task Force

Mark Engels, Dominion
Chair – Cyber Attack Task Force
Board of Trustees Meeting
May 9, 2012

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Coordinated Cyber Attack

Scenario

- A coordinated cyber attack disables or impairs multiple control systems, intruders take operating control, and key elements of the bulk power system are damaged or operated improperly

Attack Tree Methodology

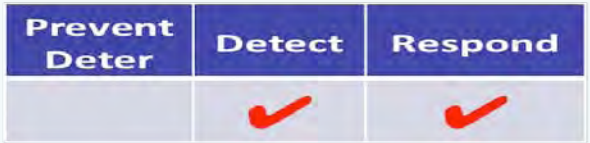
- Assumes cyber attack causes bulk power system instability **AND** disrupts situation awareness

Provides Industry Guidance

- Sources for alerts and warnings
- Early indicators and unusual events
- Cyber attack scenarios (operator training)
- Response actions to a cyber attack
- Isolation and survivability tactics

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Enhancing Resilience

Recommendation	Resilience Contribution
Continue work on “Attack Trees”	
Continue to develop security and operations staff skills to address increasingly sophisticated cyber threats	
Augment operator training with cyber attack scenarios	
Conservative operations	
Conduct transmission planning exercise	

Enhancing Resilience

Recommendation	Resilience Contribution
Endorse NERC initiatives that help entities prepare/respond to a cyber attack	
Increase awareness of Department of Energy initiatives	
Continue to extend public / private partnership	

Acceptance and Endorsement

Cyber Attack:

Accept the report and endorse the recommendations

Support further study to address report recommendations

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ES-ISAC Electricity Sector Information Sharing and Analysis Center

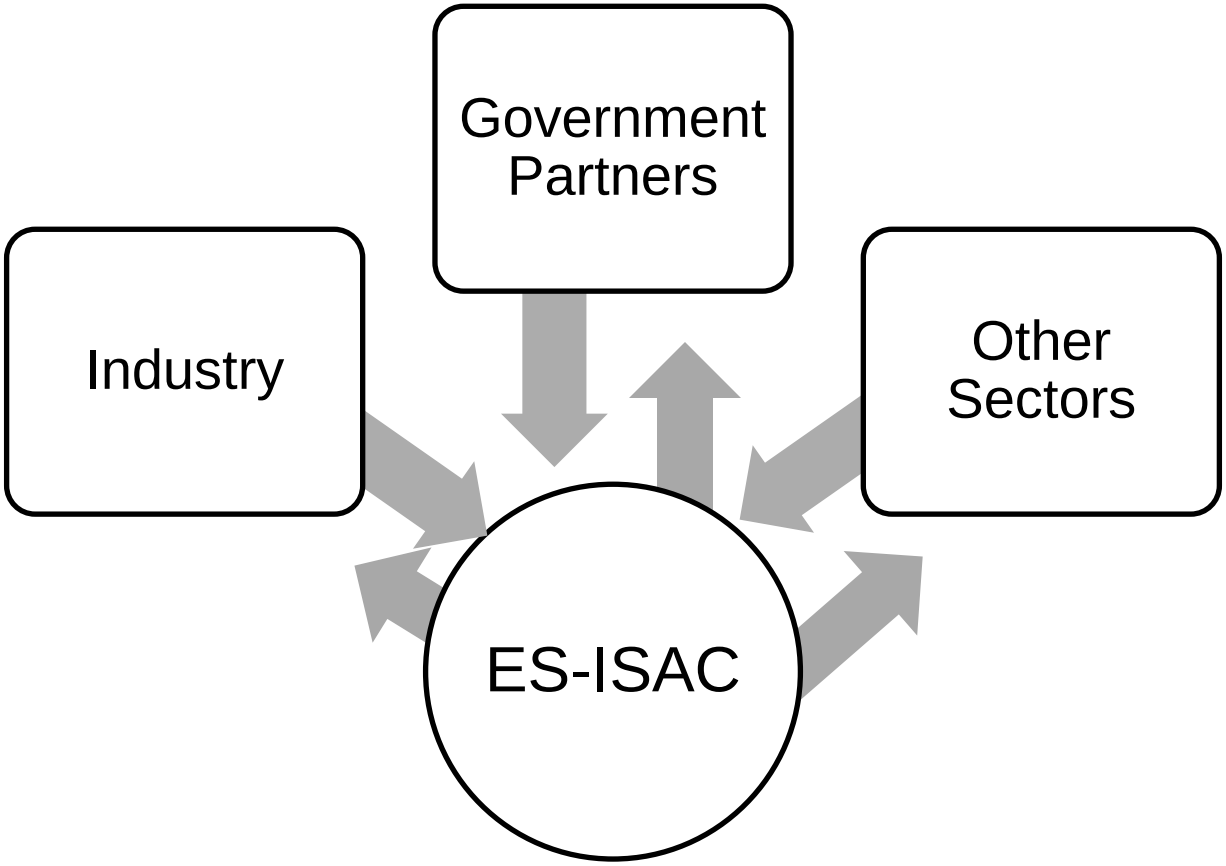
Tim Roxey, Chief Cybersecurity Officer
Board of Trustees Meeting
May 9, 2012

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ES-ISAC



ES-ISAC is the lead information sharing and analysis nexus for the sector.

Needs for Improvement

- Promote the ES-ISAC communications protocol
- Building trust to enable sharing and collaboration
- Improve analytic tools and skills
- Improve understanding of the changing “In Use” technology of the Grid

Enabling Tools in 2012:

- ✓ ES-ISAC Policy Statement was approved by BOT in February
- ✓ Continued the monthly briefing calls and webinars

- Continue to develop secure members-only portal
- Establish presence on DHS-operated National Cybersecurity and Communications Integration Center (NCCIC) watch floor
- ES-ISAC Operations Center and software tools

These tools will improve the vertical communications piece that was regarded as needed during GridEx 2011

ES-ISAC Portal Milestones

- Beginning in late April:
  - Move from pilot to full production - aggressive membership campaign
  - Initial site focused on information sharing functionality
- Summer 2012:
  - Support existing teams (Hydra, working groups, and task forces)
  - Further refinement of features
- Q4 2012:
  - Enhanced activity reporting tools
  - Integration with third party platforms

The project goal is to achieve portal membership for more than 50% of the registered entities by the end of year

Information Analysis

- New data feeds — proactive discovery of malware activity
- ES-ISAC workbench — intrusion-set analysis to link one entity reported activity with previous reports
- Saturation survey — understand what is deployed in the field for more informed risk assessments

Landing Page

Zones



IndEx

Indicators Exchange



AOO

Asset Owners and Operators



What are Zones?

Pages



Notification Center



Account Management Center

Users are presented with these options upon login to the site

Notification Center

Notification Center

AOO - Asset Owners and Operators

AOO Security Blog	No Alert	Immediate email	Daily Summary	Weekly Summary	Subscribe to RSS Feed
AOO Document Library	No Alert	Immediate email	Daily Summary	Weekly Summary	Subscribe to RSS Feed

IndEx - Indicators Exchange

IndEx Trend Reports Library	No Alert	Immediate email	Daily Summary	Weekly Summary	Subscribe to RSS Feed
IndEx ES-ISAC Watch List Blog	No Alert	Immediate email	Daily Summary	Weekly Summary	Subscribe to RSS Feed

Users can customize email alerts to get new information "pushed" to them

AOO Newsfeed

Ruggedcom backdoor public disclosure
4 views | 3 comments

A previously undocumented backdoor was publicly disclosed today on the bugtraq mailing list. This backdoor requires the ruggedcom device MAC (media access control) address in order to generate the backdoor 'factory' account password. RuggedCom supplies both serial and ethernet equipment for use in industrial environments....

by **Ben Miller**
in **ICS, Public Disclosure**
at 4/24/2012 12:03 PM

Gas Pipeline sector intrusions
2 views | 0 comments

The ES-ISAC has become aware of a FOUO ICS-CERT Alert regarding multiple computer intrusions in the pipeline sector. "ICS-CERT has recently identified an active series of cyber intrusions targeting natural gas pipeline sector companies. Currently, multiple natural gas pipeline sector organizations have reported either attempts or int...

by **Ben Miller**
in **Alert**
at 3/29/2012 4:49 AM

Microsoft Windows RDP vulnerability
1 views | 1 comments

by **Ben Miller**
in **Alert**

Security Newsfeed for rapid communication

Indicators Exchange Watchlist



Poison Ivy associated IP Addresses
3 views | 0 comments

On March 26, 2012, in the course of its daily monitoring and analysis, US-CERT observed Poison Ivy Remote Administration Tool (RAT) activity and data exfiltration with known malicious IP addresses 114[.]80[.]96[.]8, 60[.]10[.]1[.]121, 60[.]2[.]92[.]69, and 60[.]2[.]92[.]67 over port 443/TCP.US-CERT also observed DNS queries for the following do...

by **Ben Miller**
in **Restricted**
at 4/26/2012
1:26 PM

Defense Industrial Base Phishing Report
0 views | 0 comments

On March 1, 2012, a DIB Organization reported that multiple employees received the same spear phishing e-mail with a hyperlink to a malicious file:
Originating E-mail Address:
jokimdavis[@]afgimail[.]comE-mail Subject Line:
Rear_Admiral_Michael_McDevittHyperlink to Malicious File: hxxps://hotfile[.]com/dV149945781/3819a9d /Rear_Admiral_Micha...

by **Ben Miller**
in **Restricted**
at 4/26/2012
1:09 PM

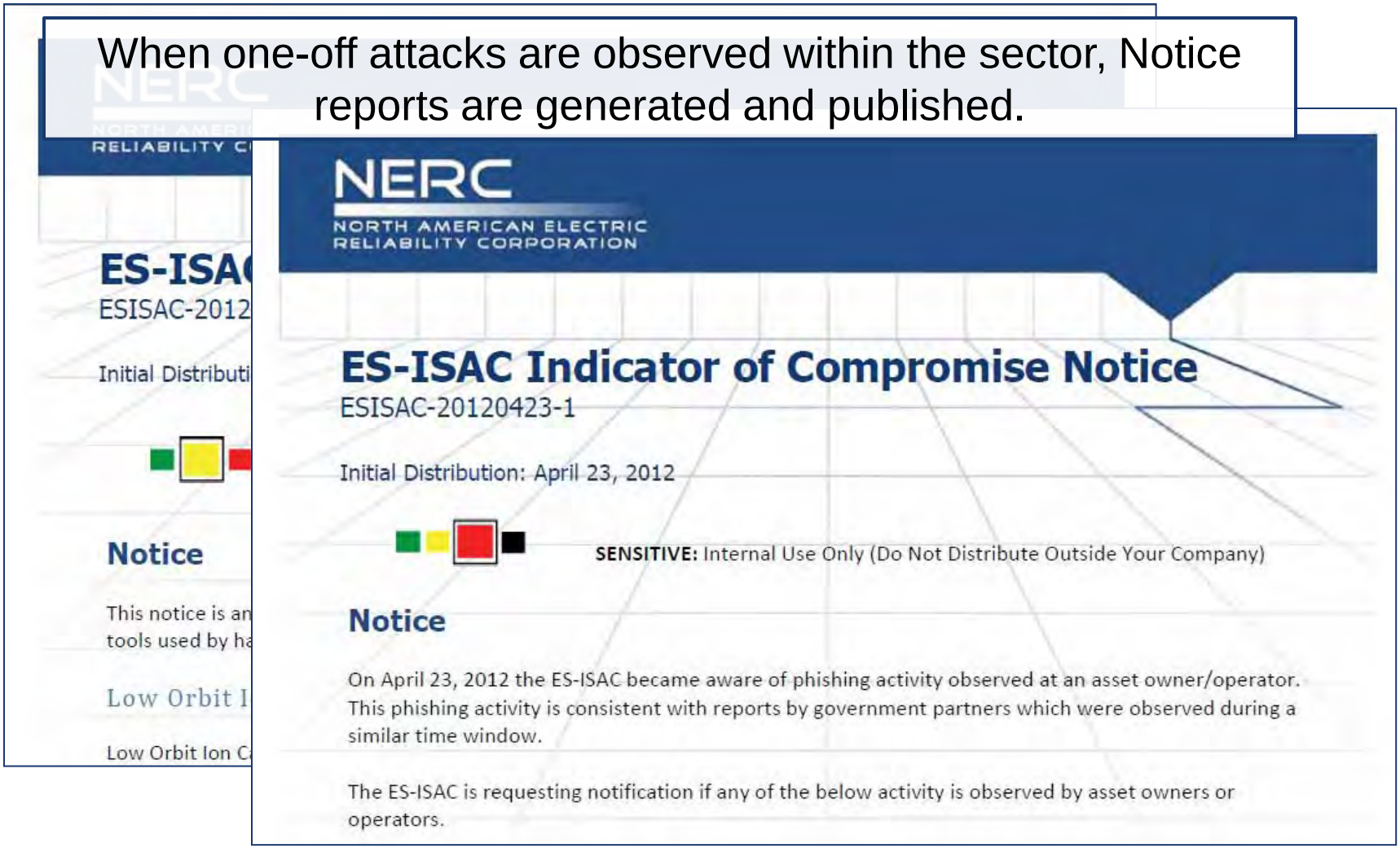
LinkedIn themed phishing attack
4 views | 0 comments

by **Ben Miller**
in **Private**

Indicators Exchange Watchlist is continually populated from attacks observed by government and other sectors

Indicator Reports

When one-off attacks are observed within the sector, Notice reports are generated and published.



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ES-ISAC Indicator of Compromise Notice

ESISAC-20120423-1

Initial Distribution: April 23, 2012

SENSITIVE: Internal Use Only (Do Not Distribute Outside Your Company)

Notice

On April 23, 2012 the ES-ISAC became aware of phishing activity observed at an asset owner/operator. This phishing activity is consistent with reports by government partners which were observed during a similar time window.

The ES-ISAC is requesting notification if any of the below activity is observed by asset owners or operators.



Questions and Answers

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External Affairs Update

Janet Sena
Vice President and Director, Policy and External Affairs

May 9, 2012

RELIABILITY | ACCOUNTABILITY






2012 External Affairs Update

- ERO Activity Support
  - Reliability Risk Management
  - Find, Fix, Track and Report (FFT)
  - Reliability Assessment and Performance Analysis
    - EPA Cumulative Regulations Report
    - EPA RE Meetings
    - FERC Whitepaper Response
- *2012 Special Reliability Assessment: Effects of Geomagnetic Disturbances on the Bulk Power System* (GMD) Report
- Administration Activities
  - Electricity Sub-Sector Coordinating Council (ESCC)
  - Department of Homeland Security (DHS) Cybersecurity Briefing

2012 Congressional Activities

- Cybersecurity Legislation
  - House Cyber Week
  - DHS Bills
  - Mandatory versus Voluntary Standards
- Nominations

Communications

- Media Inquiries
  - Solar Storm Coverage
  - GMD Coverage
  - Southwest Outage
  - Cyber
  - EPA
- ERO Support
  - Report Rollouts
  - Regional Communicators Group

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Follow-On Actions from the Coordinated Action Plan Task Forces

Stuart Brindley
NERC Consultant
Board of Trustees Meeting
May 9, 2012

RELIABILITY | ACCOUNTABILITY






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Task Force Milestones

Task Force or Initiative	Report to be Approved by	Request Comments on Draft	Receive Comments on Draft	ESCC Review	Technical Committees Approve Final	MRC and Board of Trustees Review
Geomagnetic Disturbance	OC and PC	Dec 2, 2011	Jan 6, 2012	Mid-Feb 2012	Feb 1, 2012	Feb 22, 2012
Spare Equipment Database	PC (with OC and CIPC endorsement)	Jun 1, 2011	Jun 29, 2011	Oct 3, 2011	Sep 14, 2011	Nov 3, 2011
Cyber Attack	CIPC (with OC endorsement)	Oct 15, 2011	Feb 8, 2012	Mar 5, 2012	Mar 8, 2012	May 9, 2012
Severe Impact Resilience	OC (with PC endorsement)	Dec 13-15, 2011	Jan 4, 2012	Mar 5, 2012	Mar 7, 2012	May 9, 2012
NERC Crisis Plan	NERC CEO	-	-	Aug 16, 2011	Not Required	Not Required

Shading Indicates Complete

Steps to Address Recommendations



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Announcement

Board Adopts 5 Standards; Highlights Strategic Milestones Accomplished by the ERO

May 11, 2012

ARLINGTON, VA -- The North American Electric Reliability Corporation's (NERC) quarterly Board of Trustees meeting took place on May 9 in Arlington, Va. Board Chair John Q. Anderson opened the meeting, welcoming FERC Commissioners John Norris and Cheryl LaFleur, and U.S. and Canadian industry participants.

NERC President and Chief Executive Officer Gerry Cauley commended the cooperation and collaboration between NERC and the Federal Energy Regulatory Commission (FERC) on the September 2011 Southwest outage inquiry report. The thoroughness and detail of the report lay important groundwork for how the industry can better ensure the reliability of the bulk power system.

"The joint outage report allows us to look at events from a broader perspective and see commonalities across the system, not just in one interconnection," Cauley said. "We need to look at underlying issues *before* events happen to make sure we have adequate programs in place. This introspection can be accomplished through a risk-based approach of testing and evaluating."

Cauley also highlighted three strategic milestones achieved to date in 2012 by the electric reliability organization (ERO):

- **Standards Process Input Group.** The high-level Member Representatives Committee working group was formed to provide policy input and recommendations on key issues in the standards area, including quality of process and product, timeliness, efficiency and effectiveness, and significance of American National Standards Institute requirements.
- **State of Reliability report.** This report follows the 2011 foundational report that reviews and assesses the state of reliability based on trends identified through data combined with root cause analysis of events. The key findings

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Atlanta, GA 30326
404-446-2560 | www.nerc.com

serve as technical input to NERC's Reliability Standards and project prioritization, compliance process improvements, event analysis, reliability assessment and critical infrastructure protection.

- **Severe Impact Resilience and Cyber Attack Task Force reports.** These two reports are the final of four task force reports that address high-impact, low-frequency events. The reports provide guidance to industry on enhancing and protecting the resilience of the bulk power system against debilitating grid events. Previous task force reports addressed geomagnetic disturbances and spare equipment.

During this meeting, the board adopted five reliability standards: FAC-003-3 – Transmission Vegetation Management Program; PRC-005-1.1b – Transmission and Generation Protection System Maintenance and Testing; TOP-001-2 – Transmission Operations; TOP-002-3 – Operations Planning; and TOP—003-2 – Operational Reliability Data Real-Time Operations. One interpretation, 2010-05 of CIP-002-1 for Duke Energy, also was adopted.

FERC Commissioners Cheryl LaFleur, John Norris and Philip Moeller attended the Member Representatives Committee meeting on May 8. The next NERC Board of Trustees meeting is scheduled for August 16 in Quebec City, Canada.

###

The North American Electric Reliability Corporation's mission is to ensure the reliability of the North American bulk power system. NERC is the electric reliability organization (ERO) certified by the Federal Energy Regulatory Commission in the United States to establish and enforce reliability standards for the bulk-power system. NERC has equivalent relationships with provincial and federal authorities in Canada. NERC develops and enforces reliability standards; assesses adequacy annually via a 10-year forecast, and summer and winter forecasts; monitors the bulk power system; and educates, trains and certifies industry personnel. Learn more at www.nerc.com

NERC Board of Trustees Compliance Committee Open Session
Notes de Sylvain

May 8, 2012 | 10:45 a.m.-Noon Eastern
Westin Arlington Gateway

2. Compliance Enforcement Initiative (CEI)*
a. FERC Order — Review

- *Approved all six Find, Fix, and Track (FFT) filings from September 2011 to February 2012*
- *Six-month and one year status reports due to FERC*
  - *Six-month report due May 14, 2012*
  - *One year report due in March 2013*
  - *Compliance filing due May 14, 2012*
- *FFT Program Modifications and Guidance*
  - *Minimal risk possible violations are eligible*
  - *Registered entities must have an officer certify that an issue has been mitigated*
  - *FFT informational filings publicly identify the registered entity with a Possible Violation*
  - *Finality — violations final 60 days after submittal to FERC if no further review*
  - *Not a minimal risk simply because there was no adverse impact*
  - *Must be based on facts, rather than assumptions*
  - *Not minimal risk if a serious shortcoming in reliability —related processes*
  - *Must be based on facts at the time of the Possible Violation*
  - *Should address actions that made actual risk of a Possible Violation less than potential risk*

b. Find, Fix, Track (FFT) Statistics to Date — Information

- *Could we get quantitative measures?*
- *Why so much differences between regions? MRO has most FFT, WECC barely has any, etc.*
- *Training of auditors is the key.*
- *Everyone is pleased with the progress and wants to see more consistency between the regions.*

c. Ongoing Implementation of CEI — Information

3. Compliance Operations*
a. Risk-Based Compliance Monitoring and Entity Assessments — Information

- *What Would Success Look Like?*

    - *Emphasis on reliability and less on compliance bureaucracy*
    - *Compliance programs that are forward-looking*
    - *Entity assessments that justify scope of monitoring*
    - *Greater consideration of internal controls*
    - *Industry finds, fixes, tracks, and reports (FFT mechanism)*
    - *Focus resources on high risk reliability issues*
- *Wouldn't the large entities become more audited simply because they have more equipment?*
- *Confusion of mechanism to provide guidance both at the regional and NERC level (CAR, CAN, RSAWs, VSL, etc.)*
- *Gerry responds that we should get the RSAWs right and he'd be happy to retire CANs and other documents.*

Sylvain Clermont
8 mai 2012

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NERC's Compliance Enforcement Initiative
Find, Fix, Track and Report Update

Ken Lotterhos, Associate General Counsel and Director of Enforcement
Compliance Committee Meeting – Open Session
May 8, 2012

RELIABILITY | ACCOUNTABILITY






Agenda

- Compliance Enforcement Initiative (CEI) Order
- Data and trends
- Implementation

March 15 CEI Order

- Approved all six Find, Fix, and Track (FFT) filings from September 2011 to February 2012
- Six-month and one year status reports due to FERC
  - Six-month report due May 14, 2012
  - One year report due in March 2013
- Compliance filing due May 14, 2012

FFT Program Modifications

- Minimal risk possible violations are eligible
- Registered entities must have an officer certify that an issue has been mitigated
- FFT informational filings publicly identify the registered entity with a Possible Violation
- Finality — violations final 60 days after submittal to FERC if no further review

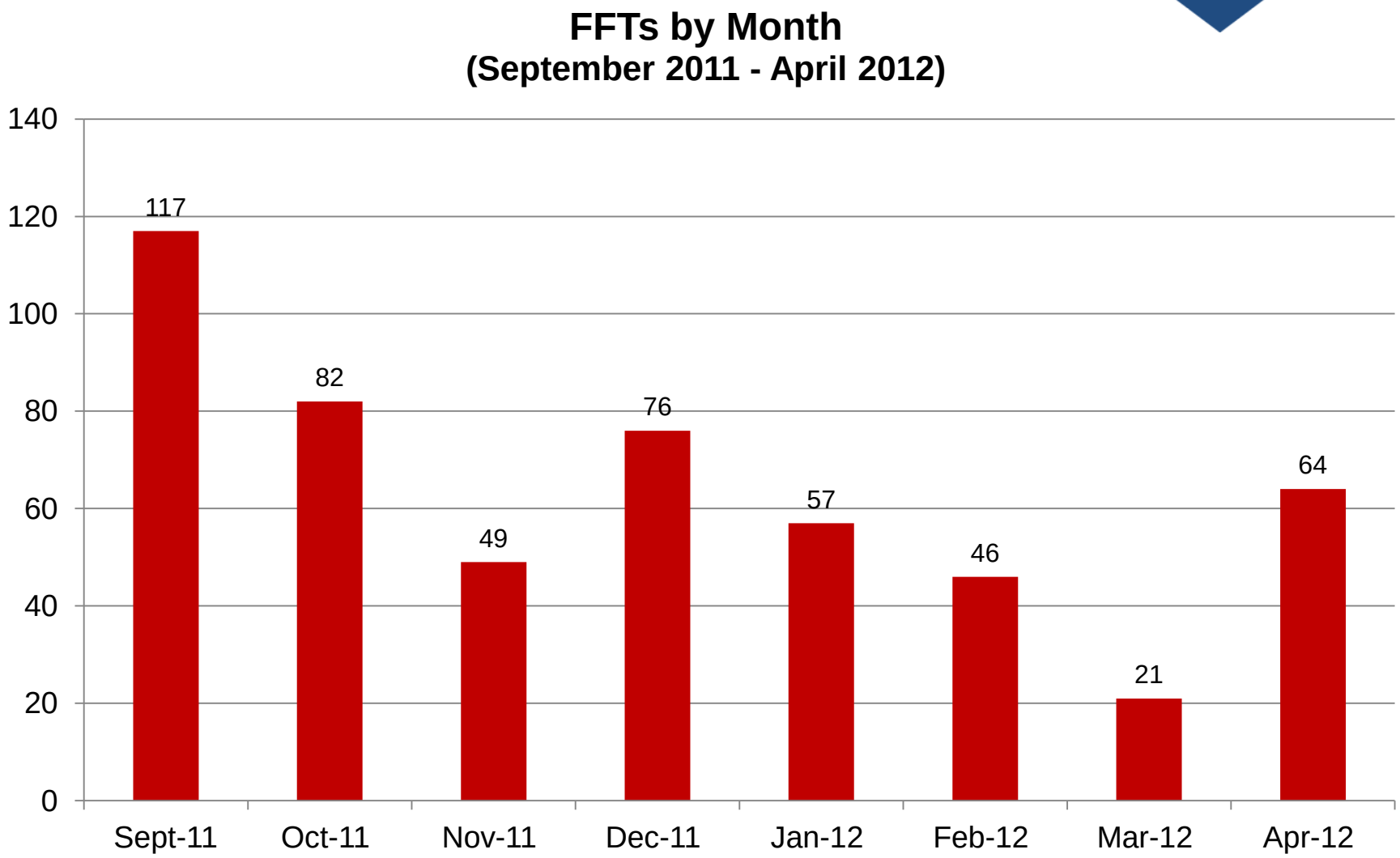
Guidance on Risk Assessment

- Not a minimal risk simply because there was no adverse impact
- Must be based on facts, rather than assumptions
- Not minimal risk if a serious shortcoming in reliability —related processes
- Must be based on facts at the time of the Possible Violation
- Should address actions that made actual risk of a Possible Violation less than potential risk

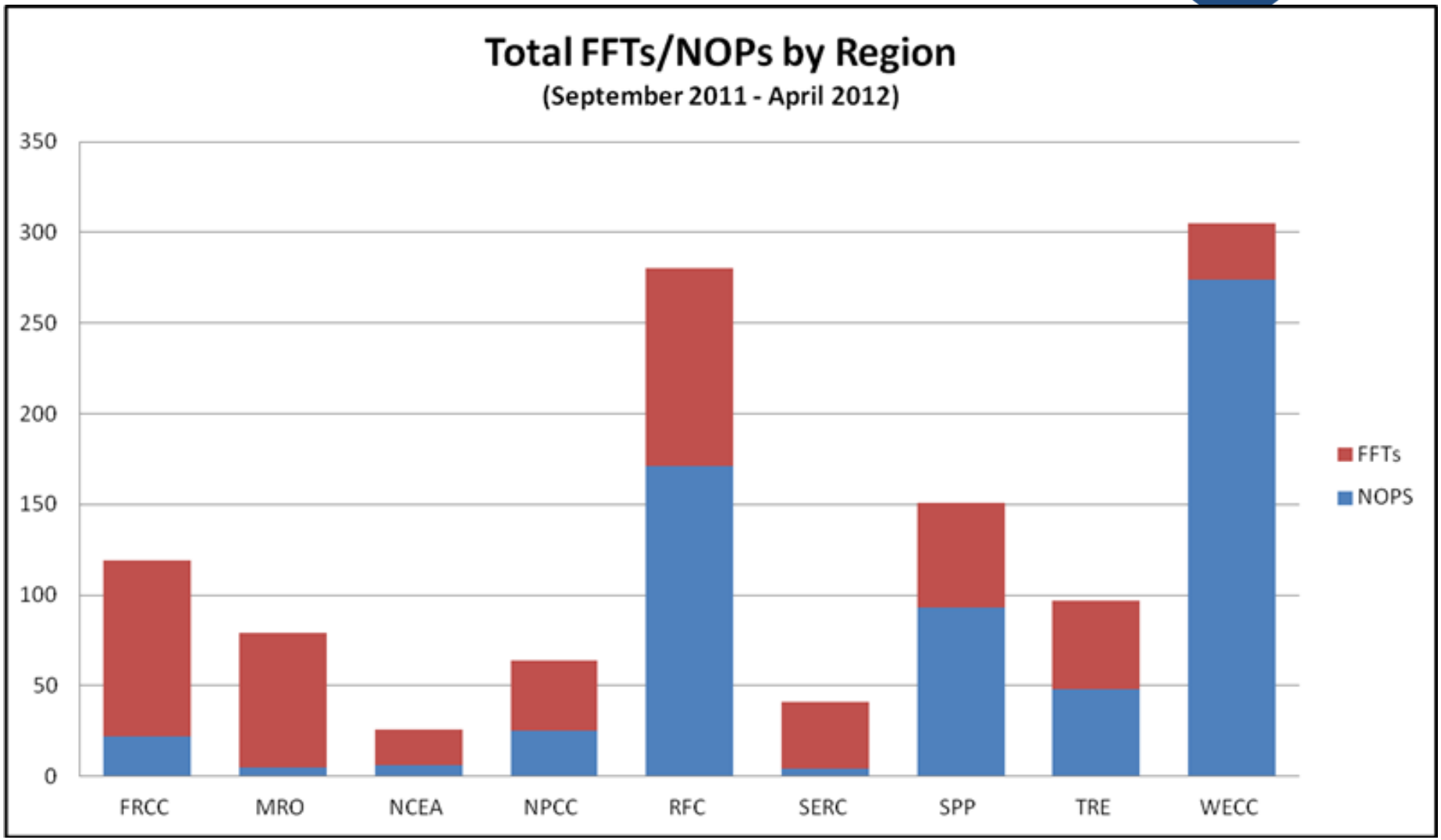
Additional Guidance

- Importance of self-reports
- Annual FFT survey by FERC
- Mechanisms to identify and revise or remove unnecessary or redundant requirements

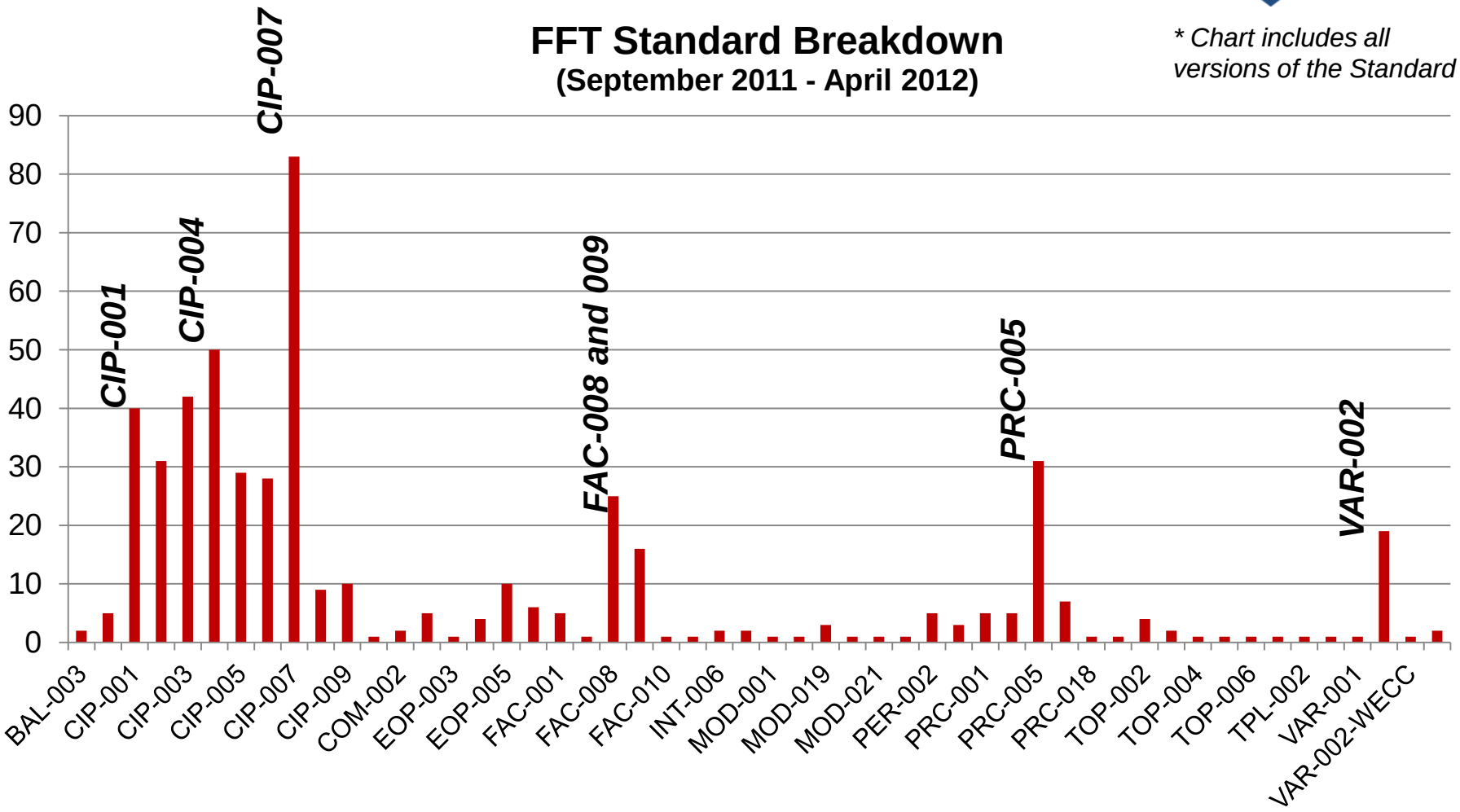
Data and Trends



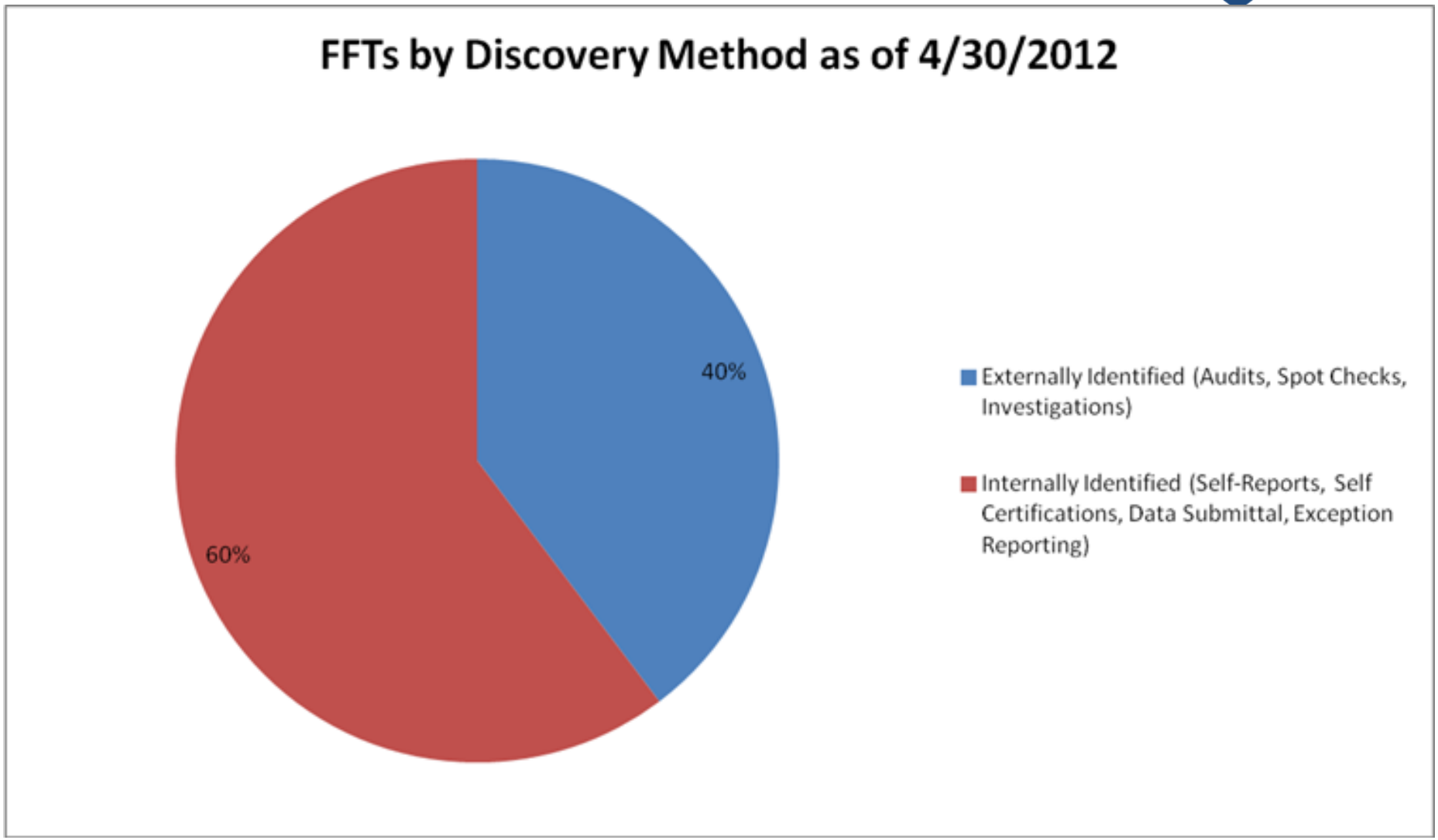
Data and Trends



Data and Trends



Data and Trends



Implementation

- CEA compliance monitoring staff will make recommendations in 2013
- Guidance for self-reports to provide FFT information by registered entities
- Ongoing training for CEA compliance staff and CEA enforcement staff
- Continued industry education and outreach

Implementation Schedule

- Second Quarter 2012
  - Develop specific training materials
- Third Quarter 2012
  - Online webinar courses for CEA staff
  - September - CEA Staff workshop/training course
- Fourth Quarter 2012
  - Online webinar courses for CEA staff
  - All CEA compliance monitoring staff complete required training course and qualification
- First Quarter 2013
  - Implement CEA compliance monitoring staff role



Questions and Answers

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Risk-Based Compliance Monitoring: A Focus on Reliability

Michael Moon, Director of Compliance Operations

Compliance Committee Meeting – Open Session

May 8, 2012

RELIABILITY | ACCOUNTABILITY

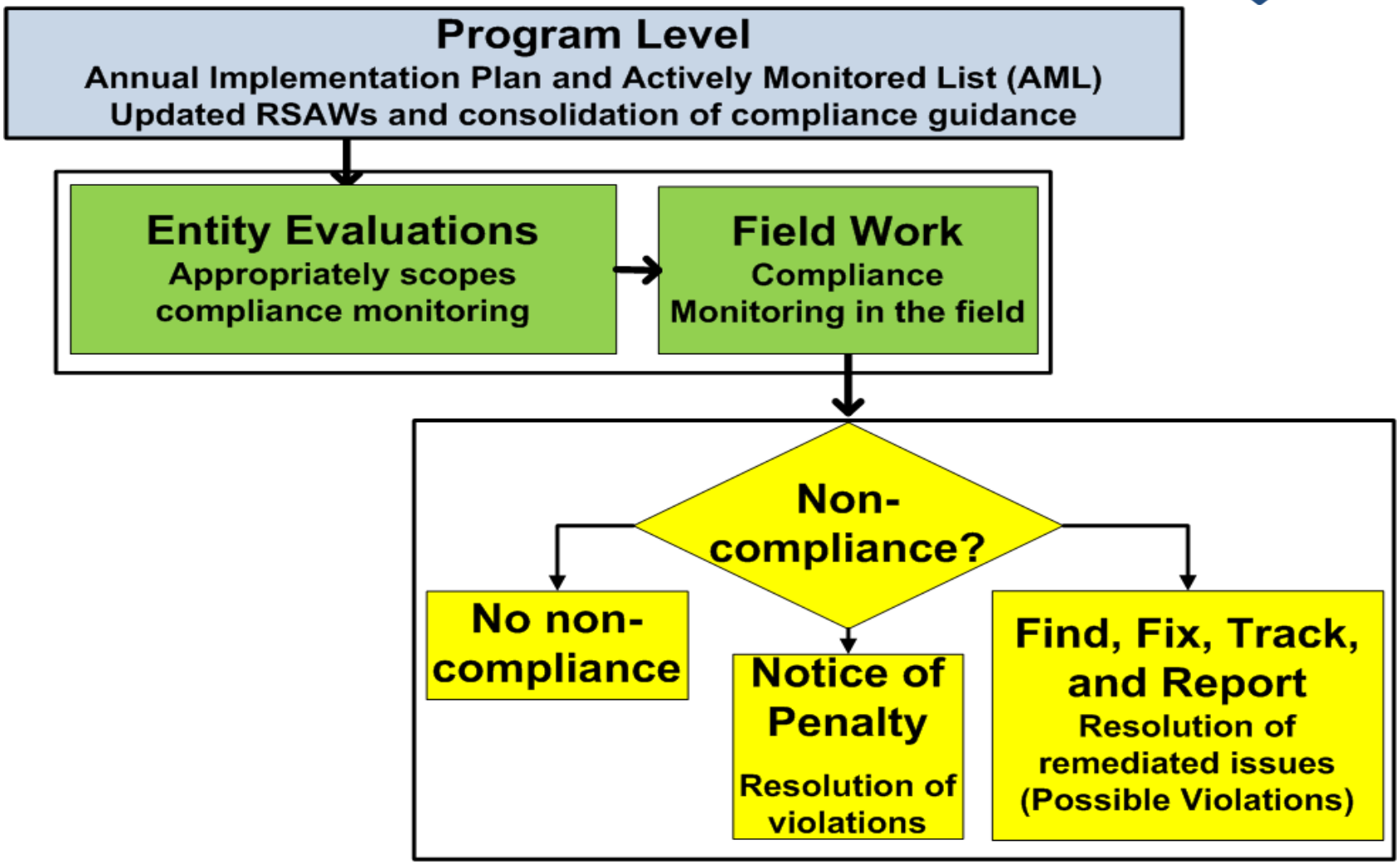





Risk-Based Compliance Monitoring

- Efforts began: 2010
- Goal: Refine compliance to support reliability
  - Greater analysis for Annual Implementation Plan and Actively Monitored List (AML)
  - Discussions to appropriately scope monitoring activities
  - White paper developed by Tom Burgess
  - NERC Compliance and Certification Committee (CCC) also provided insight and perspective

Levels to Consider Risk



What Would Success Look Like?

- Emphasis on reliability and less on compliance bureaucracy
- Compliance programs that are forward-looking
- Entity assessments that justify scope of monitoring
- Greater consideration of internal controls
- Industry finds, fixes, tracks, and reports (FFT mechanism)
- Focus resources on high risk reliability issues

Questions

Questions



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Compliance Monitoring and Enforcement Program (CMEP)

2011 Annual Report

Michael Moon, Director of Compliance Operations

Compliance Committee Meeting – Open Session

May 8, 2012

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Report Highlights

- Find, Fix, Track and Report (FFT) process is working
  - Streamlining low risk Possible Violations (PVs)
- Industry self-identified 67 percent of PVs in 2011
- Event Analysis process is working
  - Good reports
  - Self-identifying PVs on Category Two and above events

Questions

Questions



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CIP-005 Compliance Analysis Report

Electronic Security Perimeter(s)

Michael Moon, Director of Compliance Operations

Compliance Committee Meeting – Open Session

May 8, 2012

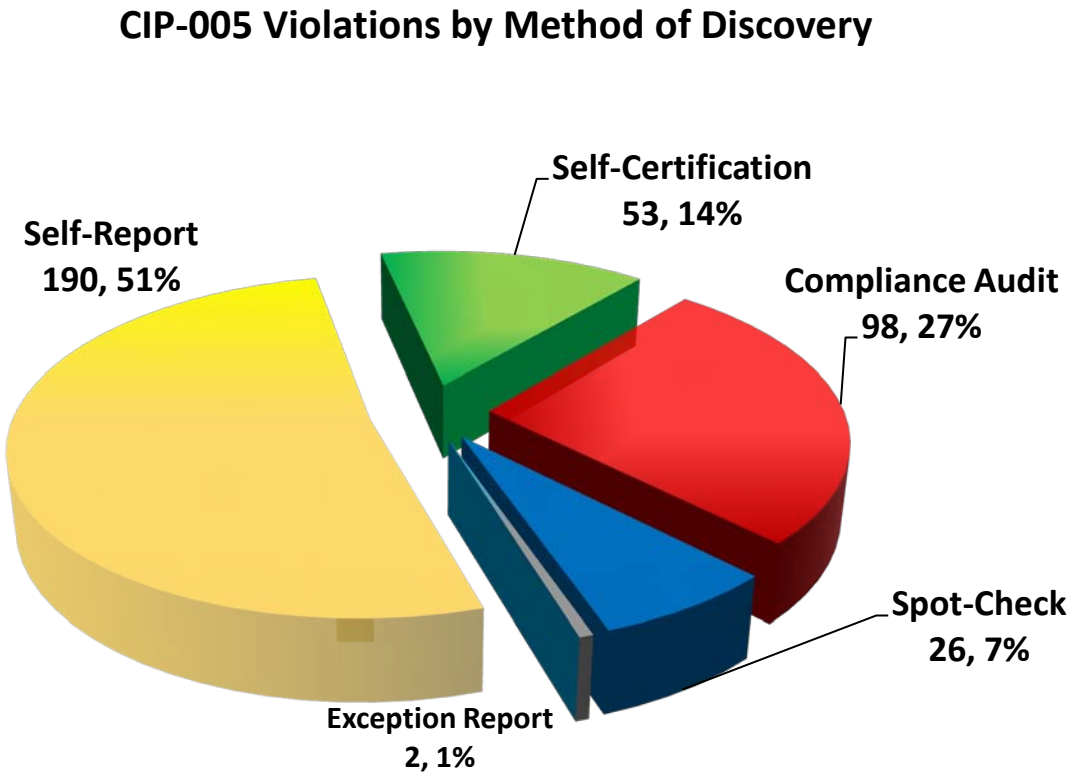
RELIABILITY | ACCOUNTABILITY






High Level Information

- As of December 2012
  - Six on all time
  - Two on previous 12 months (249)
- 66 percent possible violations (PVs) self-identified



Detailed Suggestions for R1

- Critical cyber assets determine the Electronic Security Perimeter (ESP)
  - Common error — Draw the ESP and then identify critical cyber assets
  - Remedy — Identify cyber assets, then draw the ESP
- Non-routable data crossing ESP boundary requires an electronic access point somewhere
  - Common error — Presume that an electronic access point is only required for routable networks
  - Remedy — Consider modem or protocol converter devices as likely candidates for the electronic access point

Questions

Questions



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Reliability Standards Audit Worksheets

A Partnership Between Standards and Compliance

Linda Campbell, Standards Committee Process Subcommittee

Compliance Committee Meeting – Open Session

May 8, 2012

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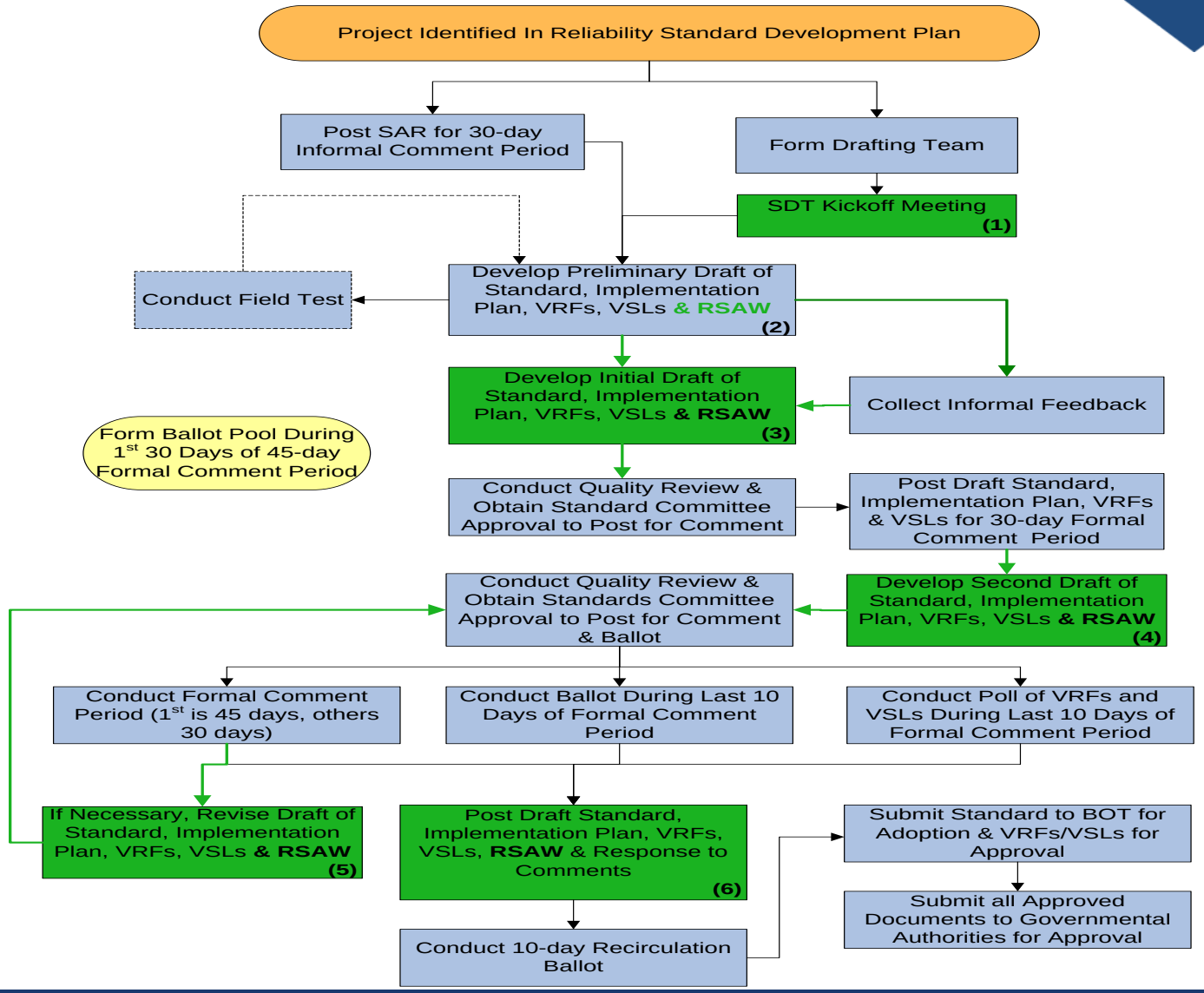



Background

- Standards Committee (SC) was interested in exploring:
  - Is there a role for drafting teams to work with Compliance in developing the Reliability Standards Audit Worksheets (RSAWs)?
- NERC Compliance Operations supports a role for drafting teams in RSAW development
- February 14, 2012 – SC Process Subcommittee working group and NERC Compliance Operations met
- This high-level proposal is the outcome of that meeting.



Proposal


Project Identified In Reliability Standard Development Plan
Post SAR for 30-day Informal Comment Period
Form Drafting Team
SDT Kickoff Meeting (1)
Conduct Field Test
Develop Preliminary Draft of Standard, Implementation Plan, VRFs, VSLs & RSAW (2)
Develop Initial Draft of Standard, Implementation Plan, VRFs, VSLs & RSAW (3)
Collect Informal Feedback
Form Ballot Pool During 1st 30 Days of 45-day Formal Comment Period
Conduct Quality Review & Obtain Standard Committee Approval to Post for Comment
Post Draft Standard, Implementation Plan, VRFs & VSLs for 30-day Formal Comment Period
Conduct Quality Review & Obtain Standards Committee Approval to Post for Comment & Ballot
Develop Second Draft of Standard, Implementation Plan, VRFs, VSLs & RSAW (4)
Conduct Formal Comment Period (1st is 45 days, others 30 days)
Conduct Ballot During Last 10 Days of Formal Comment Period
Conduct Poll of VRFs and VSLs During Last 10 Days of Formal Comment Period
If Necessary, Revise Draft of Standard, Implementation Plan, VRFs, VSLs & RSAW (5)
Post Draft Standard, Implementation Plan, VRFs, VSLs, RSAW & Response to Comments (6)
Submit Standard to BOT for Adoption & VRFs/VSLs for Approval
Submit all Approved Documents to Governmental Authorities for Approval
Conduct 10-day Recirculation Ballot

Concepts

- RSAWs would include more detail (*Elements of Ideal RSAW*)
- RSAW development would parallel standard development
- Draft RSAW would be posted with standard during recirculation (final) ballot
- RSAW would be part of package when standard is submitted for Board of Trustees adoption
- RSAWs would not be filed with FERC (no change from current practice)

Concepts

What might a Drafting Team include?

- Description of the requirement and reliability intent (from the rationale, needs, goals and objectives) in the standard
- An illustrative list of how to meet performance and for each "how", what constitutes quality evidence that would be sufficient
- Examples of what non-compliance might look like (e.g., "if the evidence is missing a date, it would not be considered compliant."), if appropriate

Concepts

- Any applicable or appropriate boundaries or parameters within which there is auditor discretion (performance may be acceptable), if any
- Identify if attestations are acceptable to “prove negative” and if there is any corroborating evidence that is “reasonable” to provide

Next Steps

- SC endorsement – March 8, 2012
- Compliance and Certification Committee (CCC) endorsement – March 15,2012
- Concept presented to ERO Compliance and Enforcement Management Group; received support
- Compliance Committee – May 8
- Next step: Field test developing a refined RSAW
  - COM-003, Operating Personnel Communication Protocols
  - PRC-027, Protection System Coordination

Questions

Questions



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Quarterly Statistics

Ken Lotterhos, Associate General Counsel and Director of Enforcement

Compliance Committee Meeting – Open Session

May 8, 2012

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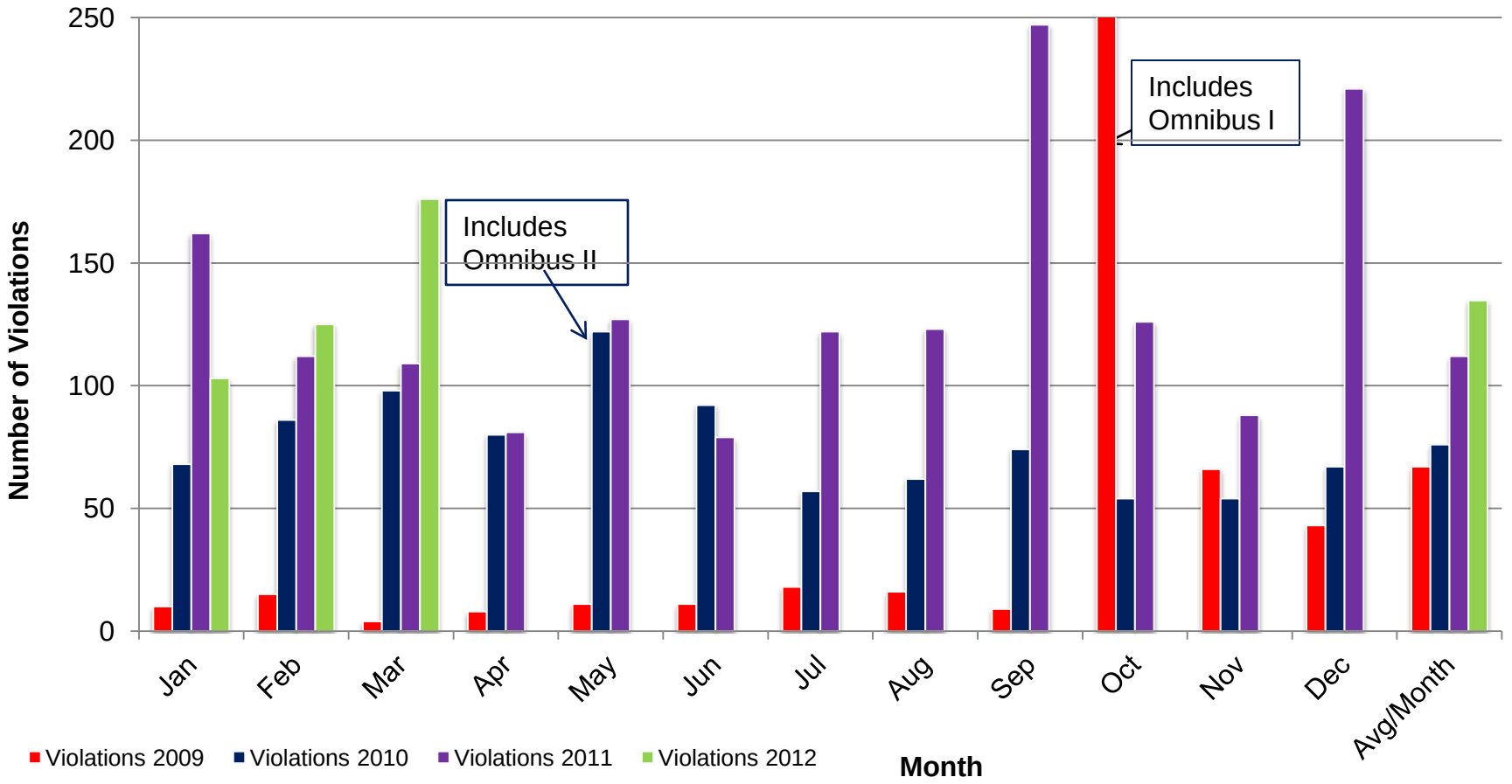





Overall Trends

- Violation monthly receipt/processing average
  - Last six months – 251 violations per month
  - Last six months – 267 violations per month dismissed or filed

Violations Approved by Compliance Committee

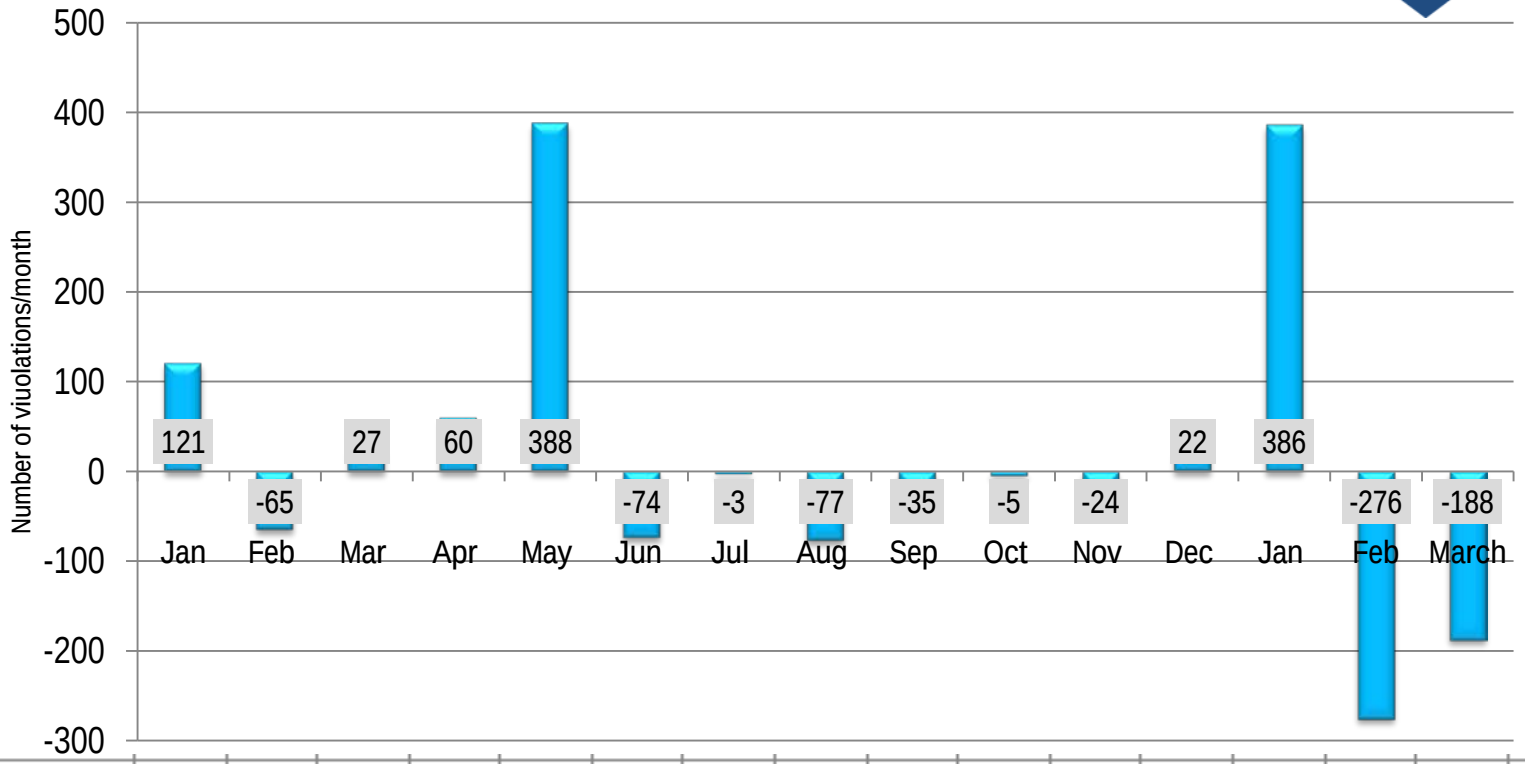


CEI Processing Statistics

Total Filed with FERC

	Full NOPs	SNOPs	FFTs	Total Filed
January	21	51	57	129
February	29	63	46	138
March	30	99	21	150

Violation Processing in 2011 and 2012



New	218	212	190	219	581	223	211	166	262	247	212	203	545	131	171	3791
Dismissed and Filed	97	277	163	159	193	297	214	243	297	252	236	181	159	407	359	3534

Caseload Index Description

- NERC Caseload Index — Total number of Active Violations divided by the sum of the 6-month average of number of violations filed with FERC plus the 6-month average number of dismissals
- Regional Caseload Index — Total number of Active Violations divided by the sum of the 6-month average of number of violations filed with NERC plus the 6-month average number of dismissals
- Active violations include all violations as of March 30, 2012 that are not closed or dismissed. This includes violations that are being processed by NERC or have been sent to FERC and are awaiting closing actions

NERC Caseload Index

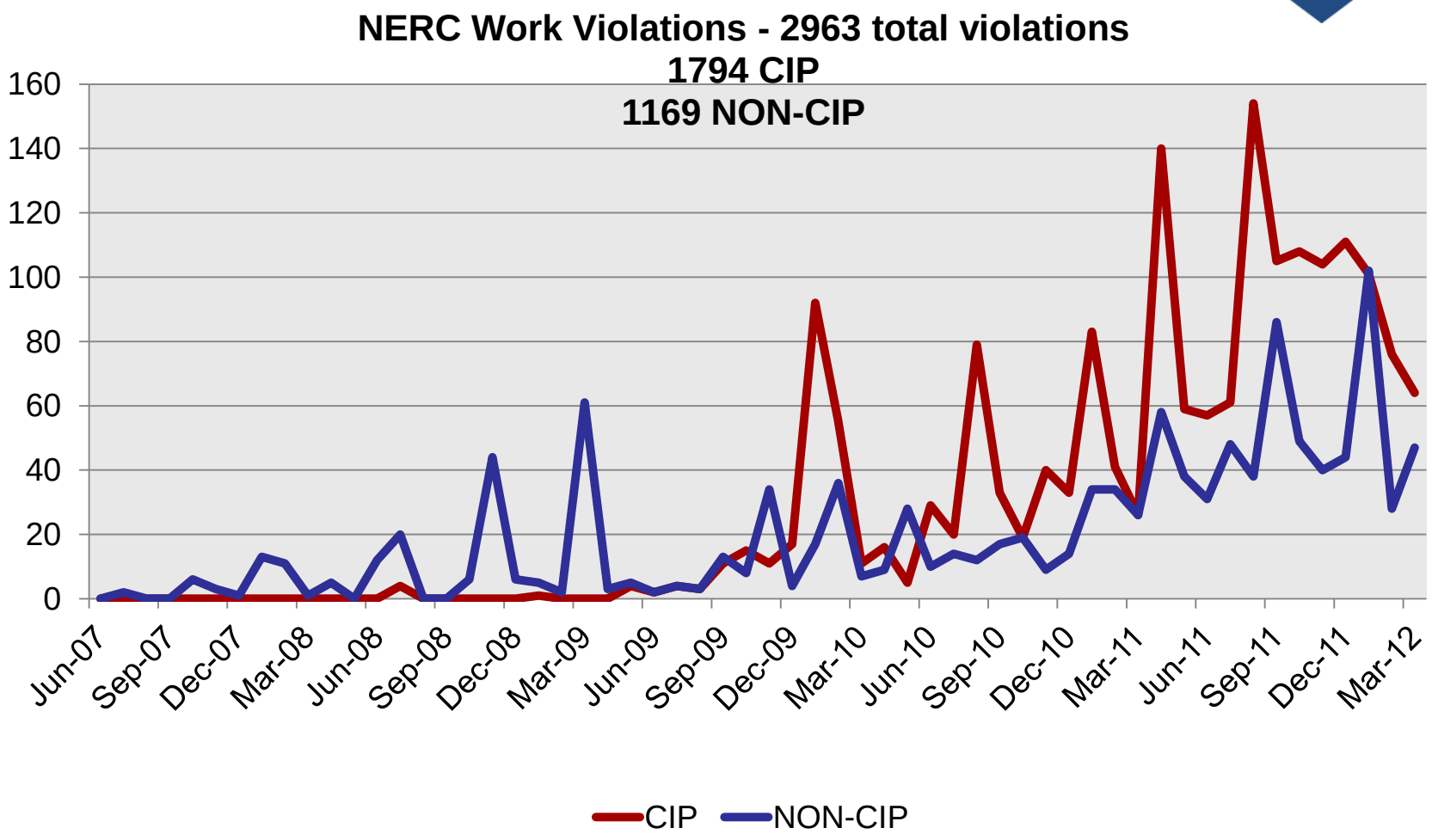
	NERC Caseload Index –as of March 30, 2012 (months)			
	Active Violations	Violations Filed with FERC (October 1, 2011 to March 30, 2012)	Total # of Dismissals (October 1, 2011 to March 30, 2012)	Caseload Index (Months)
NERC	3702	852	750	13.9

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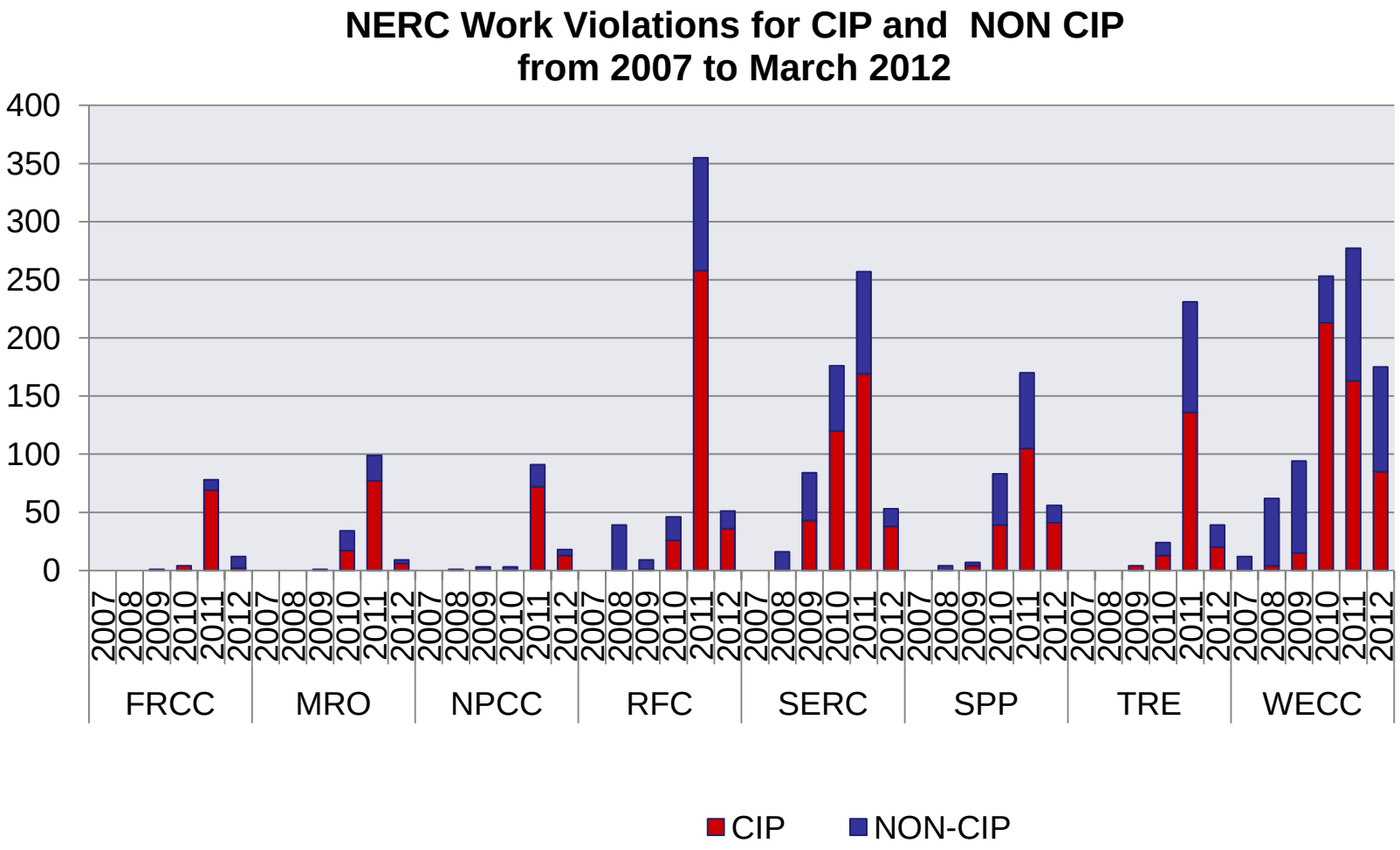
Regional Caseload Index

	Regional Caseload Index –as of March 30, 2012 (months)			
	Active Violations	Violations Filed with NERC (October 1, 2011 to March 30, 2012)	Total # of Dismissals (October 1, 2011 to March 30, 2012)	Caseload Index (Months)
FRCC	137	59	23	**10.0**
MRO	147	89	39	**6.9**
NPCC	114	61	2	**10.9**
RFC	689	195	83	**14.9**
SERC	583	26	44	**50.0**
SPP RE	369	106	35	**15.7**
TRE	322	66	36	**18.9**
WECC	762 211 'On-hold' violations excluded	265	504	**5.9**

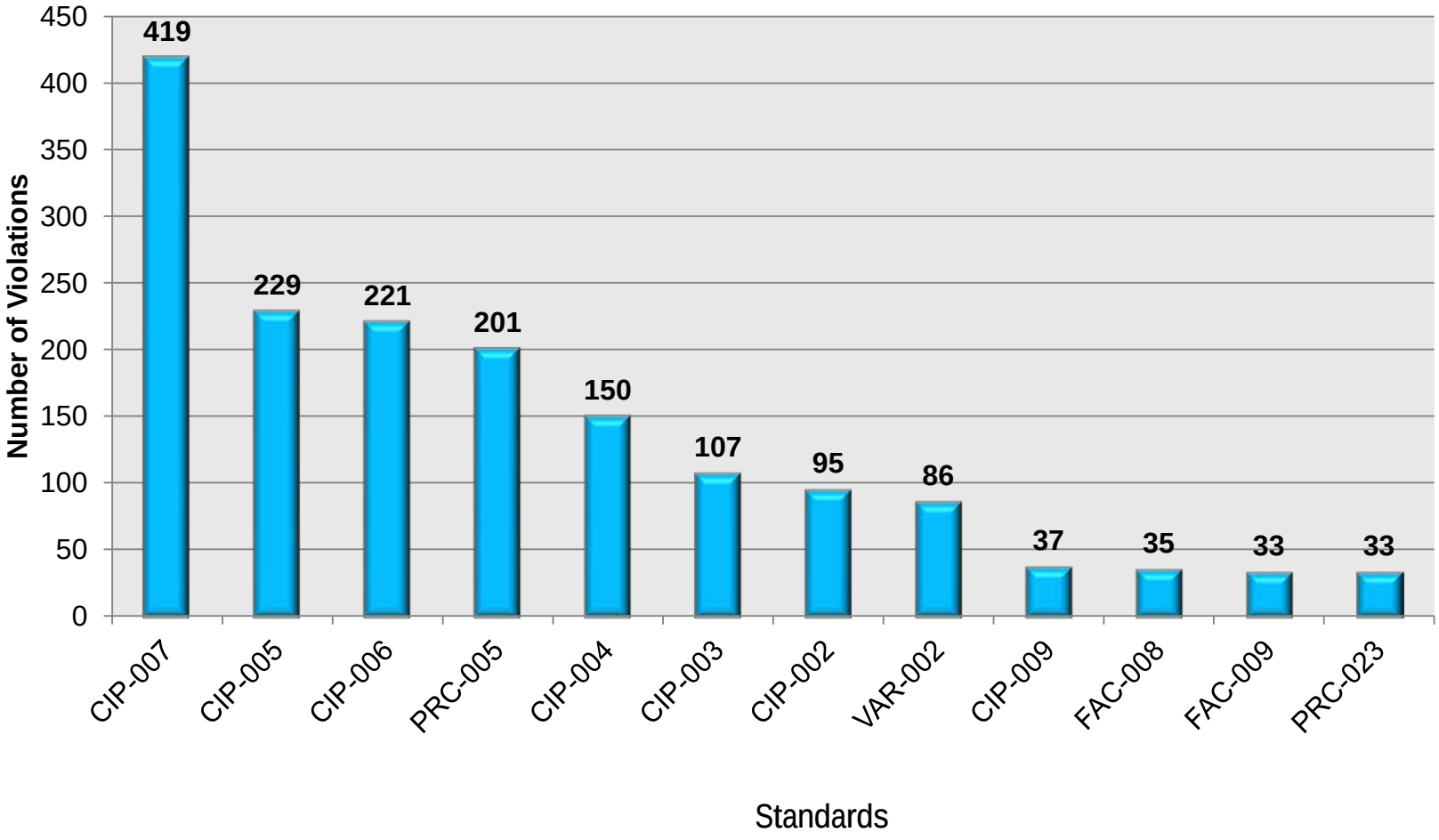
NERC Work CIP and Non-CIP Violations- Based on Discovery Dates from June 2007 to March 2012



NERC Work CIP and Non-CIP Violations by Region

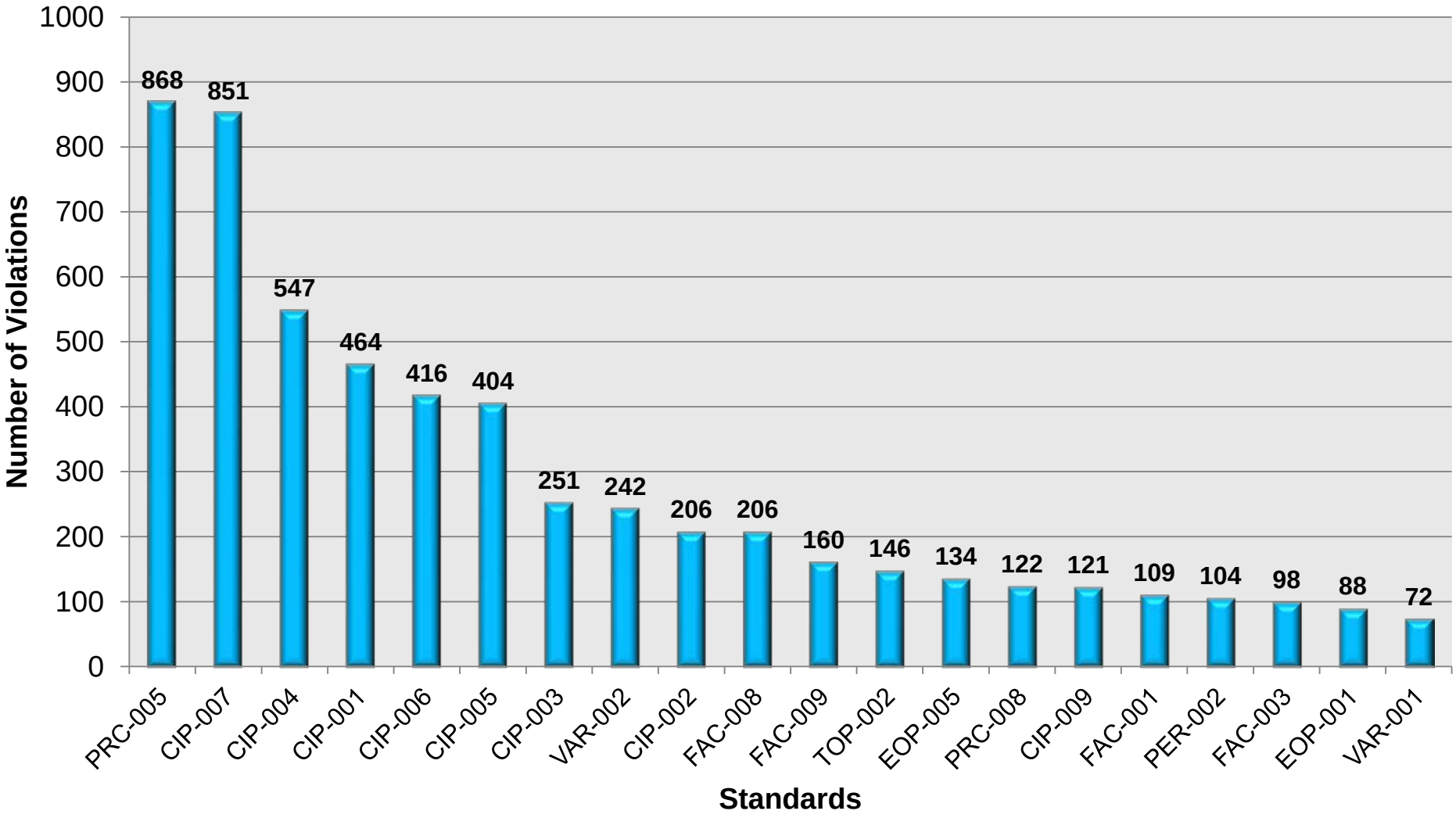


Top 12 Enforceable Standards – Violated Active and Closed from April 1, 2011 to March 30, 2012



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Top 20 Enforceable Standards – Violated Active and Closed Violations thru April 1, 2012



Future Metrics Development

Metrics being considered:

- Caseload index
- Violations in inventory trending over time
- Violation aging chart
- Violation aging by disposition method (FFT/NOP)
- Violation mitigation activities aging and status chart

- *Future discussion - violation heat map*

NERC Member Representatives Committee
Notes de Sylvain

May 8, 2012 | 1:00-4:30 p.m. Eastern
Westin Arlington Gateway

Introductions and Chair's Remarks

Commissionners Lafleur and Moller are happy to be here and looking forward to the discussion about standard development.

NERC Antitrust Compliance Guidelines and Public Meeting Notice

Consent Agenda
1. Minutes* – Approve
a. March 29, 2012 Conference Call
b. February 8, 2012 Meeting

2. Future Meetings* – Information

3. Remarks from Gerry Cauley, NERC President and CEO

- *We will not be discussing the audit during this meeting. NERC is disappointed and is taking this seriously.*
- *Southwest event report. This is a good example of collaborative work with FERC, NERC and entities. What can we do better to prevent those situations? How do we make sure our reliability framework works?*
- *Standards process. Commission been patient. Recent remand. Gerry is extremely pleased with the proposal. There will be details to work but it establishes a chain of accountability with FERC and Canadian regulators and improves process.*
- *He is very please with order on FFT. Make sure we train our staff and work with the region.*

4. Nominations*
a. Recommend Slate of MRC Members to Serve on the Board of Trustees Nominating Committee
b. Nominate Slate for the Electricity Sub-Sector Coordinating Council (ESCC)

- *Anthony Montoya suggested that we make sure there is a representative from the Western Interconnect.*
- *The proposed slate was approved. Paul Murphy from the IESO has been reelected.*

5. 2013 NERC Business Plan and Budget – Information

- *Gerry said NERC was able to introduce discipline in the last couple of year including strategic planning and Priorities settings. Multi-year projections were also introduced.*
- *Priorities:*
    - *Standards and compliance*
    - *Identify significant risks to reliability*
    - *Coordination and collaboration*
- *Challenges*
    - *Improving the standards development process*
    - *Focusing on reliability risk and delivery of results*
    - *Continuing to improve the compliance enforcement framework, focus and processes*
    - *Identifying and addressing critical infrastructure protection priorities*
- *Working capital and contingency operating reserves*
    - *Proposed policy and guidelines*
    - *Projected starting and ending balance*
- *Second Draft will include:*
    - *A detailed capital expenditures budget*
    - *Additional meeting expense detail*
- *$933K (1.8%) overall increase in operating costs and capital expenditures (lowest increase in NERC's history).*
- *This includes the reduction of cost due to transfer of IDC to a contractor. The industry will need to continue paying for this (to other than NERC). The 1,8% becomes around 4% if we account the IDC costs.*

6. Additional Discussion of MRC Informational Session Items, May 1* – Discussion

a. Bulk Electric System (BES) Definition, Phase 2

- *Phase 1 has not been approved!*

b. Definition of Adequate Level of Reliability (ALR)

- *How SDTs are supposed to handle the ALR documents? As a step back from standards and requirements.*
- *Webinar is coming.*
- *Speak now or regret it later. It will be used (for metrics and other).*

c. Risk-Based Compliance Monitoring and Entity Assessments

- *Criteria and templates are not completed yet. Focus groups are working on this. NERC is reaching out directly to entities. There will be self assessment tools for entities. All of this will be posted for comments by the end of June.*

d. Compliance Enforcement Initiatives

7. Status of Current Standards Projects – Discussion
a. Status of Regional Standards Development Programs*

- *There are only seven active regional standards and 2 are already approved. Some are Interconnection wide. No more are announced. The size of the problem is not large.*
- *Regions need to answer to stakeholder requests.*

b. Status of Underfrequency Load Shedding (UFLS) Activities*
c. Status of Operating Communications Protocols*
d. Standards for Board of Trustees Adoption, May 9 [Reference: Board of Trustees Agenda Item 6]
8. 2012 State of Reliability Report* – Information
9. Recommendations from the 2011 Southwest Outage* – Information

- *The sequence of events and the main recommendations were presented.*

10. Culture of Reliability Excellence* – Tom Bowe, PJM – Discussion
11. Regulatory Update* – Information
12. Recommendations of the Standards Process Input Group (SPIG)* – Discussion

- *The MRC adopted a motion to present the recommendations to the Board tomorrow after very few discussions. Clearly there is a lot of work remaining to bring substance, but the general feeling is that it is a step in the right direction.*

Sylvain Clermont
8 mai 2012

NERC
NORTH AMERICAN ELECTRIC RELIABILITY CORPORATION

Draft Minutes
Member Representatives Committee (MRC)

May 8, 2012 | 1:00–4:30 p.m. ET
Westin Arlington Gateway
801 North Glebe Road
Arlington, Virginia 22203

Chair Scott Helyer called to order the North American Electric Reliability Corporation (NERC) Member Representatives Committee (MRC) meeting on May 8, 2012 at 1:00 p.m., ET. The meeting announcement, agenda, and list of attendees are attached as **Exhibits A**, **B**, and **C**, respectively.

NERC Antitrust Compliance Guidelines and Public Meeting Notice

Chair Helyer called attention to the NERC antitrust compliance guidelines and the public meeting notice. Any questions regarding these guidelines or notice should be addressed to NERC's general counsel, David Cook.

Introductions and Chair's Remarks

Chair Helyer declared a quorum present with the following recognized proxies:

- Barry Lawson for Eric Baker and Michael Smith – Cooperative
- Bill Gallagher for Terry Huval - Transmission Dependent Utility
- Charles Acquard for Larry Nordell – Small End-Use Customer
- Stacy Dochoda for Gordon Gillette – Regional Entity (non-voting)
- Gilbert Neveu for Jean-Paul Théorêt – Canadian Provincial (non-voting)

Chair Helyer acknowledged and welcomed Vice Chair Carol Chinn, the NERC Board of Trustees, Commissioners Cheryl LaFleur and Philip Moeller[1], Federal Energy Regulatory Commission (FERC), and Assistant Secretary of Energy Pat Hoffman, Department of Energy (DOE). Chair Helyer also recognized the policy input provided by the MRC and stakeholders at the request of John Q. Anderson, chair of the NERC Board of Trustees.

[1] Commissioner John Norris attended the meeting following Commissioner Moeller's departure.

Minutes

The MRC approved the draft minutes of its March 29, 2012 conference call and February 8, 2012 meeting (**Exhibits D and E**).

Remarks from Gerry Cauley, NERC President and CEO

President Cauley recognized the MRC's submission of policy input and strong support for a number of current ERO initiatives. One notable initiative was the release of the 2011 Southwest Outage Report, which serves as a model for successful collaboration between FERC, NERC, and others involved in the inquiry of this event. The report points to a number of significant findings, expected remediation actions, and lessons learned that are relevant throughout industry and which should help ensure reliability institutions, processes, and standards remain effective and continue to improve.

Another initiative noted was the recent work to improve the development of timely standards that produce real reliability results. President Cauley stated he is encouraged by the proposal of the Standards Process Input Group (SPIG) and the chain of accountability now established between FERC, Canadian regulators, NERC Board of Trustees, the ERO Enterprise, and other stakeholders. The real measure of success for this initiative will be determined during the implementation phase of the five SPIG recommendations.

Lastly, President Cauley shared that he is pleased with the recent March 15 Order in which FERC accepted NERC's petition requesting approval of the Find, Fix, Track and Report (FFT) initiative and accompanying guidance. NERC will continue to work with the Regions and train staff on minimizing risks, setting an initial level of discretion, and sustaining, growing, and expanding the FFT initiative without jeopardizing the regulatory assurance that ensures focus on the right risks and priorities.

Nominations

Board of Trustees Nominating Committee

Chair Helyer announced the annual request for MRC participation on the Board of Trustees Nominating Committee (BOTNC). Jan Schori will chair the BOTNC in its search to fill two trustee terms, for John Q. Anderson and Tom Berry, scheduled to become vacant in February 2013. Three members will be selected, along with Chair Helyer and Vice Chair Chinn, as part of the MRC's proposed slate to the BOTNC.

Electricity Sub-Sector Coordinating Council

The MRC approved the proposed slate of the following executive members to the Electricity Sub-Sector Coordinating Council (ESCC), effective July 1, 2012:

Paul Murphy, Independent Electricity System Operator - Subsequent term expires June 2013
Jim Torgerson, UIL Holdings Corporation - Subsequent term expires June 2013
John Procario, American Transmission Company, LLC - Subsequent term expires June 2014
Kevin Wailes, Lincoln Electric System - Initial term expires 2014
Duane Highley, Arkansas Electric Cooperatives, Inc. - Initial term expires 2014

The MRC requested that the ESCC consider equal representation from the various interconnections. President Cauley, who chairs the ESCC, confirmed that equal representation is desired among the membership and the MRC's suggestion will be considered during future nomination periods.

Chair Helyer noted that the board is being asked to consider a procedural adjustment to the ESCC charter that would allow the timeframe for the annual nomination process of the executive member slate to better coincide with the MRC's quarterly May meeting dates. The ESCC charter currently states for the process of selecting the CEO-level executives**:** *Annually, starting June 1, the NERC Member Representatives Committee (MRC) will accept nominations for three weeks ending June 21 (or the next business day), for qualified individuals to serve as executive members on the ESCC.*

2013 NERC Business Plan and Budget

President Cauley introduced the 2013 business plan and budget development process. Michael Walker, senior vice president and chief financial and administrative officer, reviewed the 2013 resource and financial projections and schedule for the remainder of the cycle. Mr. Walker cited improvements to the 2013 planning cycle, including the development of multi-year objectives and budget projections, earlier collaboration with the Regions, and production of a common strategic plan. Key deliverables and resource drivers include:

a. Working with industry to implement standards process improvements to address efficiency, timeliness, and effectiveness
b. Focusing on issues having the most significant impact on reliability
c. Developing risk control strategies
d. Facilitating the transfer of best practices, lessons learned, and industry innovations
e. Enhancing bulk power system threat and vulnerability information sharing through the Electricity Sector Information Sharing and Analysis Center (ES-ISAC)
f. Expanding training and education programs

The following questions and comments were provided by the MRC regarding this topic:

- The transparency that NERC has offered is commendable, but the level of detail is not consistent with the amount of time allowed for review and comment.
- It is encouraging to hear about leveraging tools and programs such as FFT to reduce costs and resource pressures at NERC and among the Regions.
- Compliance and enforcement budgets should remain flat for the next year.
- The three year budget planning horizon should help highlight which items might be reduced this year, but potentially increased next year. The three year planning horizon should also help focus most on the things that matter to reliability.
- It is difficult to provide policy advice on the budget and business plan based on the level of detail provided. It seems that the industry should be providing advice on the strategic focus and overall priorities for the year. Even though understanding the cost of delivery is important, it seems that a lot is lost in the budgetary details.
- What are NERC's longer range objectives with respect to the ERO and the Regions over the next three years? What are the driving forces and direction behind moving the organization through the next three years? Is there a way to promote greater visibility and collaboration of these strategic objectives over the next three years?

President Cauley confirmed that the MRC is asking for a better strategic view of where NERC is trying to get in the next three years. There is a strong obligation to identify and articulate risks and to make sure these risks are resolved. NERC does not have to be the entity that provides the solution to every risk. There needs to be continued dialogue regarding what solutions and achievements can be owned and accomplished by others.

Additional Discussion of the May 1 MRC Informational Session Items

Chair Helyer asked for any additional discussion needed on the agenda items from the May 1 MRC information webinar session. The following comments were provided by the MRC regarding these various topics:

<u>Bulk Electric System (BES) Definition, Phase 2</u>

- Members cautioned against creating another burden for the regional entities when defining the exception process. Anything coming forward needs to be able to be implemented within the framework of budget and staffing.
- Members encouraged the approval of Phase 1.

Definition of Adequate Level of Reliability (ALR)

- A draft definition paper and several supporting documents were recently made available for industry comment. It is still unclear how a standard drafting team is supposed to handle and apply the various documents that are currently available for review.
- These documents are intended to raise awareness of overall reliability objectives and performance outcomes. The first step of the standard drafting team (SDT) is to think through the reliability objectives that are trying to be accomplished to determine if the scope is properly defined and the requirements are aligned with the goals. The development of a standard is only one element or strategy used to accomplish higher level objectives.
- Another important consideration is whether the current reliability principles can be retired or modified to sync with the new reliability objective.

Chair Helyer reported that the former BES/ALR Task Force will be dismissed until and unless a further need arises.

Risk-Based Compliance Monitoring and Entity Assessments

- It is unclear how reliability standard audit worksheets (RSAWs) will negate the need for compliance application notices (CANs)? RSAWs should not be used for alternative reasons in the compliance realm.

Mike Moon, director of compliance operations, NERC, confirmed that the RSAW is the best tool to offer appropriate, clarifying guidance to facilitate compliance. The CAN is not the optimal solution. The RSAWs are an essential tool that both auditors and the industry use. Better utilization of RSAWs should help alleviate the need for CANs.

- There is large support for the risk-based compliance monitoring approach; however, the criteria have not been made available for review or comment. It is unclear how this initiative will be applied consistently across the regions.
- Specialized attention may need to be given to Canada where one size of assessment may not fit all.

Mr. Moon confirmed the criteria and template are not yet finalized and available for distribution. However, there are two outreach efforts underway:

1. The NERC Compliance and Certification Committee is providing a broad view of how to set up the template, and
2. Registered entities participated in four focus groups to share details regarding their compliance history and assessment functions. The intent is to promote the individual assessment of an

entity and further their work with the region. Risk is not consistent among all entities so the common template should only be considered as a base starting point.

Status of Current Standards Projects

At the previous request of the MRC, Herb Schrayshuen, vice president of standards and training, NERC, provided an update on several ongoing standards projects.

Status of Regional Standards Development Programs

Tim Gallagher, Reliability*First* (RFC), reported there are only 7 regional standards under active development. Two of the 7 have been approved by the NERC board. The majority of the regional standards developed have been in response to fill-in-the-blank standards. The regions believe that these standards are consistent with the NERC standards even though additional detail or implementation steps may be included based on their stakeholders' response. The elimination of regional standards is dependent upon the development of NERC-wide solutions to the fill-in-the-blank standards. Encouraging progress has been made in this area with the underfrequency load shedding project.

The MRC shared concern that there are no natural seams that limit specific regional standards from exposing a full interconnection to reliability risks. Intuitively, the majority want to migrate away from using regional standards.

Status of Underfrequency Load Shedding (UFLS) Activities

Mr. Schrayshuen confirmed that FERC issued an order on the UFLS Standard on May 8. The purpose of the PRC-006 standard is to arrest declining frequency after a disturbance, assist in the recovery following under-frequency events, and provide load preservation measures. The North American standard contains variances for WECC and the Quebec Interconnection. The conclusion of the SDT was to focus on the planning coordinator as the entity to manage the process. Historically, the regions have been managing this process so a transition continues to be underway for many of the regions. A regional report of activities was provided as part of the agenda package for this meeting.

Status of Operating Communications Protocols

Mr. Schrayshuen reported the interpretation for COM-002, Communications and Coordination, was approved and is on hold to be sent to the FERC pending the completion of several other activities that include: The current posting and industry review of the COM-003, Operating Personnel Communication Protocol, the completion and approval of the NERC Operating Committee Reliability Guideline, a revised RSAW and petition for the COM-002 Interpretation.

The following comment was provided by the MRC members regarding this project:

- The COM-003 combined with the TOP standards highlights a potential process issue. The TOP standards assumed a certain definition would be written for a reliability directive. The reliability

coordination drafting team was writing that definition and now the posting of the COM-003 actually rewrites that definition, without the approval of the TOP standards.

Mr. Schrayshuen recommended that the Standards Committee review this concern during an upcoming meeting to determine a solution.

2012 State of Reliability Report

Mark Lauby, vice president of reliability assessment and performance analysis, NERC, provided a summary of NERC's independent view of the state of reliability. The report was issued in conjunction with the Planning Committee and the Performance Analysis subcommittee. Additional support and comment was received by the Operating Committee and the MRC. There were six key findings:

1. Reliability of the bulk power system remains adequate
2. Frequency response is stable with no deterioration
3. Protection system misoperations are a significant reliability issue
4. Equipment failure warrants further analysis
5. Resource mix changes necessitate new metrics
6. More data and research is needed

Recommendations of the 2011 Southwest Outage

Dave Nevius, senior vice president, NERC, and Heather Polzin, Office of Enforcement, FERC, provided a summary of the joint inquiry, sequence of events, and the findings and recommendations from the September 8, 2011 cascading outage in the Pacific Southwest.

Culture of Reliability Excellence

Tom Bowe, executive director of reliability and compliance, PJM Interconnection, provided a presentation on the activities related to PJM's culture of reliability excellence.

Recommendations of the Standards Process Input Group (SPIG)

Chair Helyer announced the opportunity to review the recommendations of the SPIG and announced that the Standards Oversight and Technology Committee will meet immediately following the MRC meeting to provide for continued discussion of this issue.

In February 2012, the board requested that the MRC prepare recommendations on improving the standards development process. The SPIG was formed to address this task through gathering feedback and input and reporting back recommendations to the MRC for approval and delivery to the board.

The following questions and comments were provided by the MRC regarding this topic:

Recommendation #1: American National Standards Institute

- This recommendation is important to Canadian members. It provides the right safeguards.
- Is there an opportunity that we are missing to meet the maximum requirements? Should this be adjusted to read "at a minimum, there should be an ANSI process…"? Are we unnecessarily encumbering the process by exceeding the minimum requirement, where necessary?

Chair Helyer clarified that this statement aligns more with the expectation that NERC will provide a response to all comments submitted, adhering to the minimum requirements versus trying to apply the ANSI process every step of the way through commenting and balloting.

Recommendation #2: Reliability Issues Steering Committee (RISC)

- It will be important to articulate the role, responsibility, and function of the high-level RISC since it may assume a portion of activities currently assumed by other committees. A mandate will be necessary to avoid overlap. Need to be careful not to overburden the anticipated members who may also serve on other technical committees.
- It is unclear how the RISC will save time and make the standards development process quicker and more efficient. How much time will it take for the RISC to act on nominations?

Chair Helyer recognized the need for a front-end process to evaluate, clarify, and potentially reduce the actual number of issues that are being pushed into standards development. Currently, a lot of SARs enter, and potentially burden, the process. There are issues that may not warrant the development of a standard that can be addressed through other alternative solutions. There will be more thought going into the beginning of this cycle, which will hopefully cut down on the amount of invested resources and overall workload that is required. The intent is to better manage what is going into the standards process for better throughput of solutions. There are details that still need to be considered once we decide this is the route to pursue.

President Cauley recognized that RISC is a new and different function that will rely on collective brainpower, facts, and risk assessments to form justifications and recommendations for taking action. The RISC will prioritize key issues and provide the regimented focus for documenting and tracking actions towards a solution and benefit to reliability. This is not a replacement of the SAR, but rather a new path for steering the agenda of the ERO and instilling accountability. The key is to bring together all of the standing committees to support this new initiative.

- The RISC seems to allow stakeholders, especially those with limited resources, to be more focused on reliability gaps. It will hopefully focus on what needs to be done to satisfy the gap. We are evolving past just putting standards in place for the sake of having standards. The RISC also has the potential to comb through standards to determine the subset of what is important to focus on for reliability.
- Will the RISC be expected to develop a project plan with milestones and targets to indicate a measurable path to pursue for any given issue to ensure there is some tracking and oversight for accomplishing a solution.
- The concept of the RISC sounds good, but a flowchart is needed to show relationships and illustrate how the RISC is assisting and facilitating the current process. There needs to be reassurance that the RISC will not assume the role of "gatekeeper".
- It is unclear if the RISC will just have the authority to advise the board or to actually perform certain actions. The front-end process is equally confusing regarding how nominations enter the RISC.

President Cauley clarified that the front-end process is not exclusive and the only route for identifying risks. The front-end process has more to do with how the ERO is sponsoring issues that need to be defined, prioritized, vetted and tracked. The process does not preclude others from performing similar nomination activities or working on similar technical issues. The risk portfolio of the ERO needs prioritization and board visibility.

Recommendation #4: Standards Product Issues

- A lot of the standards development process is assumed to be in the hands of the stakeholders. Has there been enough consideration for what will be required for stakeholder implementation versus which things will actually require board approval? Once an item or issue has received board approval, it is much more difficult to modify or adjust at a later date. There needs to be consideration for stakeholder involvement and flexibility.

President Cauley recognized that there may be confusion with the wording of the recommendation. The board may not take ownership for each recommendation of the SPIG or the RISC, but instead decide what standing committee will have primary responsibility. So this will still include stakeholders via the input of committees and the MRC.

- Encouraged by the proposed alignment with the RSAWs. Compliance guidance structured in the RSAWs allows for minimizing and even eliminating VSLs and other products in use.
- All of the recommendations seem like they are standards-related so it is still unclear what might go through the RISC besides issues/ projects geared towards standards-related outcomes.

President Cauley recognized that all of the SPIG's recommendations except for #2 involving the RISC, are directly linked to standards development. This unfairly presumes that all reliability risks end with standards. There are options that may not be communicated in these five recommendations that still need to be developed, perhaps with the formation of the RISC.

- Is the RISC linked to the risk-based assessment?

President Cauley clarified that the risk-based assessment is in the compliance monitoring arena regarding individual entity assessment, the quality of internal controls, etc.

- Seems like this recommendation struggles with the material impact to the BPS. The retirement of standards that are no longer needed sounds good, but a lot of the standards we have in place are based on lessons learned and as we get better at preventing outages and lengthening time between major events we need to ensure that we do not become complacent and forget why we are doing certain things and not getting rid of things that we need. It will be hard to define "what is no longer needed for an adequate level of reliability."
- Remember that the standards are made up of requirements so we may need to just consider adjustments to the requirements and not the entire standard itself.

<u>Recommendation #5: Standards Development Process and Resource Issues</u>

- Regarding the "no vote", there needs to be caution when reviewing the comment and determining whether it is good enough for the no vote to count. We need to consider who makes the decision, what is the basis for how is it determined, etc. There is also need for additional clarity regarding a voting record for each entity. It is unclear why this type of list is needed and what it will be used for.

Chair Helyer confirmed that the "no vote" option is to identify what the problem is perceived to be and why the no vote is cast. A new format may be necessary so the voter can select from a list of pre-determined reasons for why they are voting no. There will always be the option of providing comments.

President Cauley confirmed that standards development is the responsibility of all among the industry. With responsibility comes accountability for the decisions made regarding standards development.

- Strong agreement with the proposed composition of the SDTs, especially the involvement of a project manager and facilitator. This role is a key contributor to a more efficient and timely process.
- A detailed quality review is typically performed at the back end of the standards process, but we need to strive towards conducting this review "during" or "as we go along" in the process. The quality goes in before the name goes on.

On a motion by Tom Burgess with a second by William Taylor, the MRC approved advancing the SPIG's report and recommendations to the board for further consideration, additional tasking, and further development of the RISC.

August 15, 2012 Meeting and Future Meetings

The following are future MRC meeting dates and locations:

- August 15–16, 2012 – Quebec City, Canada
- November 6–7, 2012 – New Orleans, LA
- February 6–7, 2013 – San Diego, CA
- May 8–9, 2013 – Philadelphia, PA
- August 14–15, 2013 – Montreal, Canada
- November 6–7, 2013 – Atlanta, GA
- February 5–6, 2014 – Phoenix, AZ

Update on Regulatory Matters

Chair Helyer invited MRC members with questions or concerns regarding additional regulatory matters to meet with David Cook, senior vice president and general counsel, NERC, at the conclusion of the meeting.

Adjournment

There being no further business, the meeting terminated at 5:00p.m. ET.

Submitted by,



Holly Mann
MRC Secretary

Exhibit A

From: Eleanor Crouch
To: Eleanor Crouch
Bcc: _____ _____ _____ _____ _____ _____
Subject: NERC ANNOUNCEMENT: Member Representatives Committee (MRC) and Board of Trustees (BOT) Meetings-May 8-9, 2012 | Arlington, VA
Date: Friday, March 09, 2012 12:09:00 PM

Meeting Announcement

Member Representatives Committee (MRC)
Board of Trustees (BOT)

May 8-9, 2012 | Arlington, VA

Click Here for: Meeting Registration

Click Here for: Meeting Details

When making your hotel reservation, please be sure to mention "NERC" to get the preferred rate and ensure your reservation is credited to the NERC room block. The hotel will charge NERC a penalty if the total rooms blocked for this event are not picked up. Also, if you use a travel agency for your travel plans, please make sure the agency mentions NERC. For more information or assistance, please contact Eleanor Crouch at eleanor.crouch@nerc.net or (404) 446-2572.

For more information or assistance, please contact Eleanor Crouch at eleanor.crouch@nerc.net

3353 Peachtree Road NE
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Atlanta, GA 30326
404-446-2560 | www.nerc.com

NERC
NORTH AMERICAN ELECTRIC RELIABILITY CORPORATION

Exhibit B

Agenda
Member Representatives Committee

May 8, 2012 | 1:00-4:30 p.m. Eastern

Westin Arlington Gateway
801 North Glebe Road
Arlington, Virginia 22203
703-717-6200

Introductions and Chair's Remarks

NERC Antitrust Compliance Guidelines and Public Meeting Notice

Consent Agenda

1. **Minutes* – Approve**
   a. March 29, 2012 Conference Call
   b. February 8, 2012 Meeting
2. **Future Meetings* – Information**
3. **Remarks from Gerry Cauley, NERC President and CEO**
4. **Nominations***
   a. Recommend Slate of MRC Members to Serve on the Board of Trustees Nominating Committee
   b. Nominate Slate for the Electricity Sub-Sector Coordinating Council (ESCC)
5. **2013 NERC Business Plan and Budget – Information**
6. Additional Discussion of MRC Informational Session Items, May 1* **– Discussion**
   a. Bulk Electric System (BES) Definition, Phase 2
   b. Definition of Adequate Level of Reliability (ALR)
   c. Risk-Based Compliance Monitoring and Entity Assessments
   d. Compliance Enforcement Initiatives
7. **Status of Current Standards Projects – Discussion**
   a. Status of Regional Standards Development Programs*
   b. Status of Underfrequency Load Shedding (UFLS) Activities*
   c. Status of Operating Communications Protocols*
   d. Standards for Board of Trustees Adoption, May 9 [Reference: Board of Trustees Agenda Item 6]

8. **2012 State of Reliability Report* – Information**
9. **Recommendations from the 2011 Southwest Outage* – Information**
10. **Culture of Reliability Excellence*** – Tom Bowe, PJM **– Discussion**
11. **Regulatory Update* – Information**
12. **Recommendations of the Standards Process Input Group (SPIG)* – Discussion**
    a. **Further Discussion on Recommendations of the SPIG in Standards Oversight and Technology Committee Meeting (to follow MRC Meeting)**

*Background materials included.

List of Attendees
Member Representatives Committee Meeting
Arlington, VA
May 8, 2012

Member Representatives Committee	
Chairman	Scott Helyer
Vice Chair	Carol Chinn
Investor-Owned Utility	Thomas Burgess
Investor-Owned Utility	Robert Schaffield
State/Municipal Utility	Timothy Arlt
State/Municipal Utility	John DiStasio
Cooperative Utility	~~Eric Baker~~ **(Proxy: Barry Lawson)**
Cooperative Utility	Michael Smith
Federal/Provincial Utility	Julius Penstone
Federal/Provincial Utility	Anthony Montoya
Federal/Provincial Utility	Lorne Midford
Federal/Provincial Utility	Sylvain Clermont
Transmission Dependent Utility	John Twitty
Transmission Dependent Utility	~~Terry Huval~~ **(Proxy: Bill Gallagher)**
Merchant Electricity Generator	Maggie Powell
Merchant Electricity Generator	William Taylor III
Electricity Marketer	Jason Marshall
Electricity Marketer	Jack Cashin
Large End-Use Electricity Customer	Michelle D'Antuono
Large End-Use Electricity Customer	John A. Anderson
Small End-Use Electricity Customer	~~Larry Nordell~~ **(Proxy: Charles Acquard)**
Small End-Use Electricity Customer	Charles Acquard
ISO/RTO	Paul Murphy
ISO/RTO	Terry Boston
Regional Entity (Voting)	Jeff Gust (MRO)
Regional Entity (Voting)	Harvey Reed
State Government	Thomas Dvorsky
State Government	Robin Lunt
Canadian Provincial	~~Jean-Paul Théorêt~~ **(Proxy: Gilbert Neveu)**
Canadian Federal	Amitabha Gangopadhyay
U.S. – Federal	Pat Hoffman
U.S. – Federal	Joseph McClelland

Regional Entity	~~Gordon Gillette (FRCC)~~ **(Proxy: Stacy Dochoda)**
Regional Entity	Ed Tymofichuk (MRO)
Regional Entity	Harvey Reed (NPCC)
Regional Entity	Susan Ivey (RFC)
Regional Entity	Maureen Borkowski (SERC)
SPP RE	Ron Ciesiel (SPP RE)
Regional Entity	Lane Lanford (TRE)
Regional Entity	Constance White (WECC)
Secretary	Holly Mann

Board of Trustees	
Chairman	John Q. Anderson
Vice Chair	Bruce Scherr
Member	Vicky Bailey
Member	Paul Barber
Member	Thomas Berry
Member	Janice Case
Member	Gerry Cauley
Member	Fred Gorbet
Member	David Goulding
Member	Ken Peterson
Member	Jan Shori
Member	Roy Thilly

Regional Executives	
MRO	Dan Skaar
NPCC	Edward A. Schwerdt
Reliability*First*	Tim Gallagher
SPP RE	Ron Ciesiel
WECC	Mark Maher

Guests	
SPP	Alice Wright
APPA	Allen Mosher
WAPA	Anthony Montoya
Edison Electric	Barbara Hindin
NRECA	Barry Lawson

MISO	Bill Phillips
USE	Bob Dintelman
Southern Company	Bob Schaffeld
SERC	Carter Edge
Georgia System Operators Corporation	Clay Smith
WECC	Connie White
WPPI	Dan Brent
EEI	David Batz
NERC	David Cook
EEI	David Dworzak
NERC	David Nevius
Texas RE	Derrick Davis
PSE&G	Don Holdsworth
NERC	Earl Shockley
Entergy	Ed Davis
NERC	Ed Kichline
KG&E-KU LLC	Ed Staton
NERC	Elizabeth Heenan
SPP	F. John Meyer
FMPA	Frank Geoffrey
NERC	Frazaneh Tafreshi
SPP RE	Gerry Burrows
Lafayette Utilities System	Gini Ingram
Tampa Electric Company	Gregory Ramon
BPA	Hardev Juj
NPCC	Harvey J. Reed
NERC	Herb Schrayshuen
The Dayton Power and Light	Hertzel Shamash
Natural Resources Canada	Ivan Harvie
Nebraska Public Power	Jake Burger
Edison Electric Institute	James Fama
WIEB/WIRAB	James M. Williams
Arizona Public Service Company	Jana Van Ness
NERC	Janet Sena
Reliability*Fi*rst	Jason Blake
ACES Power Marketing	Jason Marshall

NERC	Jason Wang
NERC	Jeff Hicks
PSE&G	Jeff Mueller
ReliabilityFirst Corp.	Jeffrey Mitchell
Oncor Electric Delivery	Jen Fiegel
Northeast Power Coordinating Council	Jennifer Budd Mattiello
MRO	Jim Burley
Canadian Electricity Association	Jim Burpee
NYISO	Jim Castle
Wisconsin Electric	Jim Keller
WIEB	Jim Williams
Residential Utility Consumer Office	Jodi Jerich
Ameren	Joe Power
Associated Electric Cooperative	John Bussman
PSEG Services Group	John Seelke
SERC	John Twitchell
TAPS	John Twitty
CPS	Jose H. Escamilla
Madison Gas and Electric Company	Joseph Depoorter
Schweitzer Engineering Laboratories	Katie Schnider
Sempra Generation	Katy Wilson
NERC	Ken Lotterhos
ERCOT ISO	Ken McIntyre
LG&E-LU LLC	Ken Sheridan
Detroit Edison	Kent Kujala
SERC	Kevin Berent
NERC	Kimberly Mielcarek
FERC	Larry Gasteiger
NERC	Laura Hussey
SMUD	Laura Lewis
Montana Consumer Counsel	Lawrence Nordell
FRCC	Linda Campbell
Dominion	Lou Oberski
Georgia System Operations Corp	Lloyd S. Snyder
Dominion Resources	Lou Oberski
Dominion	Louis Slade

Exelon	Maggy Powell
SERC	Marissa Sifontes
Competitive Power Venture	Mark Bennett
NERC	Mark Lauby
NERC	Marvin Santerfeit
NERC	Matt Blizard
Ameren	Maureen Borkowski
NERC	Michael DeLaura
MRO	Miggie Crambilt
NERC	Mike Moon
NERC	Mike Walker
National Grid	Nabil Hitti
Duke Energy	Nelson Peeler
Canadian Electricity Association	Patrick Brown
Florida Reliability Coordinating Council	Peter Heidrich
WECC	Rachel Sherrard
New York Power Authority	Randy Crissman
NERC	Rebecca Michael
ReliabilityFirst	Robert Wargo
SPP RE	Sara Patrick
NERC	Scott Halleran
SERC	Scott Henry
NERC	Stacey Tyrewala
FRCC	Stacy Dochoda
Exelon	Steve Naumann
NERC Consultant	Stuart Brindley
SJC Energy Consultant, LLC	Susan Court
APPA	Sue Kelly
Exelon	Susan Ivey
TRE	Susan Vincent
National Energy Board, Canada	Tab Gangopadadhyay
WECC	Taud Olsen
Midwest ISO	Terry Bilke
Santee Cooper	Terry Blackwell
Southern Company	Terry Coggins
Nebraska Public Power District	Tim Arlt

NERC	Tina McClellan
PJM	Tom Bowe
NATF	Tom Galloway
NERC	Tracy Ruffin
NERC	Wanda Peoples
NERC	Willie Phillips

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Exhibit D

Minutes
Member Representatives Committee
Pre-Meeting Conference Call

March 29, 2012 | 3:00 p.m. Eastern
Dial in: 800-743-4304
No pass code necessary

Chair Scott Helyer convened a duly-noticed open meeting by conference call of the North American Electric Reliability Corporation's Member Representatives Committee (MRC) on March 29, 2012 at 3:00 p.m. Eastern. The meeting announcement, agenda, and list of attendees are attached as **Exhibits A, B,** and **C**, respectively. MRC membership attendance/roll call was not necessary since no quorum was required.

NERC Antitrust Compliance Guidelines and Public Meeting Notice

Holly Mann, assistant to the NERC president and CEO, and committee secretary, directed the participants' attention to the NERC Antitrust Compliance Guidelines and the public meeting notice.

Review of May 8, 2012 Draft MRC Agenda

Chair Helyer reviewed the preliminary agenda for the upcoming May 8, 2012 MRC meeting in Arlington, VA **(Exhibit D)**.

- Topics for discussion will include: regional standards development, underfrequency load shedding, operating communications (COM-002, COM-003, technical guidance), Rules of Procedure changes, 2011 Southwest Outage, and the progress of the Standards Process Input Group (SPIG).
- The Standards Oversight and Technology Committee will meet immediately following the MRC on May 8 to provide additional discussion of the recommendations of the SPIG.
- Tom Bowe, executive director, reliability and compliance, PJM Interconnection, will present on the Culture of Reliability Excellence.
- Additional time will be given to discuss the May 1 MRC Informational Session, which will include: Bulk Electric System (BES) and Adequate Level of Reliability (ALR) definitions, entity assessments, demand response availability, summer assessment conclusions, and Find, Fix, Track and Report (FFT) initiative.

Review of May 9, 2012 Draft Board of Trustees (Board) Agenda
Chair Helyer reviewed the preliminary agenda for the May 9, 2012 BOT meeting in Arlington, VA (**Exhibit E**).

The MRC was reminded of the Board's upcoming request to provide policy input on several emerging issues. A letter requesting policy input from the MRC will be distributed on April 6.

Schedule of Events for Upcoming Meetings
Chair Helyer reviewed the schedule of events for the upcoming MRC, Board, and Board Committees meetings (**Exhibit H**). MRC members were encouraged to review all materials for the MRC, Board, and Board committee meetings and attend as many of these meetings as possible, in advance of the MRC's discussion on May 8.

Committee Nominations
Holly Mann announced two upcoming nomination processes:

1. MRC members for the Board Nominating Committee
2. CEO executive slate for the Electricity Sub-Sector Coordinating Council (ESCC)

MRC members were informed that they will receive additional information prior to the May 8 meeting regarding these nomination processes.

Meeting Adjourned
There being no further business, the call was terminated at 4:00 p.m. Eastern.

Submitted by,



Holly Mann,
Committee Secretary

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Exhibit E

Minutes
Member Representatives Committee (MRC)

February 8, 2012 | 1:00–5:00 p.m. MT
Arizona Grand Resort
8000 S. Arizona Grand Parkway
Phoenix, AZ 85044

Chair Scott Helyer called to order the North American Electric Reliability Corporation (NERC) Member Representatives Committee (MRC) meeting on February 8, 2012 at 1:00 p.m., MT. The meeting announcement, agenda, and list of attendees are attached as **Exhibits A**, **B**, and **C**, respectively.

NERC Antitrust Compliance Guidelines and Public Meeting Notice

Chair Helyer called attention to the NERC antitrust compliance guidelines and the public meeting notice. Any questions regarding these guidelines or notice should be addressed to NERC's general counsel, David Cook.

Introductions and Chair's Remarks

Chair Helyer declared a quorum present with the following recognized proxies:

- Tom Bowe for Terry Boston – ISO/RTO
- Bill Gallagher for Terry Huval - Transmission Dependent Utility
- Jodi Jerich for Charles Acquard – Small End-Use Customer
- Del Smith for Robin Lunt – State Government
- Linda Campbell for Gordon Gillette – Regional Entity (non-voting)
- Gilbert Neveu for Jean-Paul Théorêt – Canadian Provincial (non-voting)

Chair Helyer acknowledged and welcomed Vice Chair Carol Chinn, six new members to the MRC, and attending staff from the Federal Energy Regulatory Commission (FERC). Chair Helyer also recognized the policy input provided by the MRC and stakeholders at the request of John Q. Anderson, chair of the NERC Board of Trustees.

Minutes

The MRC approved the draft minutes of its November 2, 2011 meeting and January 12, 2012 pre-meeting conference call (**Exhibits D and E**).

Election of Board of Trustees (BOT)

Dave Goulding, chair of the nominating committee, provided a report and recommendation for the re-election of three NERC board members for the class of 2015. Chair Helyer called for a vote of the MRC for the re-election of Ken Peterson, Bruce Scherr and Jan Schori. Chair Helyer confirmed a two-thirds affirmative vote from eligible members and congratulated the returning members of the NERC board of trustees.

Welcome to Phoenix

Dave Areghini, retired associate general manager for Salt River Project, welcomed participants to Phoenix and provided opening remarks regarding the advancement of the ERO Enterprise concept for the purpose of strengthening Reliability. Mr. Areghini shared that he believes the greatest deficiency facing the ERO is the inability to successfully quantify progress, use appropriate metrics, and leverage resources that exist among the industry. NERC and the Regions are encouraged to reach out to the industry and promote training and practice that reinforce our culture of reliability.

Remarks from Gerry Cauley, NERC President and CEO

Mr. Cauley recognized the policy input received by the board and shared his appreciation for the continued opportunities for dialogue with the MRC and industry. There were a number of accomplishments by NERC and the ERO Enterprise in 2011 which utilized support from the Industry; these included the filing with FERC of the Bulk Electric System (BES) definition, continued prioritization of standards, completion of GridEx, and progression of the find, fix, track and report (FFT) initiative. Additional investment in the events analysis process and procedure also proved successful for 2011.

<u>Update on ERO Enterprise Strategic Planning and Corporate Goals</u>

The current ERO Enterprise Strategic Plan (2012-2015) includes goals that span three major focus areas:

1. Standards and compliance
2. Risks to reliability
3. Coordination and collaboration

The 2012 goals are structured around achieving efficiency and effectiveness, a risk-management focus, and accomplishable outcomes and results. The NERC standards need to be results-based with effective compliance monitoring and internal controls.

NERC is in the process of confirming weights for each of the three focus areas and the multiple corporate performance metrics associated with each since they are not all equal in the eyes of NERC, the regions, industry or FERC. The goals, objectives and measures will continue to be scaled over the upcoming weeks based on importance, relevance, and timeliness of each. A more refined version is

expected to be delivered to the board Corporate Governance and Human Resources Committee by the end of the month.

Mr. Cauley also recognized opportunities exist to collaborate with registered entities and the forums to analyze data and align risks and cause codes. The forums and others among the industry could also take on the responsibility of identifying risks and analyzing data to determine trends and patterns. As the ERO, NERC is obligated to identify and prioritize certain risks and patterns between identifying risks and fixing them there is a lot of work to be done.

Mr. Cauley confirmed NERC's intent to be more transparent in its corporate year-end report for 2012.

Standards Development Process Improvements

Mr. Cauley wants to introduce, in 2012, another opportunity to seek clarification on the overall structure and timeliness of the standards development process to ensure greater efficiency and quality of results. The ERO must equally consider the weight of compliance on those entities that have to implement and meet the requirements of standards.

In the past, additional time has been allocated to address improvements to the administrative processing, balloting, etc. It is now the time to address several additional issues in the upcoming year:

1. **Process** - Determining how to address the efficiency of the process by breaking the existing mold for how we develop standards. Are there other options and alternatives for developing a successful development cycle that will improve a timely standards process?
2. **Resources** - Maximizing the use of appropriate resources. Protecting the right of all stakeholders involved while deriving the necessary talents to comprise the drafting team and ensuring the correct legal, writing, and enforcement support for standards development.
3. **Governance** – Determining if sustainable governance is in place to produce adequate reliability through standards development. Encouraging the ERO Enterprise to continue identifying risks and setting the priorities and timeline for producing a standard through the use of an improved process.

Chair Helyer recognized the MRC has a role to support and advise the board on the issue of standards development. Various comments were received in writing prior to the meeting, but the following comments were provided by the MRC members regarding this topic:

- The current process lacks a clear scope and facilitation framework for the drafting team.
    - There need to be clear rules for everyone who participates in a standard drafting team (SDT), including NERC and FERC staff.
    - The team structure currently lacks sufficient policy advisors and technical writers.

    - NERC should serve in a guiding role for the team, as a facilitator to address the scope, manage the schedule, and to maintain specific issues.

- Concerns were raised about the need to have the industry included in the governance of the standards development.
- NERC is not the only organization that has tried to master the development of standards. NERC should benchmark its process against other organizations that set standards. MRC should take a role in leading the effort to revise the standards development process. The board relies on the MRC for this involvement.
- The MRC should ensure that input from stakeholders remains at the forefront and be careful to remember the international collaboration and policy input from CEA.
- Attention should be given to the comments and recommendations of the trades. There needs to be a senior group of leaders to consider other process optimization, such as ANSI's process, as well keeping the industry input.
- The development of FFT process has been a success and should be trusted.

Suggestions were made for the MRC to form a small steering group to provide policy input to the BOT regarding improvements to the Standards development process. Chair Helyer suggested the MRC form a small steering group under the invitation of Chair Anderson and the board. Participants may include MRC members, a Canadian representative, chair of the Standards Committee, representative from the trades and/or forums, NERC staff, BOT members, and others. Projected milestones would include:

- **April 1** - an initial progress report from the steering group to the full MRC
- **MRC Informational Webinar** – a preview of the presentation intended for the BOT meeting in May
- **May meeting** – the full presentation and discussion to the BOT

Rules of Procedure (ROP) Updates

Rebecca Michael, associate general counsel, NERC, reviewed a number of substantive changes to the ROP that are scheduled to be presented to the board for approval on February 9.

The substantive changes also include a proposal to delete appendices, 3C and 6. There are currently agreements and memoranda of understandings in place between NERC and it international partners that warrant the retirement of the current Appendix 3C. Appendix 6 contains minor administrative details that no longer warrant inclusion in the ROP.

Future action regarding the ROP includes:

- Edits to Appendix 8 following the implementation of the event analysis process document; addressing the roles of situational awareness staffing in the ES-ISAC.
- Section 511, interventions in regional transmission organizations (RTOs)/ independent system operators (ISOs) enforcement matters. Action on this section was deferred to the BOT meeting on February 23, 2012.

The following comments were provided by the MRC members regarding this topic:

- The board is asked to delay their decision/approval of the proposed updates and deletions to the ROP in an effort to give the MRC and Industry ample time to review and provide final inputs to the changes discussed today.
- Some are concerned about changes to Section 400 that grant an appeals process to the Regional Entity (RE) if a ruling from the hearing body is not considered favorable or desirable. Is there an added concern for circumstances involving REs that select/appoint the hearing body?
- Some are in support of the RE acquiring the ability to appeal the decision of the hearing body. This change to the ROP is considered a positive parallel to the existing language that currently limits appeals to the RE.
- There is large support for the removal of Appendix 8 from this cycle of changes to the ROP. Future changes to Appendix 8 should be presented to the MRC as a package submission, in conjunction with other applicable areas of the ROP.
- It is unclear what warrants the MRC's discussion or policy input regarding changes to NERC's bylaws. A stakeholder would have to garner support from 50 entities across two segments or acquire a NERC officer to champion their proposal for a change to NERC's bylaws.
- The proposed change to the certification of entities is not a minor change. A reliability business case is needed for this proposed change to determine the impact across Industry and the benefit to reliability.

Events Analysis Update and Reliability Risk Trends

Earl Shockley, director of reliability risk management, NERC, summarized the events analysis field trial that resulted in the finalization of an ERO event analysis process document scheduled to be presented to the board for approval on February 9.

The following comments were provided by the MRC members regarding this topic:

- Members would like to receive additional details regarding the industry alert expected to be issued for the purpose of identifying change management events.

- There is little known about the timeframes that are targeted by NERC to issue reports from event analysis and lessons learned. How will the industry know when to expect these reports to be issued and available for peer-reference and use?

NERC confirmed it will ensure there is no breach in confidentiality, for those entities or regions involved in the event analysis process, through the release of these lessons learned and reports (**Exhibit F**).

Generator Owners and Operators That Own and Operate Transmission Facilities

Mike Moon, director of compliance, NERC, presented an update on the status of draft compliance guidance and directive concerning the registration of Generator Owner/Operators (GO/GOPs) as Transmission Owner/Operators (TO/TOPs).

The following comments were provided by the MRC members regarding this topic:

- It is important to support the work invested by the SDT and recognize the potential for benefit to the industry. There is continued encouragement to utilize the SDT, NERC staff, the regions, etc. and standards development process that is currently in place to address any concerns that may arise around this issue.
- The full package of 4 standards (FAC-001, FAC-003, PRC-004 and PRC-005) might be remanded to the SDT to allow time to resolve the issue and objection of on FAC-003 and return for MRC input during the May meeting. PRC-005 will also be balloted before the May meeting.
- There may be some facilities that are so complex that they require additional standards to be applied. A one size fits all approach may not be sufficient for this issue.
- The SDT and NERC staffs need to ensure all gaps are addressed with this set of standards before the package is submitted to FERC.
- Is there a list of requirements that are still a concern for NERC staff? Based on the presentation from the SOTC, it is not clear which standards NERC staff believes should be within scope of this current project.
- Complexities surrounding issues, such as this one, ultimately limit the timeliness involved with the standards development process.

NERC staff agreed to provide a review of the technical details that can support the SDT and provide a full picture regarding “completeness” of this initiative.

COM-002 Interpretation

The MRC provided the following input on the interpretation from SDT on COM-002 regarding three-part communications during emergency circumstances:

- The interpretation of the COM-002 standard is the industry's opinion via the SDT.
- Nothing in the standard prevents using three-part communications during normal, non-emergency conditions and there is no penalty described in standard for using three part communications during non-emergency conditions.
- A concern was raised that the standard interpretation appears that we are backing away from reliability. Also, what is the risk between now and when the standard interpretation is approved?
- If three-part communications is used on a routine basis, can we determine when the emergency actually occurred?
- Three-part communications will not necessarily solve all dilemmas surrounding the exchange of information between entities. Many entities strive to use three part communications most of the time while clearly recognizing that during emergencies it is required. Pursuing entities in terms of compliance should only be done if there is failure during emergency circumstances. Allocating resources to hunt down every time we fail to use three part communications, even in the routine operations, then we are not focusing ourselves on the risks that are most important.
- Industry has been surprised with how the standard has been enforced, based on how we want it to read or say and not by what it actually does read/say.
- The enforcement issue implies there may need to be a review of the language within the standard itself and not necessarily the interpretation of that standard that we are faced with today.
- It is hard to demonstrate that an entity has participated in three part communications 100% of the time. Is it a violation with a penalty process if one sample is found where three part communications was not used, during non-emergency times? We need to focus on making a reliability difference.
- Is this interpretation following the strict construction-approach of the standard?

The MRC concluded that the interpretation does follow the strict intent of the standard, during emergency conditions. The way the standard was being applied ultimately leads to the need for an interpretation.

Definition of Adequate Level of Reliability (ALR)*

The ALR task force is re-evaluating the existing ALR definition and determining objectives that will be measurable along with cost benefits, load loss distinctions, and an accompanying definition of "cascading". Ongoing efforts include the development of a white paper on the management of social impacts and risks to reliable BES operations. The schedule for industry comment is March 2012.

The MRC requested an update during their May informational session prior to the next face-to-face meeting in Arlington, Virginia. The BOT is expected to receive a final presentation in November 2012.

Bulk Electric System (BES) Definition — Filing of Phase 1 and Preparations for Phase 2

Herb Schrayshuen, vice president of standards and training, NERC, recognized the success of Phase 1 and confirmed the petition was filed with FERC in January 2012. Phase 2 is underway to finalize the SAR, develop the technical justification, and provide clarification from Phase 1. The schedule for industry comment is March 2012.

The MRC requested an update during their May informational session prior to the next face-to-face meeting in Arlington, Virginia.

Geomagnetic Disturbance Task Force (GMDTF) Update

Mark Lauby, vice president of reliability assessment and performance analysis, NERC, provided an update on the GMDTF's interim report. The major conclusions include loss of reactive power, challenge to maintain supply, and damage to certain transformers. The task force continues to work with industry to develop open source coding, create source tools for modeling, simulation, and measurement, and to review NERC reliability standards for opportunities for enhancement. The BOT is expected to receive the interim report for acceptance and endorsement of the recommendations during the February 23 meeting. An embargoed copy will be shared with various entities following BOT acceptance and endorsement.

The following comments were provided by the MRC members regarding this topic:

- This is a positive demonstration on how technical reports should be developed based on accurate data. Industry provided world class experts to support this task force initiative with NERC. This is how NERC is intended to work and operate.
- Members want to ensure this good work and the recommendations are continually shared with FERC, Congress and other entities.
- A parallel communication effort should be established with the Electricity Sub-Sector Coordinating Council (ESCC) regarding the release and socialization of this report.

Compliance Enforcement Initiative (CEI) Update

Ken Lotterhos, director of enforcement, NERC, confirmed NERC is preparing for the six-month status report to submit to FERC during March 2012 and is seeking comments from industry by February 23. The following comments were provided by the MRC members regarding this topic:

- A question was asked about the difference in timelines between processing the FFT violations versus the full notice of penalty (NOP) violations.
- Many regions initiated the FFT process with a majority of under-processed cases and immediately noticed efficiencies. As more cases enter the FFT process, efficiencies are expected to continue.
- A plan needs to be in place with a schedule for how auditors will accomplish all the steps necessary to reach Phase 2.
- The MRC is interested in knowing how FERC will address FFT.

FERC staff acknowledged the MRC's interest to receive more information once it becomes available.

NERC confirmed its intent to provide more data for the FFT and NOP processes so issues such as timelines are clearer to the Industry.

Culture of Reliability Excellence

Eric Ruskamp, standards and compliance manager, Lincoln Electric System, provided a presentation on the subject matter expertise of its personnel who are cross trained to address NERC standards, compliance, and enforcement (**Exhibit G**)

Tom Bowe, executive director of reliability and compliance, PJM Interconnection, is scheduled to provide a presentation during the May 2012 meeting.

November 2011 FERC Technical Conference on Reliability

There were no MRC comments regarding this FERC technical conference.

May 8, 2012 Meeting and Future Meetings

The following are future MRC meeting dates and locations:

- May 8–9, 2012 – Arlington, VA
- August 15–16, 2012 – Quebec City, Canada
- November 6–7, 2012 – New Orleans, LA
- February 6–7, 2013 – San Diego, CA
- May 8–9, 2013 – Philadelphia, PA

- August 14–15, 2013 – Montreal, Canada
- November 6–7, 2013 – Atlanta, GA
- February 5–6, 2014 – Phoenix, AZ

Update on Regulatory Matters

Chair Helyer invited MRC members with questions or concerns regarding additional regulatory matters to meet with David Cook, senior vice president and general counsel, NERC at the conclusion of the meeting.

Adjournment

There being no further business, the meeting terminated at 5:30p.m. MT.

Submitted by,



Holly Mann
Secretary

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NERC 2013 Business Plan and Budget Overview

Mike Walker, Senior Vice President and Chief Financial and Administrative Officer

Member Representatives Committee Meeting

May 8, 2012

RELIABILITY | ACCOUNTABILITY






NERC 2013 Business Plan and Budget

- Budget Planning Background
- Goals and Priorities
- Challenges
- Business Planning Framework
- Key Deliverables and Resource Drivers
- 2013 Projections
- Next Steps Schedule

Background

- In 2010 NERC initiated a multi-year business planning and budgeting process
  - Develop long-term goals and assumptions
  - Three-year budget projections
- 2013 goals and deliverables updated to reflect prioritized focus on reliability, stakeholder feedback
- 2013 plan and budget remain on track

Strategic Goals

- Standards and compliance
  - Develop clear, reasonable, technically sound standards in a timely and efficient manner
  - Strong, independent and fair enforcement authority
  - Promote culture of compliance
- Identify significant risks to reliability
  - Prioritize risks, develop solutions, monitor results
  - Accountable for mitigation of risk
  - Promote culture of reliability excellence
- Coordination and collaboration
  - Transparency, consistency, efficiency, cost effectiveness

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Focusing on Priorities

- Issuing new and revised standards
- Improving enforcement efficiency and productivity
- Identifying significant reliability risks
- Training and education
- Improving ERO processes and efficiency

Challenges

- Improving the standards development process
- Focusing on reliability risk and delivery of results
- Continuing to improve the compliance enforcement framework, focus and processes
- Identifying and addressing critical infrastructure protection priorities
- Addressing regulatory mandates

Business Planning Framework

- Develop strategic goals, objectives and common assumptions
- Review existing resource needs and operating costs
- Project 2013 cost of current operations
- Identify 2013 incremental resource requirements and costs
- Develop projections for 2014-2015

Key Deliverables and Resource Drivers

Standards

- Work with industry to implement standards process improvements to address efficiency, timeliness and effectiveness
- Continue development of risk-based standards focused on key reliability outcomes, including support for 3-year development plan
- Meet regulatory obligations for standards development and revisions and reduce directives backlog
- Implement improvements in project management of standards development projects

Key Deliverables and Resource Drivers

Compliance Operations

- Develop a compliance trial program which provides an opportunity for mitigation while achieving compliance, as well as an opportunity to validate compliance measures and procedures
- Develop risk-based compliance monitoring approaches to maximize reliability benefits and improve efficiencies
- Continue education programs regarding effective compliance programs and risk controls
- Improve Regional Entity oversight

Key Deliverables and Resource Drivers

Enforcement

- Achieve efficiency by focusing on cases having the most significant impact on reliability
- Sustain and expand Find, Fix, Track, and Report process
- Reduce prior caseload
- Identify the causes and trends in violations

Key Deliverables and Resource Drivers

Reliability Assessment and Performance Analysis

- Revised definition of Adequate Level of Reliability
- Analyze emerging risks to reliability
- Develop risk control strategies
- Support for standards development process and response to FERC directives
- Subject to final regulatory action, finalize Bulk Electric System (BES) exception and consequential load loss exception processes

Key Deliverables and Resource Drivers

Event Analysis and Investigations

- Use of more sophisticated cause codes for analysis
- Refinement of risk-based methodologies
- Provide timely publication of lessons learned
- Refine the criteria and process for self-analysis of events and disturbances

Key Deliverables and Resource Drivers

Situation Awareness

- Ongoing SAFNR support of FERC, Regional Entity and stakeholder needs
- Respond to increased number of occurrences requiring analysis
- Managing a consistent program for issuing NERC alerts

Key Deliverables and Resource Drivers

Human Performance

- Conduct semi-annual Human Performance workshops
- Facilitate the transfer of best practices, lessons learned and industry innovations
- Identify opportunities and methods for improvement
- Improve human performance components of bulk power system reliability

Key Deliverables and Resource Drivers

Critical Infrastructure Protection

- Increase support for CIP aspects of Regional Entity audit oversight
- Support to Standards, Training, ESCC, CIP Working Groups
- Enhance BPS threat and vulnerability information sharing through ES-ISAC

Key Deliverables and Resource Drivers

Training

- Expand training and education programs
  - Standards
  - Lessons learned
  - Risks, trending, common causes
  - Effective root cause analysis
  - Reduce human performance errors
- Upgrade SOCCED database

Key Deliverables and Resource Drivers

Information Technology

- Common, enterprise-wide technology platform
- Data warehouse design
- Enhanced disaster recovery
- Laptop backup application
- Phase II of the NERC public website upgrade
- Enhance or replace applications

Increased Budget Detail

- Department level information
- More details regarding activities/deliverables
- Reconciles headcount versus FTE additions
- Greater contract and consulting budget detail
- Working capital and contingency operating reserves
  - Proposed policy and guidelines
  - Projected starting and ending balance
- Second Draft will include:
  - A detailed capital expenditures budget
  - Additional meeting expense detail

Highlights of 2013 Projection

- Projected $3.7M reduction in cost of current operations
- Projected new funding of $4.6M
- No additional working capital funding currently contemplated
- $933K (1.8%) overall increase in operating costs and capital expenditures
- Below forecast in 3-year plan

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2013 Projected Cost of Current Operations

2012 Base Operating Budget		2013 Projected Change in Base Operating Budget	Projected 2013 Base Operating Budget
$ 33,005,812	Total Personnel Expense	$ (2,239,576)	$ 30,766,236
$ 3,872,780	Total Meeting Expense	$ 50,000	$ 3,922,780
$ 8,287,314	Contracts and Consultants	$ (1,699,467)	$ 6,587,847
$ 7,174,276	Operating Expenses	$ 215,743	$ 7,390,019
$ 772,090	Capital Expenditures	$ -	$ 772,090
$ 53,112,272	Total Base Operating Budget	$ (3,673,300)	$ 49,438,972

2013 Incremental Resource Requirements and Costs

Projected 2013 Base Operating Budget		Projected inc(dec) in Staffing and Programs
$ 30,766,236	Total Personnel Expense	$ 1,100,474
$ 3,922,780	Total Meeting Expense	$ -
$ 6,587,847	Contracts and Consultants	$ 1,934,500
$ 7,390,019	Operating Expenses	$ 150,000
$ 772,090	Capital Expenditures	$ 1,421,100
$ 49,438,972	Total Base Operating Budget	$ 4,606,074

Total Projected 2013 Budget Increase

Total Projected Increase 2013 v 2012 Budget				Total Projected 2013 Budget
$	(1,139,102)	-3.5%	Total Personnel Expense	$ 31,866,710
$	50,000	1.3%	Total Meeting Expense	$ 3,922,780
$	235,033	2.8%	Contracts and Consultants	$ 8,522,347
$	365,743	5.1%	Operating Expenses	$ 7,540,019
$	1,421,100	184.1%	Capital Expenditures	$ 2,193,190
$	932,774	1.8%	Total Base Operating Budget	$ 54,045,046

Total Projected 2013 Staffing by Program Area

Total Headcount by Program Area	Total Headcount 2013 Budget	New Positions*
STATUTORY		
Operational Programs		
Reliability Standards	27.00	3.00
Compliance Operations and Organization Registration	19.00	
Compliance Enforcement, Reporting, Tracking and Analysis	21.00	
Events Analysis and Investigations	15.50	1.00
Reliability Assessments and Performance Analysis	19.00	1.00
Training, Education and Operator Certification	8.00	1.00
Situation Awareness	6.50	
Critical Infrastructure Protection	20.00	3.00
Total Headcount Operational Programs	**136.00**	**9.00**
Total Headcount Administrative Programs**	**52.00**	**-**
Total Headcount	**188.00**	**9.00**

*New positions in 2012 and/or 2013

**Includes interdepartmental transfers where the transferee was not replaced.

Recap of Cost Increases and Funding requirements

Change in Funding Requirement 2013 v 2012			% of Total 2012 Budget
Current Operations	$	(3,673,300)	-6.9%
Proposed 2013 Resource additions	$	4,606,074	8.7%
Total Funding Requirement	$	932,774	1.8%

Increase (Decrease) in 2013 Assessment			% of 2012 Assessments
Due to current operations	$	(3,673,300)	
Due to proposed resource additions		4,606,074	
Due to change in other funding sources		250,000	
Due to Penalty Offset		(2,412,508)	
Use of Working Capital-SOCCED Database		(250,000)	
Total	$	(1,479,734)	-2.9%

Next Steps — Schedule

- May 18 — Comments due on first draft of NERC Business Plan and Budget
- May 18 — FAC web-x to review draft Regional Entity Business Plans and Budgets
- May 25 — NERC posts second draft of Business Plan and Budget; will include 3-year projections, assessment and working capital detail
- June 25 — Comments due on second draft of NERC Business Plan and Budget
- July 19 — FAC web-x to review final Regional Entity Business Plans and Budgets

Next Steps — Schedule

- Aug. 15 — FAC meeting to approve final NERC, Regional Entity Business Plan and Budgets and assessments
- Aug. 15 — Board of Trustees meeting to approve final NERC BP&B, Regional Entity BP&Bs and assessments
- Aug. 24 — Submit ERO BP&B and assessments to FERC for approval and file with Canadian authorities

Questions

Questions



NERC
NORTH AMERICAN ELECTRIC RELIABILITY CORPORATION

Reliability Standards

Definition of Bulk Electric System (DBES) Phase 2 Project Update

Peter Heidrich, FRCC

Member Representatives Committee Meeting
May 8, 2012

RELIABILITY | ACCOUNTABILITY






Topics

- Phase 2 - Purpose
- Recent Developments
- Technical Justification Project
- Standard Drafting Team (SDT) Activities
- Project Milestones

Phase 2 Purpose

- Phase 2 of the project is being initiated to:
  - Develop appropriate technical justification to support refinements to the definition suggested by stakeholders during Phase 1
  - To refine the definition as technically justified

Recent Developments

- Technical Justification Project Plan established with NERC Planning Committee (PC)
- SAR finalized and accepted by NERC Standards Committee for development
- Project Schedule approved by NERC Standards Committee

Technical Justification Project Plan

- NERC PC Executive Committee established as 'lead' for development of 'technical justification'
- Assigned Subject Matter Experts to Address Deliverables:
  - 'Bright-line' voltage level – *PC ExCom*
  - Generator threshold – *Reliability Assessment Subcommittee*
  - Reactive resource threshold level – *System Analysis and Modeling Subcommittee*
  - Power flow out of Local Networks – *System Analysis and Modeling Subcommittee*

DBES SDT Activities

- Phase 1
  - Development of Guidance Document
- Phase 2
  - Support of Technical Justification Effort
    - Establish liaisons with PC Groups
    - Participating in meetings and calls
  - Clarify issues identified in Phase 1

Project Milestones

- DBES SDT
  - Posting of Guidance Document
    - Posting for industry comment will occur following NOPR or Order from FERC on initial BES filing
- NERC PC Groups
  - Technical Justification Analysis Documents
    - Deliverable target date: December 2012



Question & Answer

Website: http://www.nerc.com/filez/standards/Project2010-17_BES.html

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Risk-Based Compliance Monitoring: A Focus on Reliability

Michael Moon, Director of Compliance Operations

Member Representatives Committee Meeting

May 8, 2012

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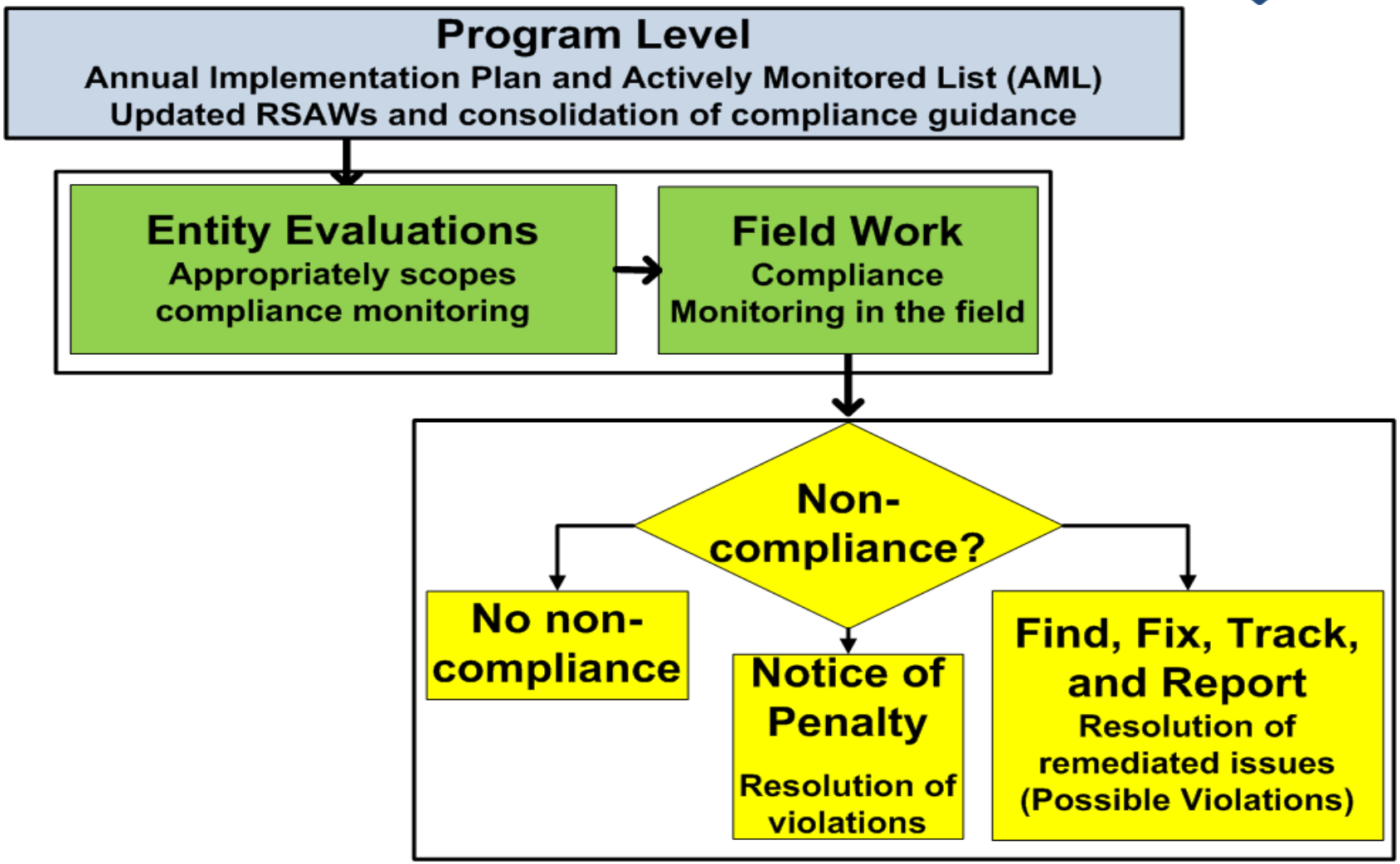





Risk-Based Compliance Monitoring

- Efforts began: 2010
- Goal: Refine compliance to support reliability
  - Greater analysis for Annual Implementation Plan and Actively Monitored List (AML)
  - Discussions to appropriately scope monitoring activities
  - White paper developed by Tom Burgess
  - NERC Compliance and Certification Committee (CCC) also provided insight and perspective

Levels to Consider Risk



What Would Success Look Like?

- Emphasis on reliability and less on compliance bureaucracy
- Compliance programs that are forward-looking
- Entity assessments that justify scope of monitoring
- Greater consideration of internal controls
- Industry finds, fixes, tracks, and reports (FFT mechanism)
- Focus resources on high risk reliability issues

Questions

Questions



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Status of Underfrequency Load Shedding Activities

Herb Schrayshuen, Vice President and Director of Standards and Training

Member Representatives Committee Meeting

May 8, 2012

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PRC-006-1

- The Board of Trustees requested a summary of the status of the PRC-006 (Underfrequency Load Shedding)
  - The petition was filed in 2010
  - FERC issued a NOPR in 2011, which is still under consideration

Overview of PRC-006-1

- PRC-006-1 establishes design and documentation requirements for automatic Underfrequency Load Shedding (UFLS) to:
  - Arrest declining frequency
  - Assist recovery of frequency following under-frequency events
  - Provide last resort system preservation measures.
- The standard contains regional variances for WECC and the Quebec Interconnection

Planning Coordinator (PC) Role

- PC has a “wide area” view
  - Some regions have many PCs
  - Others have only a few

Regional Responses

- Regional Report – responses vary
  - Some regions have an approved regional standard
  - Others will rely strictly on the application of the continent-wide standard
  - Others are waiting to see the outcome of the NOPR process

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Status of Operating Communications Protocols

Herb Schrayshuen, Vice President and Director of Standards and Training

Member Representatives Committee Meeting

May 8, 2012

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Status of Communications

- COM-002, Communications and Coordination Interpretation
- COM-003, Operating Personnel Communication Protocol Standard
- NERC Operating Committee Reliability Guideline
- Revised Reliability Standard Audit Worksheet (RSAW) for the COM-002 Interpretation
- COM-002 interpretation Petition

Goals

- File COM-002 interpretation that provides a comprehensive communications strategy
- Industry strongly support COM-003
- Industry embrace the Reliability Guideline

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Recommendations from 2011 Southwest Outage

Heather Polzin, FERC Office of Enforcement
Dave Nevius, Senior Vice President, NERC
Member Representatives Committee Meeting
May 8, 2012

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NORTH AMERICAN ELECTRIC RELIABILITY CORPORATION

September 8, 2011 Event

- 11 minute cascading outage in Pacific Southwest
- 2.7 million customers out in AZ, S.CA, MX (up to 12 hrs.)
- Initiated when single 500 kV line tripped; not sole cause
- Power redistributed, increasing flows, dropping voltages and overloading equipment in underlying systems
- Led to tripping lines, generators, automatic load shedding, and operation of RAS and intertie separation scheme
- Restoration process generally effective

Customer Impacts

Entity	Load Lost (MW)	Customers
SDGE	4,293	1.4 million
CFE	2,150	1.1 million
IID	929	146 thousand
APS	389	70 thousand
WALC	74	Note

Note: 64 MWs of WALC's load loss affected APS's customers

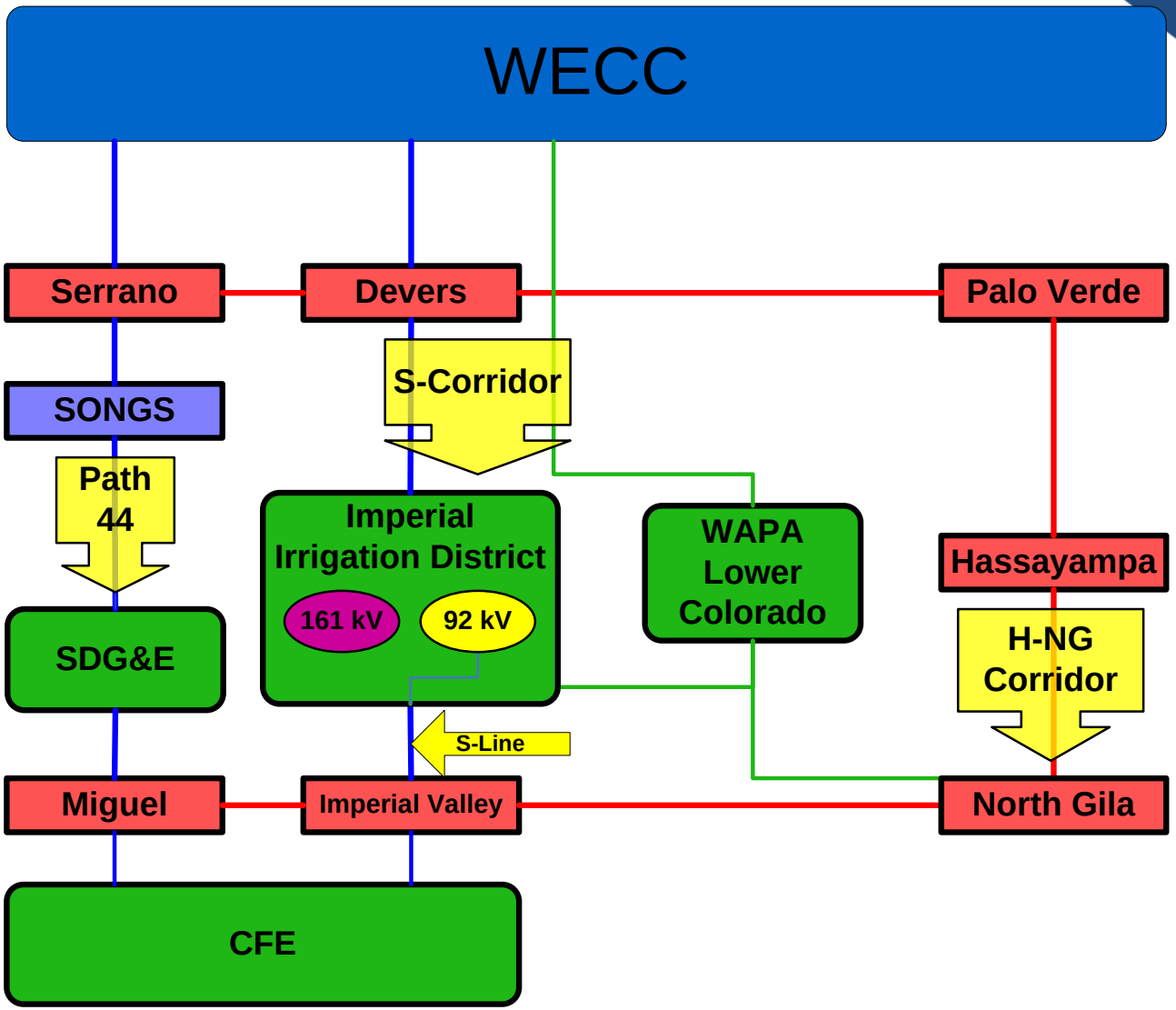
Joint FERC/NERC Inquiry

- Inquiry announced September 9, 2012
- Teams formed comprising over 30 senior technical staff of FERC and NERC
- Multiple meetings/exchanges with affected entities
- Team products combined into final report
- Outreach sessions on draft findings and recommendations

Inquiry Teams

- Data Requests/Management
- Sequence of Events
- Modeling/Simulation
- Cause Analysis/Human Performance
- Operations Tools/ SCADA/EMS
- Frequency Analysis
- System Planning/Design
- Equipment Performance/System Protection
- Restoration

Simplified System Diagram



Key Findings

Weaknesses in two broad areas:

- Operations planning
- Real-time situational awareness

Contributing factors:

- Impact of sub-100 kV facilities operating in parallel with higher voltage systems
- Failure to recognize IROLs
- Not studying/coordinating effects of protection systems and RAS during contingency scenarios
- Not providing effective operator tools and instructions for reclosing lines with large phase angle differences

Operations Planning

Failure to consider in seasonal, next-day, and real-time studies:

- Status of external generation and transmission facilities
- Impact of external contingencies
- Impacts on external systems
- Impact on BPS reliability of sub-100 kV facilities operating in parallel with higher voltage systems

Operations Planning

Recommended TOP/BA Improvements in WECC:

- Obtain information on neighboring BAs and TOPs, including transmission outages, generation outages and schedules, load forecasts, and scheduled interchanges
- Identify and plan for external contingencies that could impact their systems and internal contingencies that could impact neighbors' systems
- Consider sub-100 kV facilities operating in parallel with higher voltage systems that could impact BPS reliability
- Coordinated review of planning studies to ensure operation of affected Rated Paths will not result in reliability problems

Situational Awareness

Recommended Improvements in WECC:

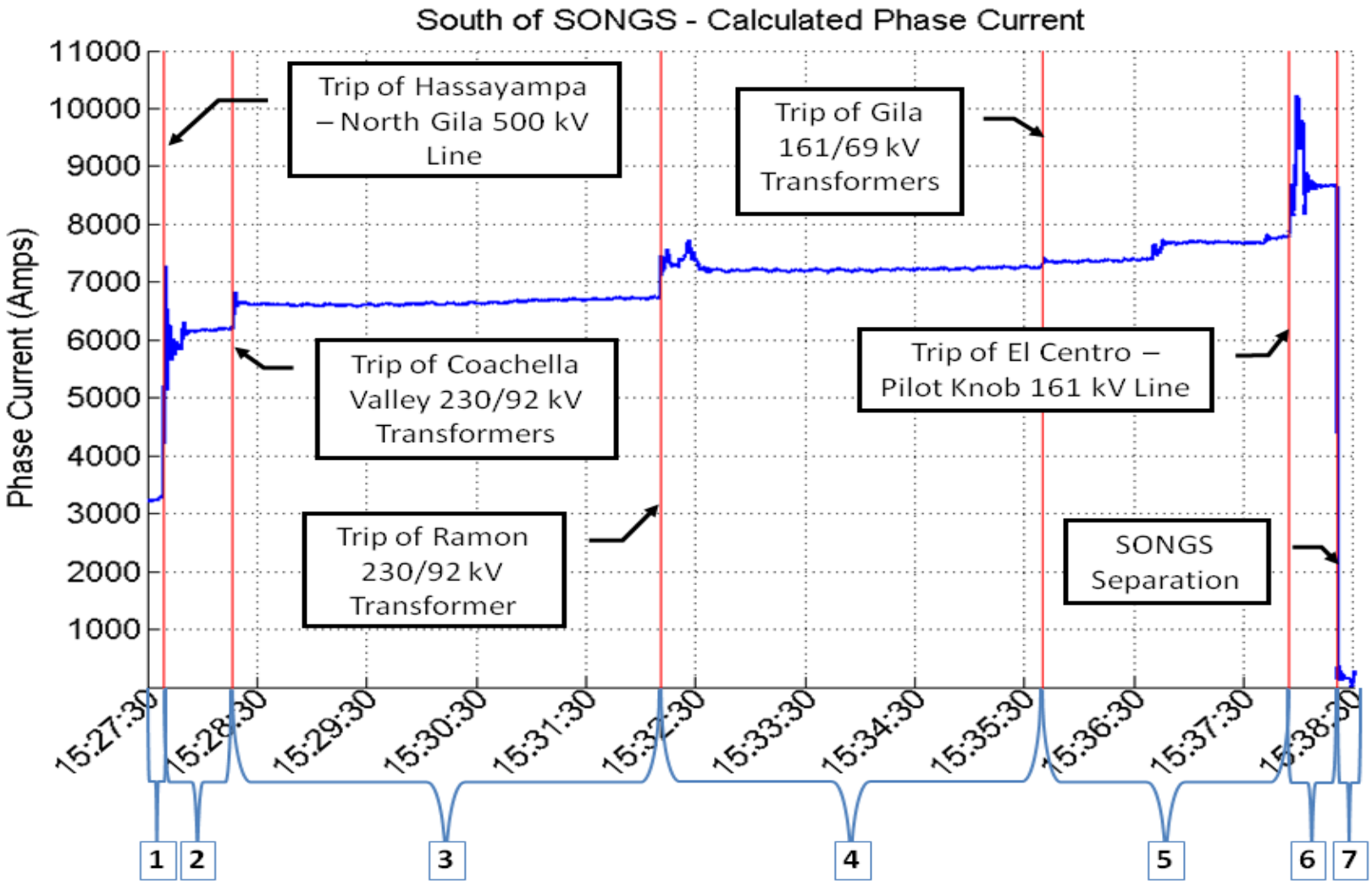
- Expand entities' external visibility in models through more complete data sharing
- Improve use of real-time tools to ensure constant monitoring of potential internal or external contingencies
- Improve communications among entities to help maintain situational awareness
- TOPs should review their real-time monitoring tools (State Estimator and RTCA) to ensure critical facilities are represented

System Protection Issues

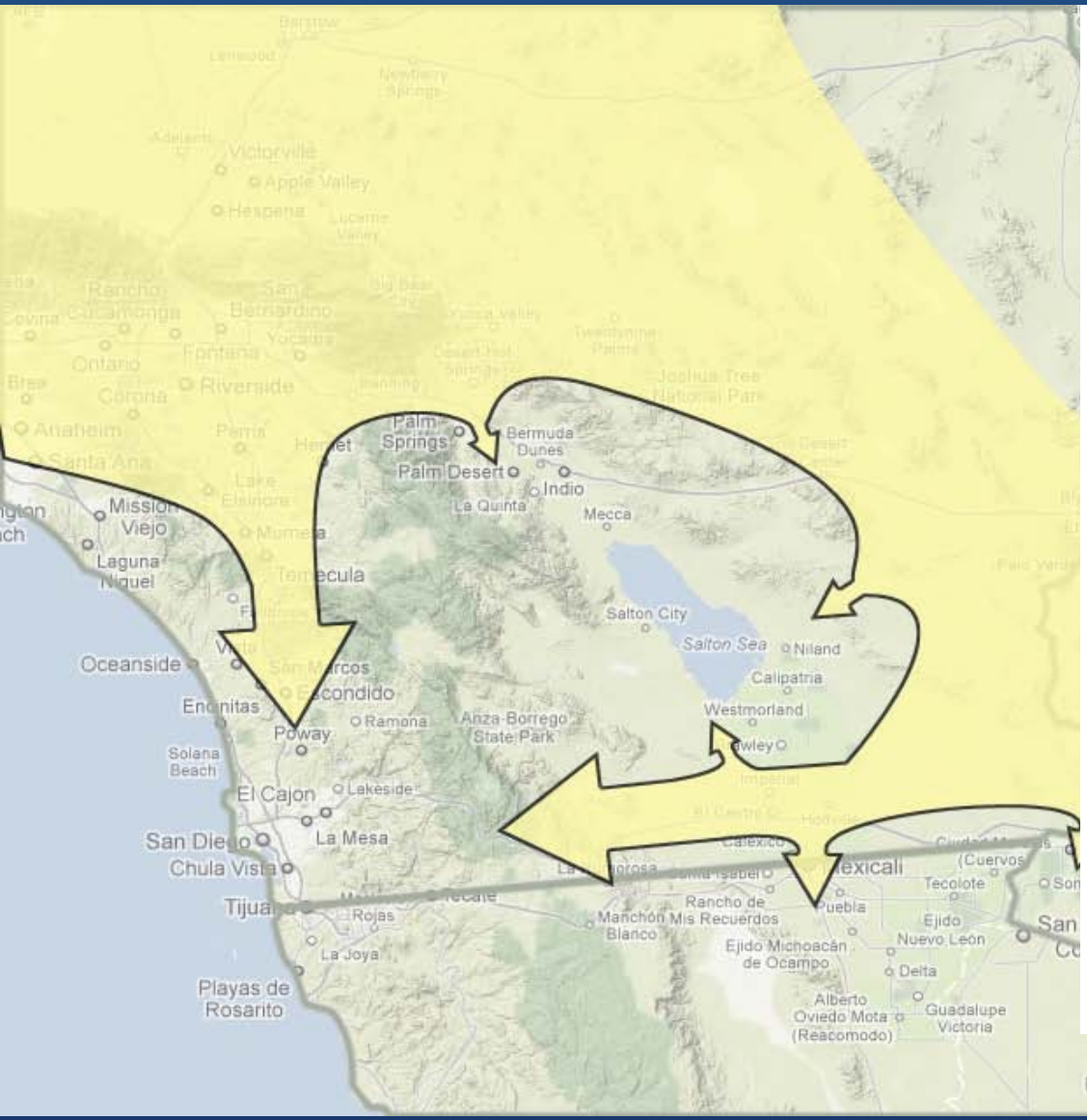
Recommendations:

- IID and other TOs review transformer overload protection relay settings
- TOPs plan to take proper pre-contingency mitigation measures considering emergency ratings and overload protection systems
- All protection systems and separation schemes (Safety Nets, RAS, and SPS) studied and coordinated periodically to understand their impact on BPS reliability to ensure no unintended or undesirable effects

7 Phases of Event

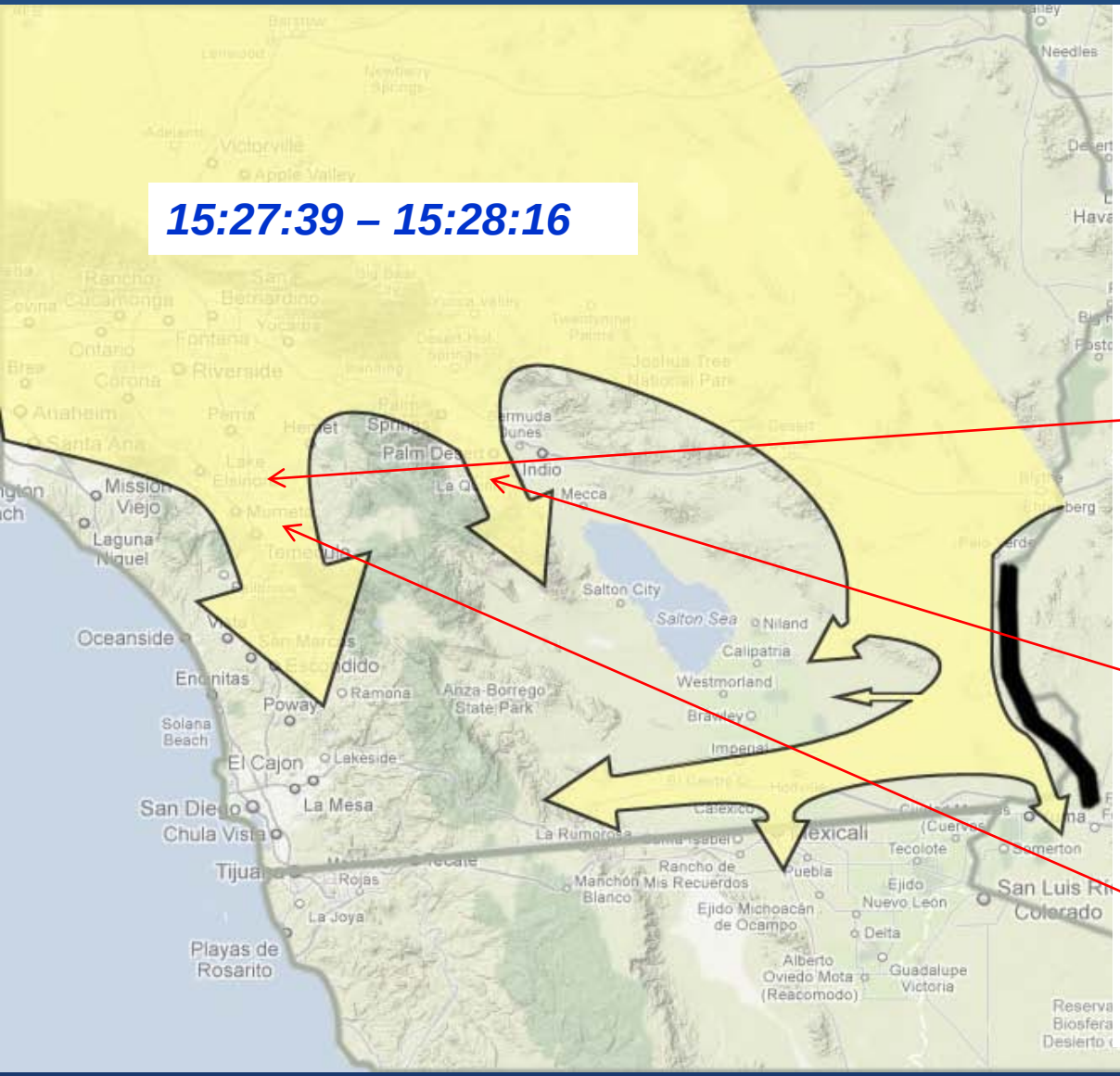


Phase 1 – Pre-Disturbance



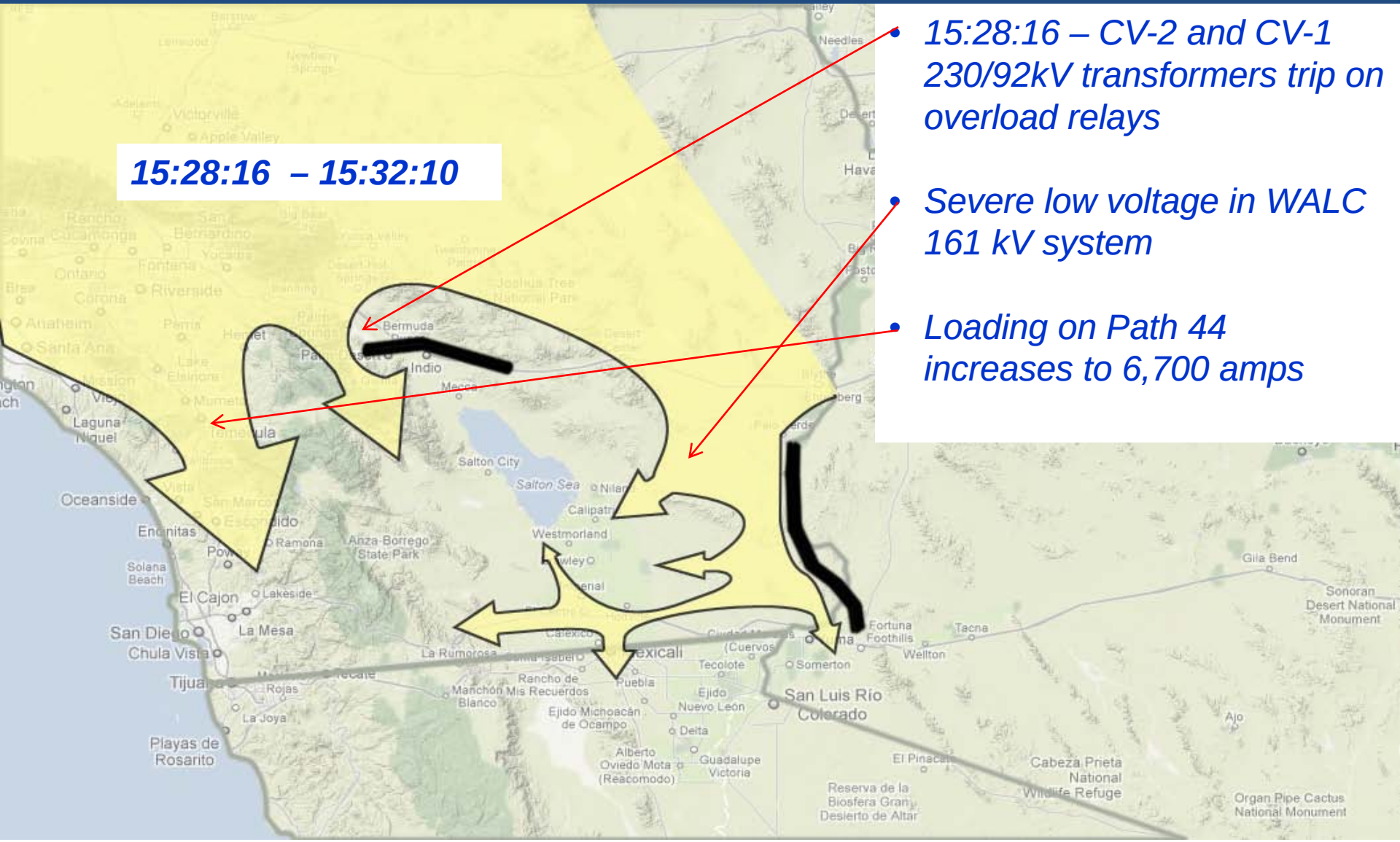
- *Hot, shoulder season day; some generation and transmission outages*
- *High loading on some key facilities: H-NG at 78% of normal rating; CV transformers at 83%*
- *44 minutes before loss of H-NG, IID's RTCA results showed loss of CV-1 transformer would load CV-2 transformer above its relay trip point*
- *15:27:39: APS technician skipped a critical step in isolating the series capacitor bank at North Gila substation; H-NG trips*

Phase 2 – Trip of H-NG 500 kV



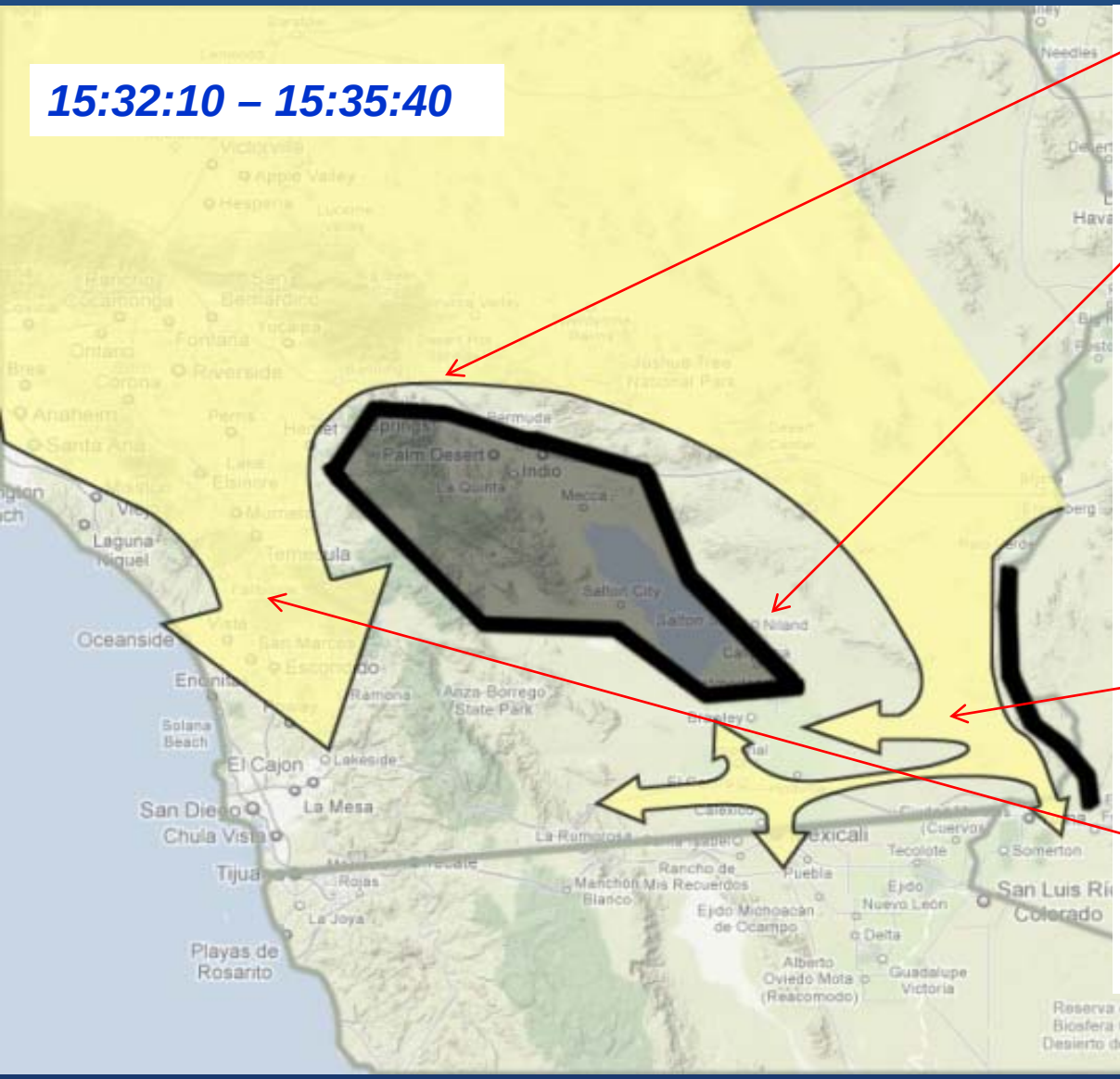
- *H-NG 500 kV trips at 15:27:39*
- *APS tells WECC RC line expected to be restored quickly*
- *SCE-SDGE flow (Path 44) increases by 84%; IID and WALC systems pick up 23% of H-NG flow*
- *CV transformers immediately overloaded above relay settings*
- *Path 44 at 5,900 amps; 8,000 amp limit on SONGS separation scheme*

Phase 3 – Trip of CV Xfmrs



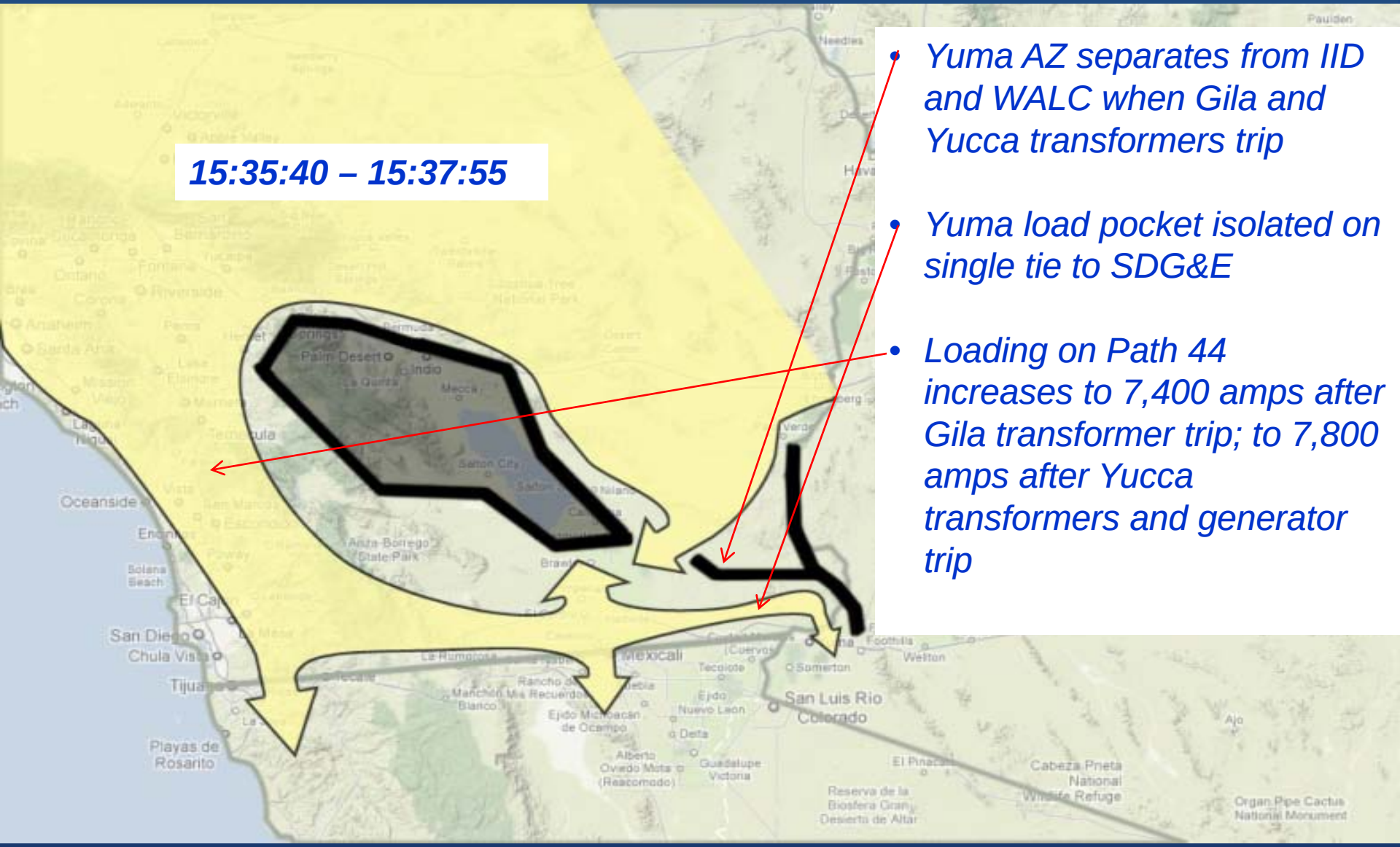
- *15:28:16 – CV-2 and CV-1 230/92kV transformers trip on overload relays*
- *Severe low voltage in WALC 161 kV system*
- *Loading on Path 44 increases to 6,700 amps*

Phase 4 – Ramon Xfmr Trip



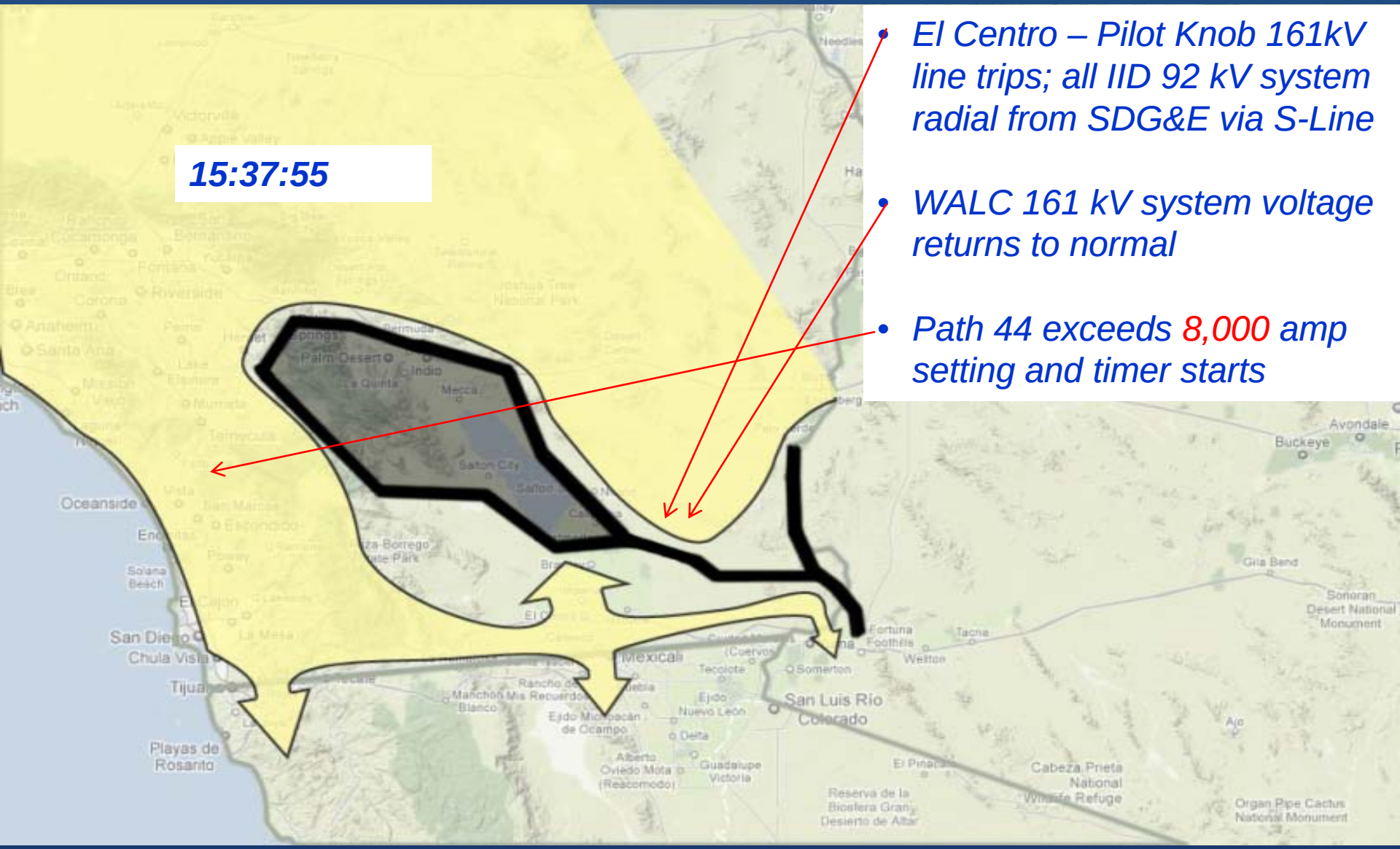
- *15:32:10 Ramon 230/92kV transformer trips on overload relay*
- *15:32:13 – 15 Blythe-Niland and Niland – CV 161kV lines trip*
- *IID undervoltage load shedding; loss of generation and 92 kV transmission lines*
- *Severe low voltage in WALC 161 kV system*
- *Loading on Path 44 increases to 7,800 amps; settles at 7,200 amps*

Phase 5 – Yuma Separates



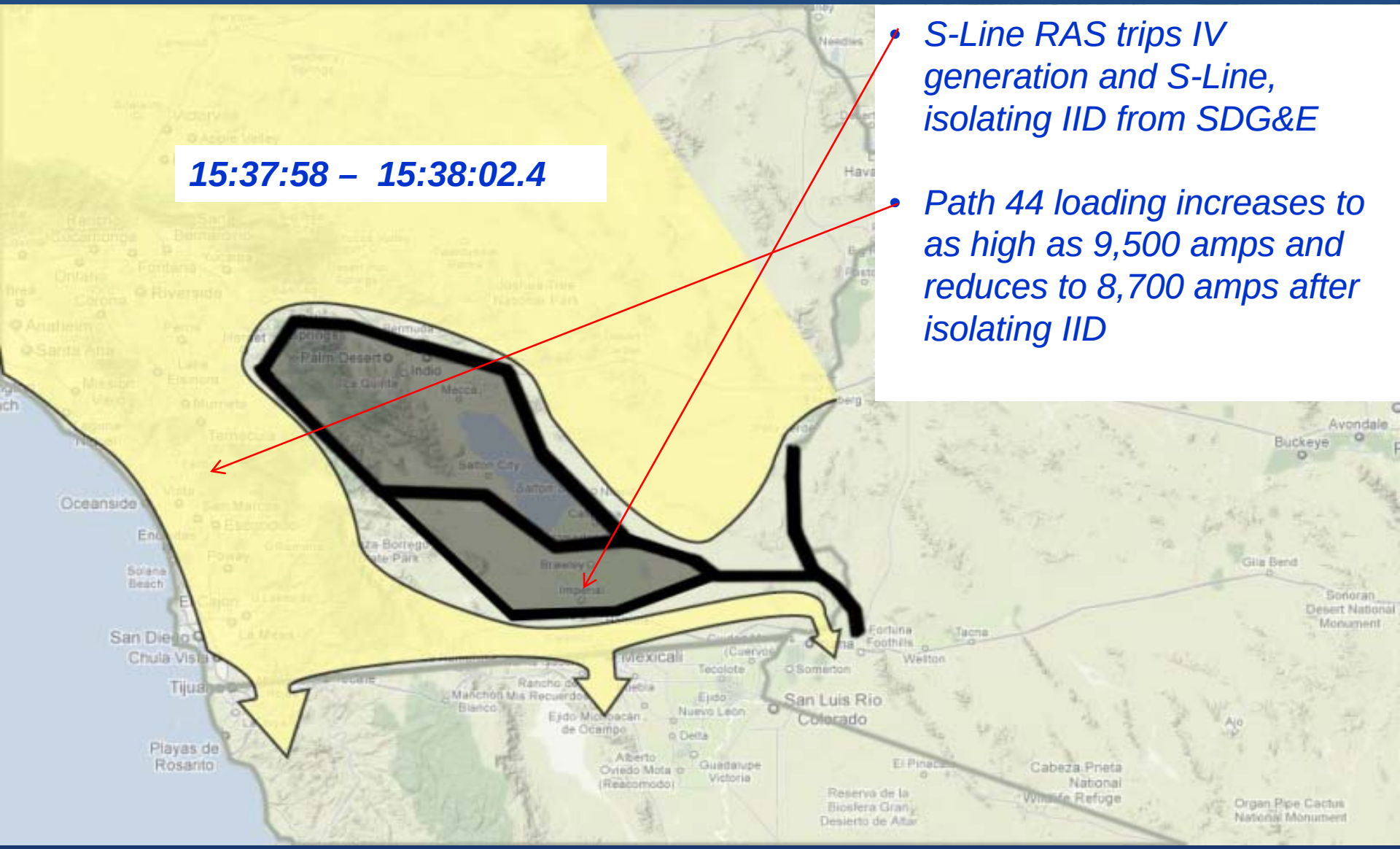
- *Yuma AZ separates from IID and WALC when Gila and Yucca transformers trip*
- *Yuma load pocket isolated on single tie to SDG&E*
- *Loading on Path 44 increases to 7,400 amps after Gila transformer trip; to 7,800 amps after Yucca transformers and generator trip*

Phase 6 – High-Speed Cascade



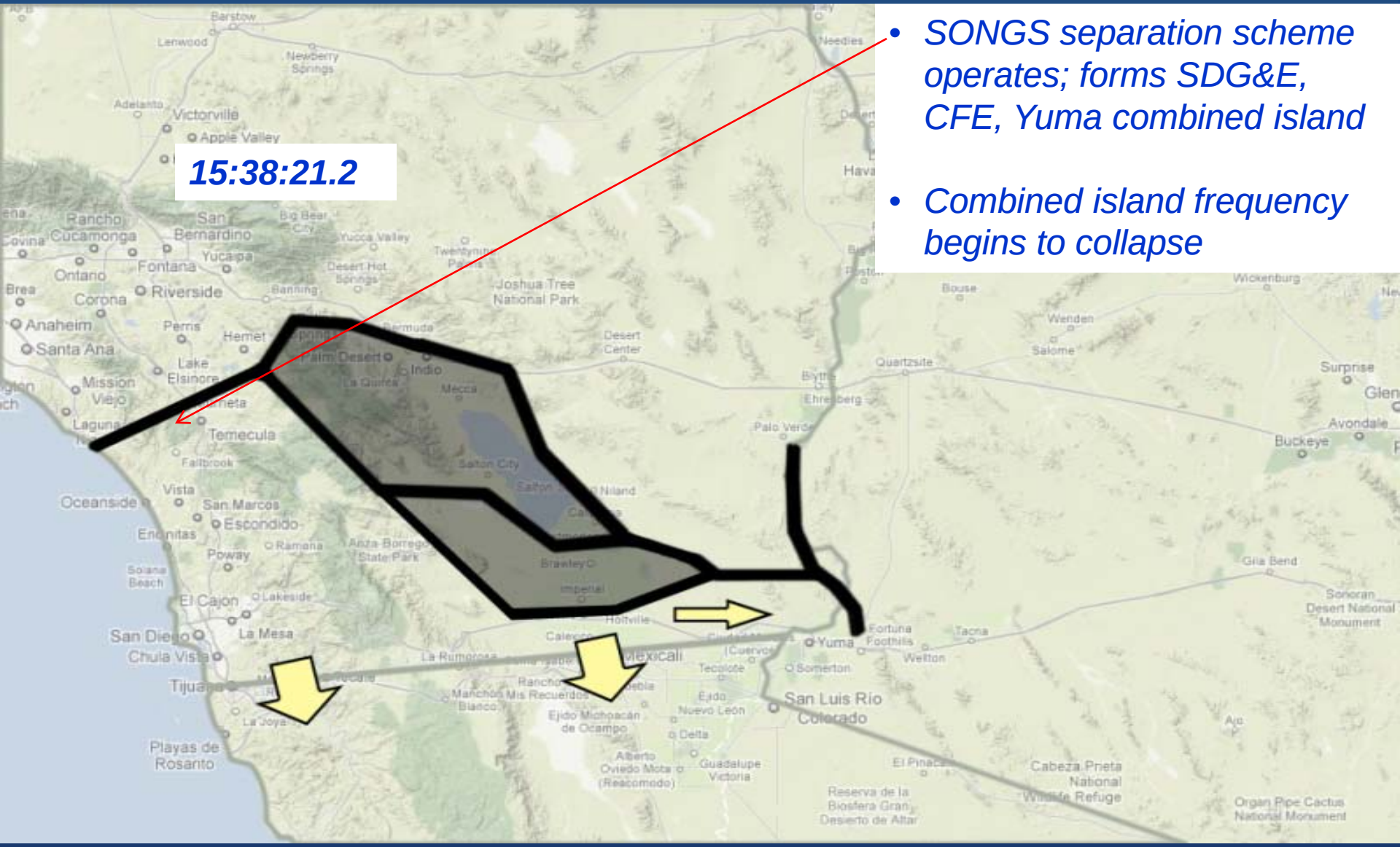
- *El Centro – Pilot Knob 161kV line trips; all IID 92 kV system radial from SDG&E via S-Line*
- *WALC 161 kV system voltage returns to normal*
- *Path 44 exceeds 8,000 amp setting and timer starts*

Phase 6 – High-Speed Cascade



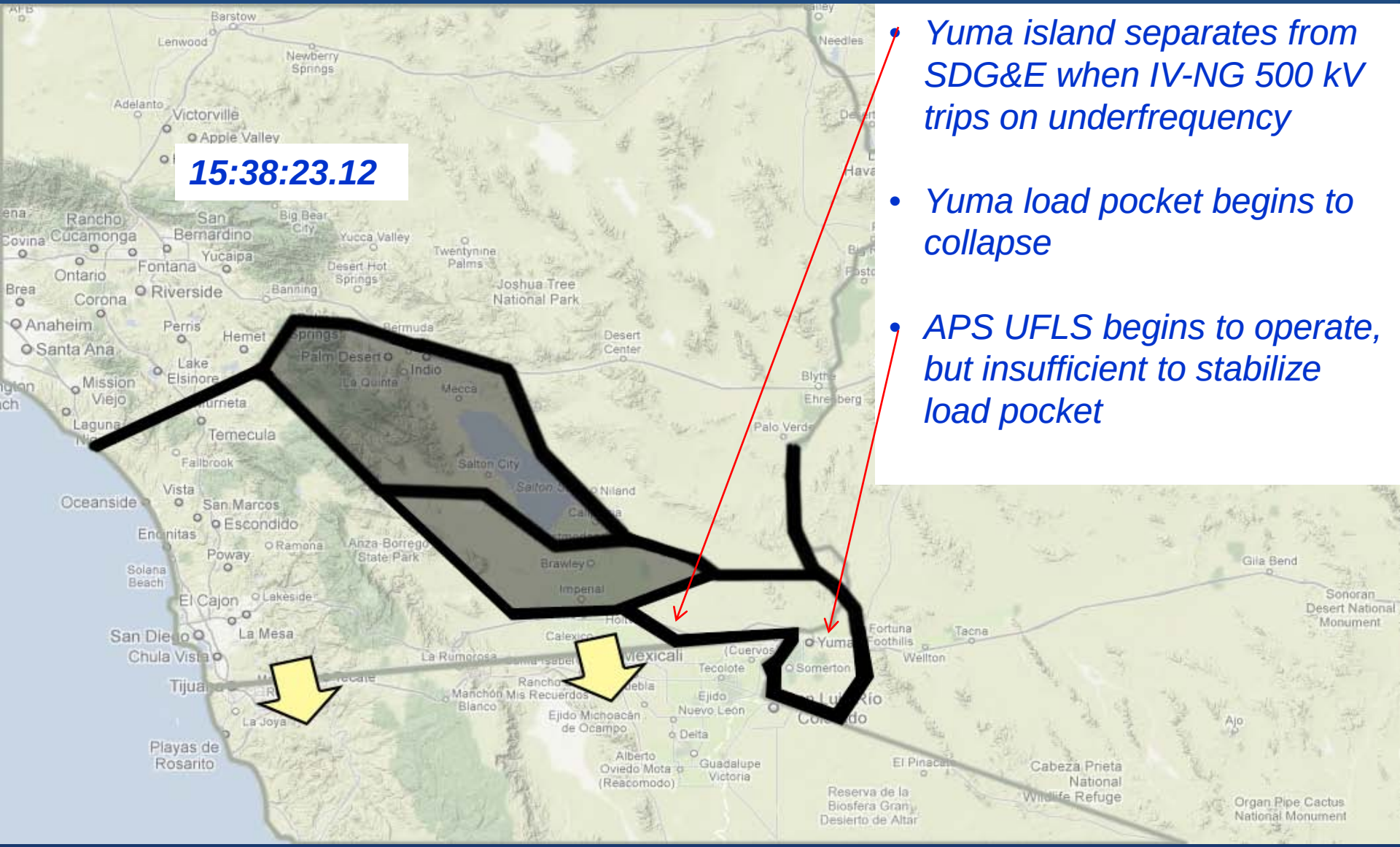
- *S-Line RAS trips IV generation and S-Line, isolating IID from SDG&E*
- *Path 44 loading increases to as high as 9,500 amps and reduces to 8,700 amps after isolating IID*

Phase 6 – High-Speed Cascade



- *SONGS separation scheme operates; forms SDG&E, CFE, Yuma combined island*
- *Combined island frequency begins to collapse*

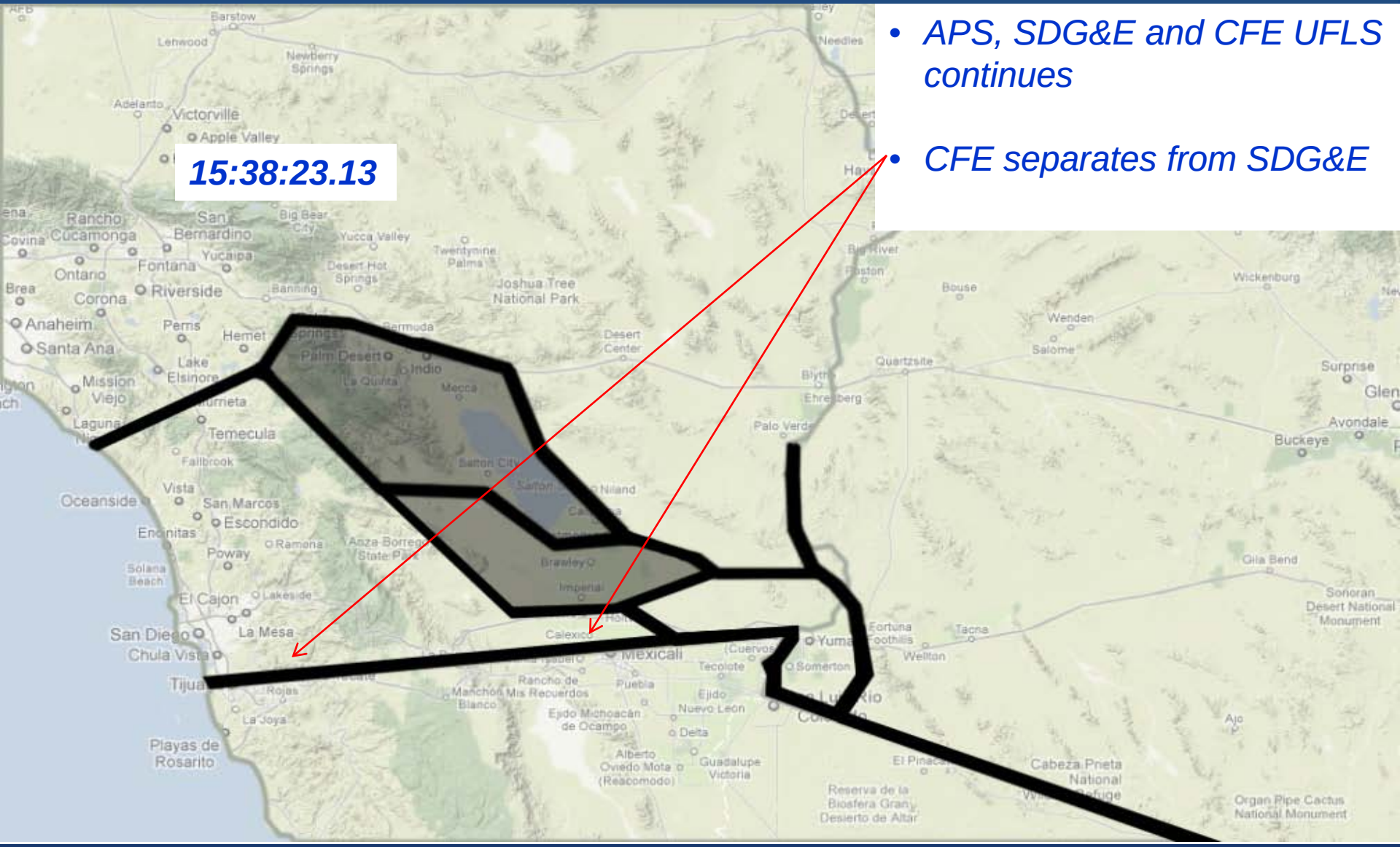
Phase 7 – Yuma Separates



- *Yuma island separates from SDG&E when IV-NG 500 kV trips on underfrequency*
- *Yuma load pocket begins to collapse*
- *APS UFLS begins to operate, but insufficient to stabilize load pocket*

Phase 7 – CFE Separates

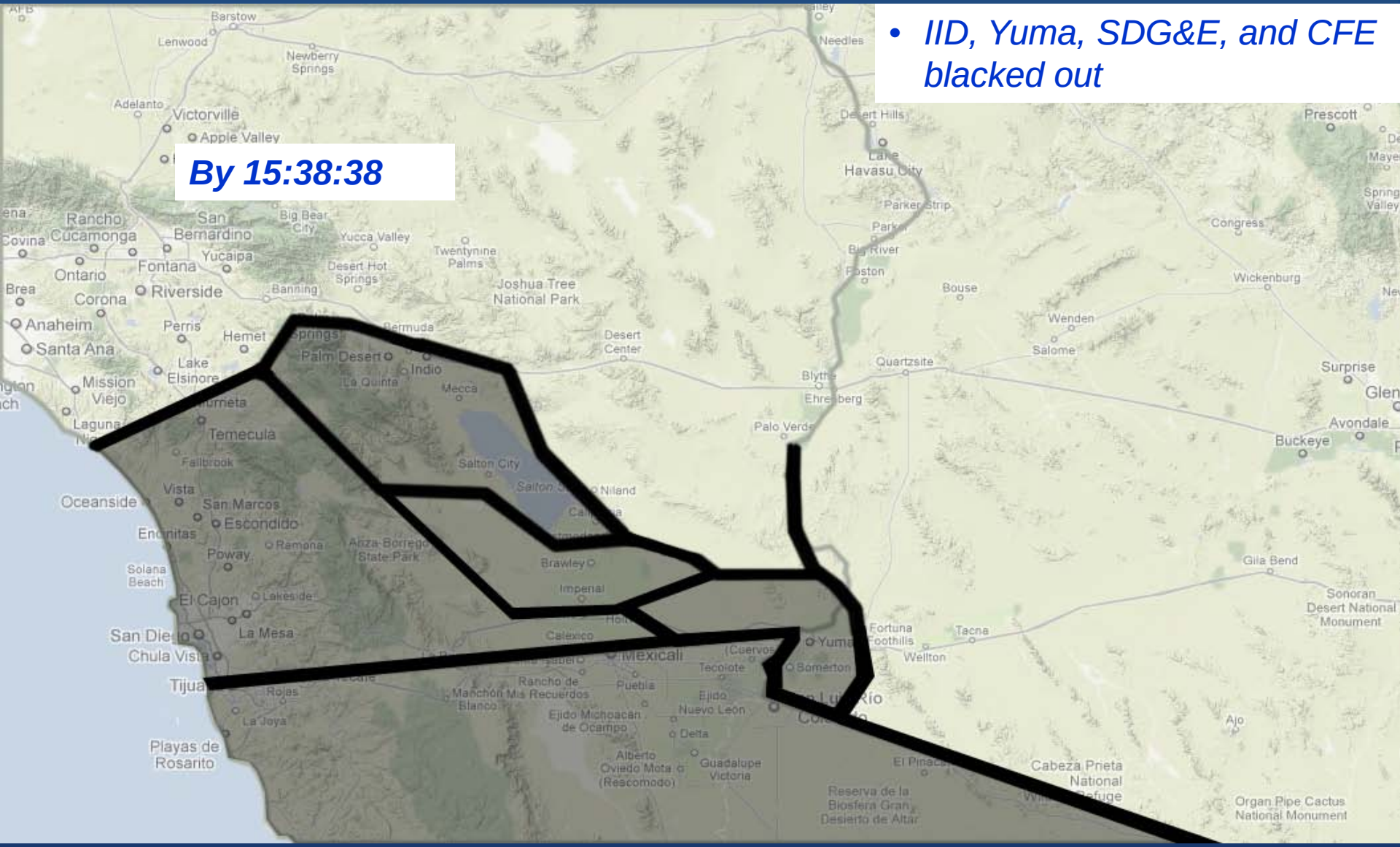
- *APS, SDG&E and CFE UFLS continues*
- *CFE separates from SDG&E*



Phase 7 – Complete Blackout

- *IID, Yuma, SDG&E, and CFE blacked out*

By 15:38:38





Questions?

PJM's Culture of Compliance a Culture of Excellence

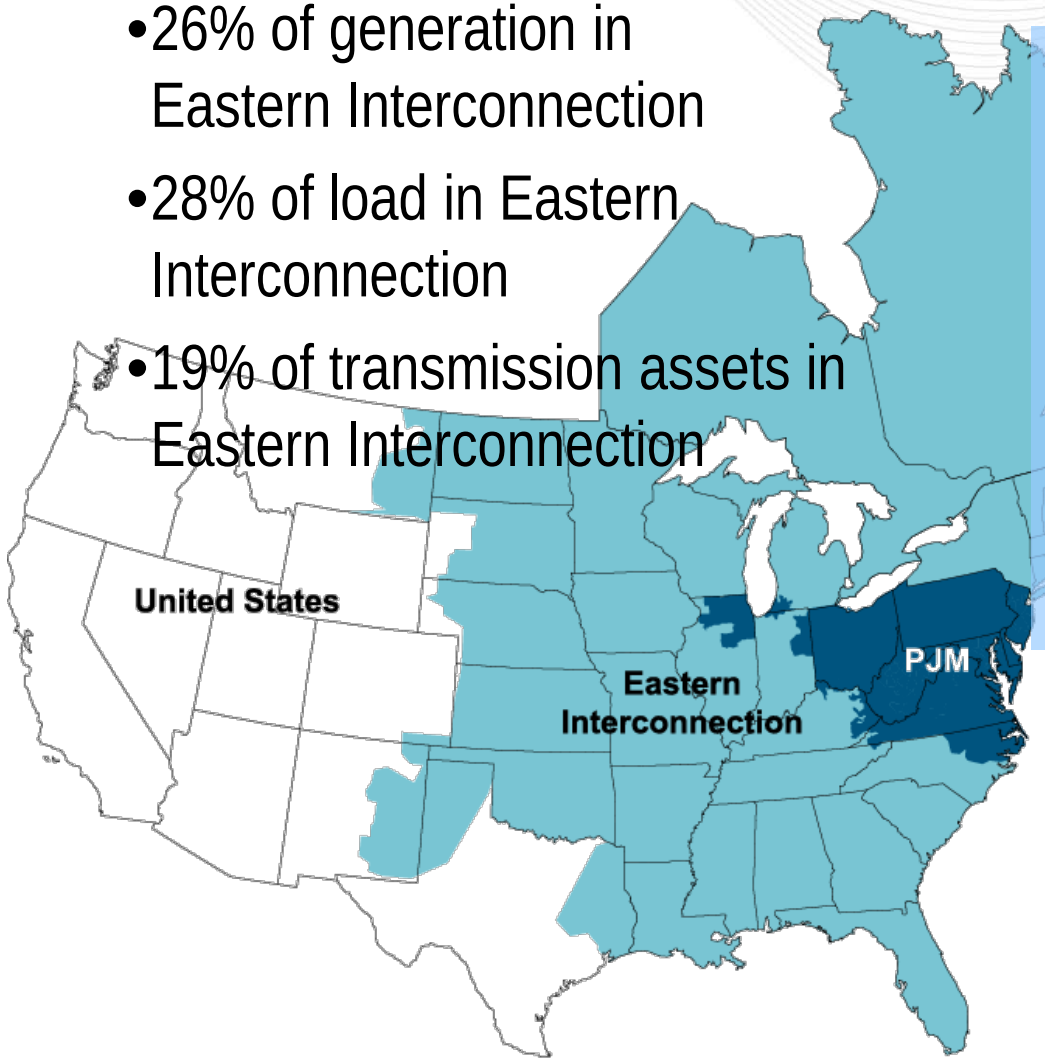
(The Little Things Matter)

Tom Bowe
Executive Director
Reliability and Compliance
NERC MRC Meeting, May 2012

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PJM as Part of the Eastern Interconnection

- 26% of generation in Eastern Interconnection
- 28% of load in Eastern Interconnection
- 19% of transmission assets in Eastern Interconnection



KEY STATISTICS	
Millions of People Served	60
Peak Load In Megawatts	163,848
MW of Generating Capacity	185,600
Miles of Transmission Lines	65,441
GWh of Annual Energy	832,331
Generation Sources	1,365
Area Served	13 States + DC

21% of U.S. GDP produced in PJM

As of 1/4/2012

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- Something Different . . .
  - Discuss PJM's Compliance Culture in action . . . How does it manifest itself in:
    - » Events Analysis
    - » Required Self Certifications
    - » RFC/NERC/FERC Audits
    - » Self Reports

Smallest of Leader Actions

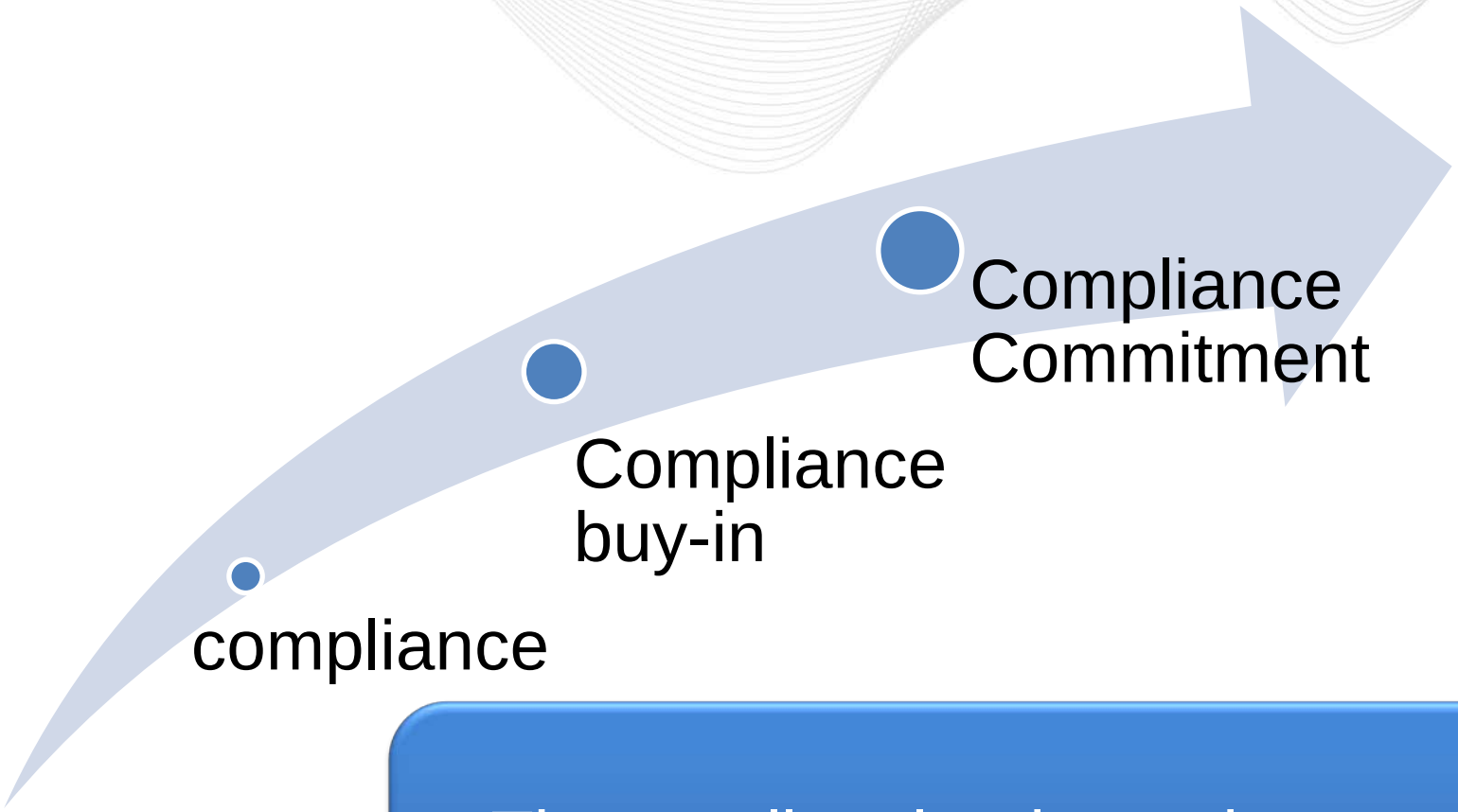
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Key Elements – The Fundamentals

- We are Not Perfect – yet strive for 100%
- Senior Leader & Board Engagement
- Organization-wide Compliance Goals
- Independent Organizational Oversight
- Frontline Ownership
- Embed compliance into the day-to-day – to achieve Muscle Memory
- Continual Improvement – avoiding repeat issues
- Sharing with others – PJM Members, Peers & Industry

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The Small Things as Catalyst of Change



The smallest leader actions can move us to greater commitment.

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Observation Points into PJM's Compliance Culture

Activity
Events Analysis
Required Self Certifications
RFC/NERC/FERC Audits
Self Reports

TRIGGER

CULTURAL ARTIFACTS

ENGAGEMENT VALUE

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Events Analysis

TRIGGERS	CULTURAL ARTIFACTS	ENGAGEMENT VALUE
Daily Operational Review	Rapid Root Cause Analysis	Leaders' Focus on What vs. Who
EAWG Process Triggers or Not	Reporting & Active Outreach	Knowledge Mgt & Transfer
PJM and/or Member Dissatisfaction	Lessons Learned Driving Training & Process Changes	We Improve Together
	Self Reports	Enhanced Reliability
	Sharing	

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Required Self Certifications

TRIGGERS	CULTURAL ARTIFACTS	ENGAGEMENT VALUE
Self Certification Schedule & Proactive Preparations	Compliance Staff as Partners	Leaders' Active Engagement Demonstrating Importance
Spot Checks	Reviewing Controls & Evidence	Requirement Owners (RO) Defending their case
	Three-Tiered Leader Review	RO Visibility with Leadership
	Self Reports	

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RFC/NERC/FERC Audits

TRIGGERS	CULTURAL ARTIFACTS	ENGAGEMENT VALUE
Audit Prep & Execution	Attitude	Teambuilding Opportunity
	RO's asking for a Challenging Prep	Pride in Showcasing Organization
	Celebrate the Small Things	
NERC & Regional Compliance Seminars	Recognizing Teamwork	Habit vs. Task
	Share the Good the Bad and the not so Attractive	

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Self Reports

TRIGGERS	CULTURAL ARTIFACTS	ENGAGEMENT VALUE
Corporate Goal Not Absolute 100%	Owners Present Possible Issues	Leaders' Focus on What vs. Who
Possible Violation = The Slightest Grey	Oversight Committee Review	Reinforce Requirement Owners' Responsibilities
Great People doing their daily work	Owners write Self Reports & Mitigation Plans	Improved Processes and/or New Applications
	Lessons Learned	
	Board Reactions	

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Questions



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From:	Eleanor Crouch
To:	Eleanor Crouch
Subject:	NERC ANNOUNCEMENT: Member Representatives Committee (MRC) and Board of Trustees (BOT) Meetings-August 15-16, 2012 | Quebec, QC, Canada
Date:	Thursday, May 31, 2012 2:10:50 PM

Meeting Announcement

Member Representatives Committee (MRC)
Board of Trustees (BOT)

August 15-16, 2012 | Quebec, QC, Canada

Click Here for: Meeting Registration

Click Here for: Meeting Details

When making your hotel reservation, please be sure to mention "NERC" to get the preferred rate and ensure your reservation is credited to the NERC room block. The hotel will charge NERC a penalty if the total rooms blocked for this event are not reserved. Also, if you use a travel agency for your travel plans, please make sure the agency mentions NERC.

For more information or assistance, please contact Eleanor Crouch via email or at (404) 446-2572.

3353 Peachtree Road NE
Suite 600, North Tower
Atlanta, GA 30326
404-446-2560 | www.nerc.com

You have received this email because you are a registered representative in the Registered Ballot Body.

From: Eleanor Crouch
To: Eleanor Crouch
Subject: NERC Webinar Announcement: Member Representatives Committee (MRC) Informational Session Webinar and Conference Call | August 8, 2012 | 11:00 a.m. - 1:00 p.m. Eastern
Date: Friday, July 13, 2012 6:29:27 PM

NERC Announcement
Member Representatives Committee
Informational Session Webinar and Conference Call

August 8, 2012 | 11:00 a.m. – 1:00 p.m. Eastern

Participant Dial-in: 800-732-5617 (No pass code necessary)| **Broadcast Audio Code:** 311790

Please note: Participants are requested to dial in 15 minutes prior to the Informational Session for registration purposes.

Presentations for this meeting will be posted by: August 1, 2012

Click Here: Meeting registration/web access

For more information or assistance, please contact Eleanor Crouch (via email) or at (404) 446-2572.

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NERC
NORTH AMERICAN ELECTRIC RELIABILITY CORPORATION

Standards Report

Herb Schrayshuen, Vice President and Director of Standards and Training
Holly Hawkins, Assistant General Counsel for Standards and Critical Infrastructure Protection

Standards Oversight and Technology Committee Meeting
May 8, 2012

RELIABILITY | ACCOUNTABILITY






Standards Program Report

- Standards delivery forecast for the remainder of 2012 and into 2013
- Filed the standards directives status report on March 31, 2012
  - Fifty-eight percent complete
  - All but 17 directives have a forecast delivery date
- Progress made relative to the backlog of interpretations
- Regional standards programs are under review

March 18, 2010 Orders-Completed

- Order directing modifications to NERC ROP pertaining to development of standards (includes FAC-008)
  - March 17, 2011 Order approving Section 321
  - November 17, 2011 Order approving FAC-008-3
- Order approving Transmission Relay Loadability Reliability Standard (PRC-023-1)
  - March 15, 2012 Order approving PRC-023-2

March 18, 2010 Orders-Completed

- NOPR proposing to reject interpretation of TPL-002-0, R1.3.10
  - September 15, 2011 Order approving interpretation
- Order setting deadline for compliance with directives on TPL-002-0 (Table 1, fn. b)
  - March 31, 2011 Petition for approval of fn. b
  - Oct. 19, 2011 Petition for approval of TPL-002-2
  - April 19, 2012 Remand Order (fn. b)
  - April 19, 2012 NOPR proposing to remand TPL-002-2

March 18, 2010 Orders-Pending

- Order No. 743 directing modifications to Bulk Electric System (BES) definition
  - January 25, 2012 petition for approval of revised BES definition
  - January 25, 2012 petition for approval of revisions to Rules of Procedure to adopt BES Exception Procedure
  - January 25, 2012 filings responded to all Order No. 743 directives
  - Phase 2 of BES Project to address issues identified in Phase 1

March 18, 2010 Orders-Open Items

- Order setting deadline for compliance with Order No. 693 Directives on BAL-003 (Frequency Response)
- Order approving the Transmission Relay Loadability Standard (PRC-023-1)
- NOPR on Time Error Correction Standard BAL-004-1
- TPL Table 1, fn. b Remand Order

FERC FFT Order

- FERC Order on Find, Fix, Track and Report – issued March 15, 2012
  - "…some current requirements likely provide little protection for Bulk-Power System reliability or may be redundant. The Commission is interested in obtaining views on whether such requirements could be removed from the Reliability Standards with little effect on reliability and an increase in efficiency of the ERO compliance program."

Related Activities

- NERC has formed a cross-functional internal team to gather data (April 2012)
- NERC will meet with industry and Regional Entity representatives to:
  - Build a database of various parameters for evaluation
  - Assess criteria options and analyze data (May 2012)
  - Determine candidate requirements that may be eligible for removal
- Will provide an opportunity for further stakeholder comments

Questions

Questions



NERC
NORTH AMERICAN ELECTRIC RELIABILITY CORPORATION

Information Technology Update

Marvin Santerfeit, Director of Information Technology and Services
Standards Oversight and Technology Committee Meeting
May 8, 2012

RELIABILITY | ACCOUNTABILITY






Agenda

Overview of Major 2013 Information Technology Initiatives

- Infrastructure Improvement
- Data Warehouse hardware and design

2013 Overview

Significant Initiatives for 2013

- Infrastructure Improvement
  - Improved NERC backup and recovery capability
  - Initial Disaster Recovery (DR) implementation
  - Analysis and selection of an Enterprise-wide technology platform
  - Continued development of major ERO initiatives (Event Analysis, BES, Reliability Assessment Database, RSAW, etc.)
  - Re-write of multiple NERC applications (User Management Program, NERC My Account, etc.)
- Benefits
  - Significantly improved backup and recovery of Servers, Laptops and Database
  - NERC critical infrastructure Disaster Recovery (Phase I) implementation
  - Centralized (ERO) Enterprise class technology platform (collaboration / data sharing)
  - ERO application development - holistic view of data across multiple disciplines

2013 Overview

Significant Initiatives for 2013 (continued):

- Phase I - Data Warehouse hardware, software and design
  - Application analysis, business requirements and development
  - Data Warehouse analysis, schema, architecture
  - Enterprise class hardware and software (servers, network, storage, database)

- Benefits
  - Similar look and feel, data consistency and aligned business requirements
  - Creation of a single data repository accessible across the ERO for data mining and analysis
  - Selection of Enterprise class hardware and software for centralized storage

Questions

Questions



NERC
NORTH AMERICAN ELECTRIC RELIABILITY CORPORATION

April 5, 2012

Mr. Scott Helyer, Chair
NERC Member Representatives Committee
Vice President, Transmission
Tenaska, Inc.
1701 E. Lamar Blvd.
Arlington, Texas 76006

Re: Policy Input to NERC Board of Trustees

Dear Scott:

Congratulations on your first meeting as chair of the Member Representatives Committee (MRC). The Board greatly appreciated the active engagement of committee members in all of the discussions, along with the prepared policy inputs provided to the Board in advance of the meeting.

I have identified below three items on which the Board will be particularly interested in policy input from the MRC members for the upcoming meetings in May. As always, the Board also welcomes input on any other issues that stakeholders wish to provide. I understand the agendas for the MRC and Board meetings are expected to be posted by April 25.

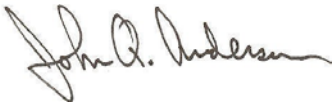
Standards Process Input Group — The Board looks forward to hearing from the MRC Standards Process Input Group (SPIG) on their findings and policy recommendations for improving the existing NERC standards development process and to active discussion of these recommendations by the entire MRC.

2013 NERC and Regional Entity Common Business Plan and Budget Assumptions — NERC and the Regional Entities jointly developed Common Business Plan and Budget Assumptions for the 2013-2015 planning period and posted them for comment on February 21, 2012. The assumptions are being updated in response to comments received from EEI, which have also been posted on the NERC website. Additional comments on the common assumptions are welcome, and will be appropriately considered in business plan and budget review and approval process. As always, it will be most helpful if these comments are as specific as possible. In addition, since the actual draft business plan and budget document will be released after the agendas are posted but prior to the MRC meeting, there will be an opportunity to discuss it at the MRC meeting, thereby providing additional input to the Board.

Definition of Adequate Level of Reliability — As part of the request to the MRC to provide policy input to the Board on the definitions of Bulk Electric System (BES) and Adequate Level of Reliability (ALR), a task force of the Planning, Operating, Critical Infrastructure Protection and Standards Committees has been working on the definition of ALR (see ALR Task Force website) and expects to post by the end of April for industry review and comment a draft definition document, a supporting technical reference document, a discussion paper on risk tolerance, and a mapping of ALR reliability objectives to NERC's Reliability Principles. While we are still not at the stage where the Board will be asked to take action, we would welcome any initial comments and discussion by the MRC members.

Thank you in advance for providing written comments to Holly Mann, MRC Secretary (holly.mann@nerc.net) **by May 1, 2012** so they can be sent to the Board for review in advance of the meeting.

Thank you,



John Q. Anderson, Chair
NERC Board of Trustees

cc: NERC Board of Trustees
Member Representatives Committee
Regional Executives

Edison Electric Institute

Power By Association®

Policy Input for the NERC Board of Trustees

Arlington, Virginia

May 9, 2012

Offered by the Edison Electric Institute

On behalf of our member companies, Edison Electric Institute (EEI) appreciates the opportunity to provide the following brief comments in advance of next week's NERC meetings in Arlington, Virginia. EEI views on reliability are formed by the CEO Reliability Task Force, CEO Business Continuity Task Force, and the Reliability Executive Advisory Committee. We look forward to the meetings and active discussion of the issues in Arlington.

SPIG

EEI strongly supports the framework proposed by SPIG as a solid roadmap for making much-needed standards development process changes. These changes are critical to improve process efficiency and timeliness, identify strategic reliability priorities that require mandatory standards, and clearly define responsibilities for process management and oversight. EEI asks that the Board of Trustees endorse the SPIG framework and seek to ensure that it receive by November 2012 a comprehensive set of changes to governing documents, rules, processes, and procedures.

2013 NERC Budget

EEI will develop and deliver more specific comments on the draft proposed budget and business plan. There is not time sufficient to conduct a detailed review in advance of the upcoming meetings and prepare useful comments.

As a general matter, EEI does believe that the compliance and enforcement program should be capped at current levels for 2013. Expansion of the implementation of FFT

and the introduction of more compliance program tools should reduce the overall resource demands in this core program area.

We make this recommendation out of the strong conviction that the majority of matters sent through the enforcement 'pipeline' are of very little importance to reliability, that dealing with these matters are a sink for wasted time and effort, and a distraction for company personnel from focusing on more important matters, and that the ability of NERC and the regions to fundamentally change this approach are readily available to put in place in a short period of time. Our reading of the March 15 FERC order is that FERC seeks a proactive NERC plan for reducing and eliminating the waste, and refocusing efforts on matters of importance to reliability.

We also believe that the policy and practices that have now been codified by NERC and the regions for compliance and enforcement drive the problems being experienced with standards development, where standards development discussions focus more on compliance risks than reliability risks. There must be accountability in the compliance and enforcement program not only for a need to find violations but also not to find 'violations' that are questionable and then leaving it to those in the enforcement pipeline to deal with unnecessary work. Process improvements in the compliance and enforcement program will go a long way for improving standards development.

Companies define strategic priorities, resource constraints, and incentives for efficiency gains to live within budgets. We view the budget cap recommendation as reasonable, and consistent with our view that the March 15 FERC order stated a strong endorsement for NERC to move ahead with confidence to significantly improve process efficiency and focus on those matters that have importance for reliability. Since the compliance and enforcement program area comprises approximately 50% of the NERC enterprise budget, and we expect significant advances in both process efficiency and risk-based compliance and enforcement processes, we encourage NERC and the regions to redouble the commitment, coordinate their activities, move ahead with a sense of urgency, and anticipate smaller budgets in the future.

Overall, we will continue to strongly challenge the NERC compliance and enforcement program, including the regions, to refocus its time and attention on issues that matter

most to reliability. As an example, we believe that a missed battery test in violation of a standard should require not much more than having the company 'find and fix' the matter, and report to the region. This should not require a months-long review and approval process, a formal mitigation plan, and approval by NERC. The matter should require a few hours and not a few years to address and resolve.

As suggested by materials prepared for the 60-day compliance filing being made by NERC in the FFT docket at FERC (RC11-6, et.al.), it is clear that regions have made varying commitments to the program, companies do not see process efficiency gains, processes and procedures internal to FFT need to be refined, guidelines for effective implementation are needed, and education and training needs to be delivered.

Compliance Operations / CANs / Entity Assessments

An example of our continued concern over compliance and enforcement program, and drivers for budgets, is the development and application of compliance guidance tools. EEI strongly supports development of tools that will help companies understand as clearly as possible how best to ensure compliance with the broad range mandatory standards. Last year, NERC developed a Compliance Applications Notices (CANs) tool, and in comments to the Board in August 2011 EEI supported as having potential as a useful tool to provide informal guidance through a transparent process. At that time, EEI raised process and substantive concerns, especially that CANs could be written in a way that they materially change the requirements in the mandatory standards.

In the nine months since EEI first made these comments, the industry experience had been that the CANs vary widely in their practical value to companies and in some cases change the standards. Furthermore, process and due process has been inconsistent. In addition, we understand that regions do not all make use of the CANs in audits and enforcement activities, and some regions limit their use. We also understand that some regions have developed their own compliance guidance tools. This is a simple recipe for significant wastes of time and other resources, and inconsistent determinations in both compliance and enforcement, thereby raising compliance risks for companies, exactly opposite the design goal.

In the short term, we ask that the Board of Trustees consider asking that the issuance of new CANs be suspended and the compliance guidance 'toolbox' be more clearly organized.

Similarly, with regard to the discussion of 'entity assessments,' while EEI agrees that NERC should consider risk in deciding how best to apply resources for compliance and enforcement, it may be premature for NERC to develop a specific template for determining the risk an entity imposes on reliability, and how that risk should be factored into decisions on compliance audit scope and frequency, or spot check frequency. A formulaic approach to determining entity risks is a complex undertaking where companies have a broad range of views on both the costs and benefits of such an approach. Instead, a reasonable first step might be for regions to apply their own experiences for determining whether audit scope should be adjusted for an entity's risk profile. In the short term, the Board of Trustees should ask NERC staff to suspend development of the entity assessment template.

These compliance operations issues also suggest that NERC and the regions need to significantly improve their coordination activities, where we understand that regions continue to develop their own processes and tools for managing this core program area. Especially for companies with operations in multiple regions, the potential for significantly different regional compliance guidance and processes adds an unnecessary layer of overhead costs that can be prevented by stronger NERC-regional coordination.

ALR

EEI supports the project as a potentially important exercise for defining the goals and objectives of the NERC strategic enterprise. It will be very important to communicate broadly to stakeholders the meaning and value of this project, how NERC intends to apply various ALR materials in standards development, and compliance and enforcement, and how ALR fits within the basic statutory framework of Section 215.

GO/TO Standards Package

EEI recommends that the Board of Trustees approve the package of standards known as "GO/TO" and proceed to file at FERC. We believe that the package offers a

comprehensive approach for addressing reliability issues relating to generator interconnection facilities, and applaud the leadership of stakeholders in proactively seeking to identify the underlying reliability issues and defining a reasonable to the reliability problem. If approved by FERC, implementation of these standards will also provide needed process efficiency gains, relieving NERC and the regions from the need to negotiate individually with generator owners and operators over registration and standards applicability issues.

Attached to this policy input document is a paper that lays out the background and context for this set of issues. The paper is supported by AWEA, EEI, ELCON, EPSA, and NRECA.

GMD

It is increasingly clear that FERC seeks a more detailed action plan from NERC to address geomagnetic disturbances (GMD). EEI supports the NERC interim GMD report and the recommendations made by the report, including milestones for a broad range of followup actions. We recommend that NERC prepare and file with FERC a status report in six months that describes the status of the various recommendations made in the report in order to keep commissioners and staff informed on the status of the many activities, including any unexpected changes.

EEI agrees with the three work areas described at the conference by Commissioner LaFleur: modeling and analysis, mitigation actions, and operational practices and processes. To move forward on a timely basis, we believe that NERC should discuss with the North American Transmission Forum (NATF) and the EEI Spare Transformer Equipment Program (STEP) various followup activities, including data and information data sets needed to perform various modeling and analytical work, as well as the review of processes, procedures, and best practices that might be applied over the near-term. As stated in the written statement for the staff technical conference delivered by Steve Naumann (Exelon Corp.), EEI recommends that the modeling and analysis should be coordinated under the NERC Planning Committee, and activities begun to define various technical parameters for the detailed analyses of asset owners' testing their equipment for GMD vulnerability. As suggested by FERC conference participants, some companies

are already actively analyzing their systems and facilities for GMD vulnerabilities, and reviewing procedures. Having NERC set forth a set of technical assumptions for ground-induced current should allow comparability of companies' examination of these vulnerabilities. Longer term, electric industry participants need to work with EPRI, NERC, and equipment vendors to discuss technical specifications for new transformers.

As additional background information, we attach the EEI written statement that was delivered by Steve Naumann at the April 30 conference.

FERC March 15 FFT Order / Paragraph 81

The March 15 FERC order endorsing the initial NERC FFT filings also asked NERC to propose to FERC candidate standards for retirement, and also asked about process to be used in the future to address the removal of standards. EEI has begun discussions with company subject matter experts to identify candidates for retirement and looks forward to discussing with NERC staff and stakeholders to reach decisions, move a project or projects through the standards development process, and file an initial proposal with FERC by the first quarter of 2013.

We also look forward to working with NERC and the regions to coordinate decisions on a set of candidate standards for retirement, and for developing the necessary technical support for filing a strong proposal at FERC. The regions in particular should bring their experiences and data to these important discussions.

Bulk Power System Reliability

Role of Generator-Transmission Interconnection: GO/TO Standards

April 30, 2012

The Joint Trades[1] recommend that the NERC Board of Trustees ("BOT") approve Project 2010-07, Generator Requirements at the Transmission Interface, and the associated package of standards, referred to as the "GO/TO" project. Approval of the project recognizes the strong consensus expressed by stakeholders in the process, increases registration process efficiency, and provides standards applicability policy guidance. Approval and implementation of the standards in this project achieve an adequate level of reliability by extending applicability of four standards to all Generator Owner ("GO") and Generator Operator ("GOP") entities, which should eliminate the need for negotiations by each GO/GOP entity to define responsibilities regarding interconnection facilities, thereby increasing NERC registration process efficiency.

This approach represents a contrast to how the GO/TO issue was framed in part by three FERC registration appeal cases[2] that affirmed TO/TOP registrations for GO/GOP entities and in a draft NERC Compliance Process Directive. In three registration appeal cases, FERC decided based on facts and circumstances in the records of the proceedings for determining both registration and applicability of various standards based on the record. The GO/TO project package is a generic approach to expand applicability of certain standards to all GO/GOP entities not already registered as TO/TOP entities. Joint Trades believe this generic approach provides a more efficient solution than a case-by-case approach that seeks to define both registration and applicability issue for each and every generator interconnection facility, and invites potentially significant process and due process issues. FERC did not address policy level matters and did not specify application of a case-by-case approach for every interconnection; therefore, the generic approach does not conflict in any way with the existing FERC orders. The GO/TO project approach can be best facilitated by the GO/TO standard drafting team, accompanied by NERC staff meeting with FERC staff prior to filing the GO/TO proposal to discuss the relevant issues, and ensure a shared, clear understanding of the underlying reliability issue. After approval by FERC and implementation of the GO/TO standards, further

[1] Trade associations supporting this paper are: American Wind Energy Association (AWEA), Edison Electric Institute (EEI), Electric Power Supply Association (EPSA), Electricity Consumers Resource Council (ELCON), and National Rural Electric Cooperative Association (NRECA). ELCON joins these comments with the exception of its opposition to revised FAC-003.

[2] (New Harquahala, Milford, Cedar Creek)

development of a draft NERC Compliance Process Directive (CPD) on these matters will be unnecessary.

In addition to approving the GO/TO package and cancelling the draft CPD, the Joint Trades believe that the BOT should also endorse as a policy matter that NERC use the generic process for determining entity registration and applicability of standards. Since the GO/TO package will have addressed TO/TOP –related issues for GO/GOP entities, who own generator interconnection facilities, we believe that NERC and the regions will no longer need to register GO/GOP entities for TO/TOP functions. Implementation of the GO/TO standards will achieve an adequate level of reliability for generator requirements at the transmission interface. Maintaining the case-by-case registration approach while also retaining generic applicability requirements necessitates the use of two separate processes, resulting in inefficient registration and undermining reliability. Maintaining two processes will increase registered entity uncertainty, by adding to the already extensive number of process and due process challenges. Moreover, it will limit NERC and Regions' efficiency and, ultimately, not improve reliability. Therefore, the Joint Trades also request that the BOT direct NERC management and the regions to remove the TO/TOP registrations for all GO/GOP entities that neither own nor operate other BES transmission facilities, once FERC approves the GO/TO package. Since the applicability of these standards will include all GO/GOP entities, the need for a separate TO/TOP registration would become redundant. On a separate track, because FERC has issued decisions on registration appeals involving New Harquahala, Milford, and Cedar Creek, the BOT should seek a legal opinion from the NERC General Counsel for addressing any issues that those FERC decisions may present.

In summary the Joint Trades recommend that the NERC BOT:

1. Approve Project 2010-07, Generator Requirements at the Transmission Interface Package of Standards, what we refer to as the GO/TO standards package.

2. As a policy matter the BOT should endorse the removal of TO/TOP registrations for all GO/GOP entities that neither own nor operate other transmission facilities. When FERC approves the GO/TO package, these TO/TOP registrations will become unnecessary.

3. Upon approval of the GO/TO package by the Board of Trustees, direct NERC management to cancel the draft NERC Compliance Process Directive.

I. Background

Our view is that FERC and NERC have addressed the GO/TO issues from different starting points and used different reasoning and, not surprisingly, reached different conclusions. Different parties have attempted to resolve the issue from different approaches that need to be addressed and resolved in an open and transparent manner by NERC, the regions, and stakeholders. We believe that the GO/TO package has accomplished this, successfully addressing the reliability issues raised by both FERC and NERC that are presented by the unique characteristics of generator interconnection facilities. While there appears to be some general understanding that some generator interconnection facilities with unusual characteristics may possibly need to be covered by the application of mandatory standards in addition to those contained in the GO/TO package, the process for decision making should be reviewed, including consideration of changes to the NERC registration process and due process to make decision-making both much more efficient and faster. We offer the following description of the actions that have taken place in the past four years that bring the GO/TO package to the Board of Trustees for approval.

A. New Harquahala Generating Company, LLC

The New Harquahala decision (Docket No. RC08-4, May 16, 2008) triggered the broader discussion around the question of the materiality of generator interconnection facilities for bulk electric system reliability, and the process and due process issues involving entity registration, and determinations of standards applicability. In its order, FERC affirmed the Harquahala registration as a TO/TOP and defined the standards that would apply, [3] and concluded that NERC and WECC adequately supported the registration as a TO/TOP under NERC's authority to register entities that own or operate assets that are "material to the reliability of the bulk power system."[4] FERC affirmed NERC and WECC findings, based on the specific facts of the case and, rather than making a generic finding for these types of facilities, determined that the reliable operation and maintenance of the interconnection facilities that connect the Harquahala generator to the Hassayampa substation are necessary to the reliability of the Bulk-Power System ("BPS"). FERC cited the reliability issues:

[3] New Harquahala Generating Company, LLC, 123 FERC ¶ 61,173, order on clarification, 123 FERC ¶ 61,311 (2008) (New Harquahala)

[4] NERC Registry Criteria, Notes to Criteria, note 1 (footnote excluded); see also NERC Rules of Procedure, Rule 501.1.2.6.

> "The potential impacts (of a failure of the interconnection facility) include disruption of service at Hassayampa and loss of the substantial generation supply that runs through transmission paths associated with that substation, and loss of the generation output of the Palo Verde nuclear power plant, the nation's largest nuclear power plant. Based on this information, the Commission finds that a reliability gap would exist if the Harquahala interconnection facilities, which are necessary for the reliable operation of the Bulk-Power System, are not subject to Reliability Standards applicable to transmission owners and transmission operators."[5]

Having affirmed the TO/TOP registration, FERC listed the following requirements as applicable:

"…coordination of protection systems, (System Protection Coordination PRC-001-1, R2, R2.2, R4), operations (e.g., Operating Personnel Credentials, PER-003-1, R1, R1.1, R1.2), maintenance (Transmission Vegetation Management Program, FAC-003-1, R1, R2), restoration for the transmission line and the associated switching facilities, and measurement devices from the Harquahala generating station to Hassayampa (Reliability Responsibilities and Authorities, TOP-001-1, R1)."[6]

B. Ad Hoc Group for Generator Requirements at the Transmission Interface White Paper (GO/TO Report)

Stakeholders responded to the Harquahala order out of concern that a case-by-case approach to entity registration and applicability decisions, and the costs of the process and due process, could produce inconsistent outcomes under an inefficient process, and provide little value to reliability. In coordination with NERC staff, a task group was formed. In 2009, the Ad Hoc Group for Generator Requirements at the Transmission Interface produced a report the basis for standards modifications should be to clarify the definitions of GO and GOP, , and Transmission, along with the creation of new definitions: one for Generator Interconnection Facility and one for Generator Interconnection Operational Interface. This report also recommended the addition of these two new definitions to 26 standards encompassing 29 requirements, along with some modifications to FAC-003 to make it applicable to Generator Owners under certain circumstances.

[5] New Harquahala at 54.
[6] New Harquahala at 52.

Following the report, a Standard Authorization (SAR) was approved and a drafting team formed to consider the recommendations of the Ad Hoc group report. Following discussion and consideration of the report and its recommendations, the drafting team concluded in its December 2011 technical justification report to set aside consideration of the new definitions.

> "Instead, the drafting team proposed that so-called 'sole-use' generator interconnection facilities above 100 kV that are owned and operated by generating entities, ' be included in a small set of standards and requirements previously only applicable to Transmission Owners or Transmission Operators. The drafting team did agree with the Ad Hoc group report recommendation that Generator Owners and Generator Operators of these sole-use generator tie-line Facilities should not be registered as Transmission Owners and Transmission Operators in order to maintain reliability on the Bulk Electric System (BES)."

The GO/TO package moved through the balloting process during 2011 and arrived at the BOT for consideration and approval at the February 2012 Board meeting in Phoenix.

C. Cedar Creek and Milford Appeals

The second FERC decision on registration appeals affirmed the case-by-case approach and added further insights into how FERC viewed the materiality and applicability issues. In its June 16, 2011 decision upholding the registrations of Milford and Cedar Creek as TOs and TOPs with respect to their ownership and operation of generator tie-lines, FERC identified certain minimum TO and TOP standards with which Milford and Cedar Creek must comply.[7] FERC also suggested but did not impose a list of other relevant standards, and ordered NERC, Western Electricity Coordinating Council ("WECC"), and the affected generators to negotiate whether to apply any additional standards applicable to TO and TOP entities should be imposed, and directed NERC to submit a compliance filing identifying those standards.[8]

FERC applied the same case "specific fact basis" approach to Cedar Creek and Milford that it used in Harquahala in deciding that the facilities are material to the reliability of the Bulk

[7] *Cedar Creek Wind Energy, LLC and Milford Wind Corridor Phase I, LLC*, 135 FERC ¶61,241 (2011) ("*June 16 Order*").

[8] *Id.* at PP 73, 89.

Power System ("BPS").[9] FERC found that reliability requirements were needed to mitigate "reliability risk that would affect the BPS."[10] Further, the Commission asserted there would be reliability gaps unless there were requirements imposed for the two wind facilities that addressed: "(1) coordination of protection systems, (2) operations and operating credentials, and (3) restoration and development and communications of system operating limits."[11]

FERC suggested the following additional requirements:

- PRC-001-1, Requirements R2, R2.2, R4;
- PRC-004-1 Requirement R1;
- TOP-004-2, Requirements R6, R6.1, R6.2, R6.3, R6.4;
- PER-003-1, Requirements R1, R1.1, R1.2;
- FAC-003-1, Requirements R1, R2;
- TOP-001, Requirement R1 and
- FAC-014-2, Requirement R2.

In ordering the negotiation, FERC offered little guidance, saying only that "…WECC and/or NERC and Cedar Creek (and Milford) may disagree as to whether Cedar Creek (and Milford) should be required to comply with additional Reliability Standards. To resolve any such disputes, the Commission directs WECC and/or NERC and Cedar Creek (and Milford) to negotiate as to what, if any, additional Reliability Standards and Requirements will be applicable to Cedar Creek [Milford]." It is important to note that FERC did clarify that the Cedar Creek and Milford decisions should not be viewed as pre-judging the GO/TO project.[12]

D. Project 2010-07 Generator Requirements as the Transmission Interface

As stated previously, the GO/TO package was developed and balloted during 2011. The package includes FAC-001, FAC-003, PRC-004 and PRC-005, and requires GO and GOP entities to comply. The project did not seek to add any formal terms to the NERC glossary as these were not supported by industry stakeholders.

[9] *Id.* at PP 58.
[10] *Id.* at PP 58.
[11] *Id.* at PP 63 (Cedar Creek), PP 77 (Milford).
[12] Rehearing Order P26, p. 12.

1. SDT's Technical Justification Review of Compliance Directive and FERC Order

While the drafting team concluded that the GO/TO package was the best and most complete set of requirements to move forward, as a due diligence matter it also reviewed and commented on other standards that had been raised in both the FERC registration appeal orders, and the draft proposed NERC CPD. The following are assessments from the Technical Justification of specific Standards raised in FERC Orders or the CPD.

EOP-003-1—Load Shedding Plans – The drafting team found that it was unnecessary to extend applicability of this standard to GO/GOP entities because PRC-001 already includes the requirement that Transmission Operators coordinate their underfrequency load shedding programs with underfrequency isolation of generating units. Since this coordination includes any UFLS settings of equipment owned or operated by GO or GOP entities, the drafting team concluded that application of the existing EOP-003-1 requirements to GO/GOP entities was not necessary as doing so would not close a reliability gap.

EOP-005-1—System Restoration Plans – In Order Nos. 693 and 749, FERC found that GO blackstart requirements have been already been appropriately addressed through the standards development process. EOP-005-2 will become effective in 2013, already having been approved by FERC. The drafting team concluded that no reliability gap existed with respect to owning or operating a generation interconnection facility, and concluded it was therefore not necessary apply this standard to a GO or GOP. The drafting team also noted that the TOP is required to coordinate its restoration plan with Generator Owners and Balancing Authorities within its area under EOP-005-1 Requirement 4.

FAC-014-2—Establish and Communicate System Operating Limits – The drafting team found that this standard should not be revised to include generators. The GO is already required by the FERC-approved versions of FAC-008-1 R1, FAC-009-1, and FAC-008-3 R1, R2, and R6 (filed for approval with FERC), to document the facility ratings for a GO/GOP interconnection circuit greater than 100kV. Voltage limits are, appropriately, set by the applicable TO/TOP with which the GO/GOP interconnects. Therefore, the SDT believes that adding the Generator Owner to FAC-014-2 R2 would be redundant. What's more, the SDT is concerned that entities with limited view (only their Facility) should not be responsible for setting IROLs or SOLs as these are interconnection and system limits. We believe this should be the responsibility of entities with a wide-area view, as shown in the standard today; otherwise, we are concerned that reliability may be jeopardized.

IRO-005-2—Reliability Coordination - The drafting team determined that IRO-005-2 did not require modification to include GO or GOP entities because of the October 2011 retirement of the standard. Further, the drafting team concluded that there was no reliability gap because PRC-001-1 R2 already requires the GO to notify reliability entities of relay or equipment failures. The SDT believes that a Special Protection System is a form of protection system and therefore any degradation or potential failure to operate as expected would be required to be reported by the Generator Operator to reliability entities (Balancing Authorities, Transmission Operators, and Reliability Coordinators).

PER Standards-Operating Personnel Training –FERC addressed PER-001 and PER-002 in Order Nos. 693 and 742. In Order No. 693, FERC directed NERC to "expand the applicability of the personnel training Reliability Standard, PER-002-0, to include (i) generator operators centrally-located at a generation control center with a direct impact on the reliable operation of the Bulk-Power System..." In Order No. 742, FERC reaffirmed this, stating that it is "not modifying the Order No. 693 directive regarding training for certain generator operator dispatch personnel, nor are we expanding a generator operator's responsibilities." The order does not address PER-001-0 or PER-002-0, but it does address PER-003-1. In paragraphs 67 and 81 of the order, FERC expresses concern that operational control over the transmission line breakers owned by the entities in question are not under the control of NERC certified operators. FERC goes on to say that "Reliability Standard PER-003-001 requires NERC certification of all operators that have responsibility for the real-time operation of the interconnected Bulk Electric System. When switching the tie-line in or out of service, operators must have the appropriate credentials and training to properly perform the switching and coordinate the switching to prevent adverse impacts such as the introduction of faults on the system."

The drafting team found no evidence that the kinds of training requirements for operating the breakers of the generator interconnection facilities cited by FERC exist elsewhere for other entities that operate breakers on lines. For instance, Transmission Owners that are not also Transmission Operators are not required to undergo any sort of training. The drafting team does dismiss this issue altogether, and it may be that training should be expanded to include GO and GOP entities, but the development of the standards and requirements necessary to address all of the directives in the cited FERC orders has implications beyond the scope and expertise of this team.

PRC-001-1, R2, R2.2, R4 and R6 —System Protection Coordination –R2 which applies to the both the Generator Operator and Transmission Operator, uses the general terms "relay or

equipment failures" which would include not only generator relaying, but generator interconnection relaying where the Generator Operator has operational responsibility for the protection system (relay or equipment). The Generator Operator is required to notify the Transmission Operator and Host Balancing Authority in R2.1 only "if a protective relay or equipment failure reduces system reliability." Requirement R2.2 requires the affected Transmission Operator to notify its Reliability Coordinator and affected Transmission Operators and Balancing Authorities. Thus, applying R2.2 to a Generator Operator would be redundant to R2.1[13]. The SDT believes it is appropriate to apply R2.2 only to the 'wide area' Transmission Operator as it reasoned that a failure on a sole-use generator interconnection facility would not reduce system reliability. Regarding R4, the SDT reasoned that a sole-use generator interconnection facility would not constitute a major transmission line or major interconnection with neighboring GOs, TOs, and BAs. The drafting team also found that R6, which requires "area" monitoring, was more appropriate for the TOP in light of its wide area view of the system.

PRC-001 also shows how the different approaches used by the Commission and the drafting team resolved coordination of protection systems differently. FERC found in Cedar Creek and Milford that coordination of protection systems would occur for each entity if they were registered as TO/TOPs and if PRC-001-1, R2, R2.2, R4 and R6 applied. Since it was seeking to find what TO/TOPs standards should apply to GOs, the SDT found that PRC-001-1 R2.1 already applies to generators and that because they are required to notify their TOP, the coordination sought in R2.2 would occur without applying R2.2 to GOP entities or registering a GO/GOP as a TO/TOP. For R4 and R6, the SDT reasoned that a sole-use generator interconnection facility does not constitute a major transmission line or major interconnection with neighboring GOs, TOs, and BAs. R6 requires "area" monitoring that a TOP normally performs and not a GO. The SDT reasoned that 'area' in the context of reliability standards is typically comprised of numerous facilities, possibly not owned by the same entity, but for which there needed to be entities with responsibility to insure operational reliability. The SDT believes that PER-003 correctly identifies the appropriate entities and establishes the appropriate hierarchy for insuring the bulk power system is operated reliably. The BA and TOP bear responsibility for facilities located in their respective areas whereas the RC has oversight over its area (which could include multiple BA and TOP areas).

[13] If a Generator Operator had a relay or equipment failure on its Facility, including its interconnection Facility, it would be required to report that to the Transmission Operator it interconnects with (under R2.1)

TOP-001-1—Reliability Responsibilities and Authority – The drafting team found that the TOP-001-1 R1 gives the TOP the necessary decision-making authority over operation of all generator facilities up to the point of interconnection. Therefore, no extension of applicability to GO or GOP entities is necessary as no reliability gap exists.

TOP-004-2—Transmission Operations – The drafting t**e**am concluded that TOP-001-1 R2 already requires GOs to comply with reliability directives from the TOP, the same task that TOP-004-2 requires. TOP-002-3 R3 provides more backup on these responsibilities. Adding TOP-004-2 contributes no additional reliability support and, as noted below, another drafting team has proposed retirement of TOP-004-2.

TOP-006-1—Monitoring System Conditions - The drafting team asserted in its discussions that there was no material difference between PRC-001-1 R1 and TOP-006-1, where the former requires knowledge of the purpose and limitations of protection system schemes applied in its area, and the latter requires knowledge of "the appropriate technical information concerning protective relays." The reliability objective is achieved by compliance with PRC-001-1 R1

TOP-008-1—Response to Transmission Limit Violations - The drafting team concluded there is no reliability benefit to adding this requirement. TOP-001-1 R7 ("Each Transmission Operator and Generator Operator shall not remove Bulk Electric System facilities from service if removing those facilities would burden neighboring systems unless…") and its parts give the GO authority over its facilities, which would include the generator interconnection facility. If there is an outage, R7.1 requires the GO to notify and coordinate with its Transmission Operator, which is required to notify the Reliability Coordinator and other affected TOPs. And as with TOP-004-2, the Project 2007-03 drafting team has proposed to delete all of TOP-008-1's requirements and retiring the standard.

III. Current Status and Recommendations Regarding Project 2010-07

We anticipate that the BOT will approve FAC-001-1 and PRC-004-2.1a, as well as FAC-003-3/FAC-003-X and PRC-005-1 when the latter two standards are balloted and receive industry approval in April. The BOT then will have the Project 2010-07 package for its consideration at its May 9 meeting. We recommend approval of the package and sending it to the Commission for approval. The package should include the *Technical Justification Resource Document* because it addresses the Commission orders, the NERC Compliance Directive, and the *Final Report from the Ad Hoc Group for Generator Requirements at the Transmission Interface*.

While many standards and their requirements have been covered in the GO/TO Report, Commission orders, and the draft NERC CPD, we support the drafting team report as offering a reasoned technical explanation to clarify what standards and requirements should apply to generators with interconnection facilities. Bottom line, we believe that the reliability issues are covered either because requirements have evolved that cover a stated FERC concern or a GO requirement already exists that corresponds with the relevant TOP requirement.

In addition and based on NERC staff recommendation, PRC-001-1 may require further review and discussion. Since this standard involves how changes on neighboring systems would require changes on the GO/GOP facilities, informal technical discussion with the Planning Committee and Operating Committee might be the best first step.

The SDT conclusions are consistent with the Commission's assertions in Cedar Creek and Milford:

> "…we did not encourage adoption of the GO/TO Report Recommendations. Rather in the June 16 Order with encouraged "NERC to develop an approach to this matter that satisfies Bulk-Power-System reliability concerns and allows entities to understand upfront the scope of their compliance responsibilities.""[14]

[14] Cedar Creek Wind Energy, LLC and Milford Wind Corridor Phase I, LLC, 137 FERC ¶ 61,141 (2011) ("Cedar Creek Order").

Table 1

The following table is taken from the GO/TO project technical justification document and lists the standards that have been addressed in the GO/TO initiative.

Standard	Ad Hoc Report*	NERC Directive	FERC Order
EOP-003-1	X		
EOP-005-1		X	
FAC-001-0		X	
FAC-003-1 or FAC-003-2	X	X	X
FAC-014-2		X	X
IRO-005	X		
PER-001-0	X		
PER-002-0	X	X	
PER-003-1			X
PRC-001-1		X	X
TOP-001-1	X	X	X
TOP-004-2	X	X	X
TOP-006-1		X	
TOP-008-1	X		

Table 2

The following table contains the standards and requirements from the draft proposed NERC Compliance Process Directive in which NERC represents that the Appendix A List "identifies all TO and TOP Reliability Standards to which the parties have agreed will apply to Milford and Cedar Creek." Since the list includes the standards and requirements identified in the June 16 order, it appears to be a comprehensive list of all TO/TOP standards and, as the Cedar Creek Order confirmed, the "Reliability Standards that Cedar Creek and Milford must comply. The list includes a number of standards and requirements in addition to those identified in the June 16 order that NERC intends to apply when the CPD is approved.

Reliability Standard	***June 16 Order***	***Draft Directive***	***Appendix A List***	***Project 2010-07***
EOP-005-1	R1, R2, R5, R6, R7	**R1, R2, R5, R6, R7**		
FAC-001-0		R1, R1.1, R1.2, R1.3, R2, R2.1, R2.1.1, R2.1.2, R2.1.3, R2.1.4, R2.1.5, R2.1.6, R2.1.7, R.2.1.8, R2.1.9, R2.1.10, R2.1.11, R2.1.12, R2.1.13, R2.1.14, R2.1.15, R2.1.16, R3	**R1, R1.1, R1.2, R1.3,** R2, R2.1, R2.1.1, R2.1.2, R2.1.3, R2.1.4, R2.1.5, R2.1.6, R2.1.7, R.2.1.8, R2.1.9, R2.1.10, R2.1.11, R2.1.12, R2.1.13, R2.1.14, R2.1.15, R2.1.16, R3	R2, R2.1, R2.1.1, R2.1.2, R2.1.3, R2.1.4, R2.1.5, R2.1.6, R2.1.7, R.2.1.8, R2.1.9, R2.1.10, R2.1.11, R2.1.12, R2.1.13, R2.1.14, R2.1.15, R2.1.16[33]

FAC-003-1	R1, R2	R1, R1.1, R1.2, R1.2.1, R1.2.2, E1.2.2.1, R1.2.2.2, R1.3, R1.4, R1.5, R2, R3, R3.1, R3.2, R3.3, R3.4, R3.4.1, R3.4.2, R3.4.3	R1, R1.1, R1.2, R1.2.1, R1.2.2, E1.2.2.1, R1.2.2.2, R1.3, R1.4, R1.5, R2, R3, R3.1, R3.2, R3.3, R3.4, R3.4.1, R3.4.2, R3.4.3	R1, R1.1, R1.2, R1.2.1, R1.2.2, E1.2.2.1, R1.2.2.2, R1.3, R1.4, R1.5, R2, R3, R3.1, R3.2, R3.3, R3.4, R3.4.1, R3.4.2, R3.4.3
FAC-014-2	R2	R2	R2	
PER-002-0		R2, R3, R3.1, R3.2, R3.3, R3.4, R4	**R2, R3, R3.1, R3.2, R3.3, R3.4, R4**	
PER-003-1	R1, R1.1, R1.2		R1	
PRC-001-1	R2, R2.2, R4, [R6]	R2, R2.2, R4	R2, R2.2, R4, **R6**[34]	
PRC-004-1	R1	R1, R3	R1, R3	R2[35]
PRC-005-1		R1, R2	R1, R2	R1, R2
TOP-001-1	R1	R1	R1	
TOP-004-2	R6, R6.1, R6.2, R6.3, R6.4	R6	R6	
TOP-006-1		R3, R6	**R3, R6**	

UNITED STATES OF AMERICA

FEDERAL ENERGY REGULATORY COMMISSION

Staff Technical Conference on Geomagnetic Disturbances to the Bulk-Power System

Docket No. AD12-13-000

Prepared Remarks of Steven T. Naumann
Vice President, Transmission and NERC Policy, Exelon CorporationOn Behalf of the Edison Electric Institute

Good afternoon. I am Steve Naumann from Exelon. Exelon is a holding company headquartered in Chicago. Our retail utilities, BGE in Baltimore, ComEd in Chicago and PECO in Philadelphia, serve 6.6 million electric customers, or over 15 million people – more than any other company – with a peak load of over 40 GW. Our generation subsidiary owns approximately 35 GW of generating facilities, including fossil, hydro, nuclear and renewable facilities.

I am appearing today on behalf of the Edison Electric Institute (EEI), of which Exelon is a member. EEI is the trade association of U.S. shareholder-owned electric companies and has international affiliate and industry associate members worldwide. EEI's U.S. members serve 95% of the ultimate customers in the shareholder-owned segment of the industry and represent about 70% of the U.S. electric power industry. Thank you for inviting me to speak at this conference.

First, EEI supports the Commission holding a technical conference on these important issues. EEI members support the NERC report on the effects of geomagnetic disturbances

(GMD) and the recommendations made by the report. In general, EEI agrees that the primary risks associated with GMD-related activity are:

- Potential for voltage collapse due to increased reactive loading;
- Possibility of damage to certain physical assets such as transformers.

We also agree that the NERC report is interim, and thus there is significant merit in conducting additional careful technical analysis and, based on the results of such analysis, taking cost-effective actions. Such actions could involve operating procedures, installation of monitoring equipment, recommendations for transformers to withstand certain levels of GMD, and where appropriate, mitigation measures for existing transformers.

That said, the purpose of this panel is to discuss moving forward on GMD issues. EEI agrees generally with the NERC GMD report recommendations for next steps, including:

- Developing tools and methods to support industry analysis of technical issues;
- Improving existing notification procedures for GMD watches and alerts;
- Conducting various training and communications-related activities;
- Evaluating the potential need for mandatory requirements;
- Exploring with EPRI, equipment manufacturers, and industry participants a broad range of technical issues related to transformer design specifications.

Next Steps – System Analysis of Severe GMD Events

We believe that the development of effective preventative tools and methods will depend on the confidence that can be placed in additional study and modeling work. Performing system studies to determine potential broad system effects and impacts on

transformers is a necessary condition before NERC can recommend what, if any, mitigation strategies should be used to ameliorate the impacts of severe GMD events. The studies, and the underlying models, must be open for review by experts from all parts of the industry. If NERC is to make recommendations for the reliability of the North American continent, and this Commission is to review NERC recommendations, possibly including proposed standards, we all must have confidence in the modeling, the data and the analysis and that confidence is best achieved by means of an open process subject to peer review.

To accomplish this goal, EEI recommends that this analytical work take place under the direction of the NERC Planning Committee (PC) as a special study assessment. The technical expertise and diversity of the NERC PC and the members of any special study group would be invaluable for defining the assumptions and parameters of such study, including specifications of any additional data that might be needed to support a strong technical study and ultimately conducting the analysis. The collection of data and information should be conducted using methods similar to those used by NERC committees to obtain data for assessments, including protection of such data as CEII. However, subject to appropriate protection of CEII information, these PC and any study group meetings, as all NERC meetings, would be open.

We anticipate that the studies will analyze in more detail the response of the North American bulk power system following severe GMD events. The analysis would determine among other results whether and at what GMD levels any potential voltage collapse might occur and if so, how broad an area would be affected. The analysis also would determine the magnitude of geomagnetic induced currents at different GMD levels and this data in turn would be used for further analysis by asset owners to determine impacts on their transformers.

Next Steps – Transformer Analysis of Severe GMD Events

EEI also shares concerns regarding the potential vulnerabilities of transformers of a certain age and design to severe GMD events. As stated above, after NERC completes the development of additional methods and tools and the PC completes its analysis, asset owners will conduct detailed technical analysis of transformers, especially those that have the greatest vulnerability to GMD effects, using the technical expertise from the North American Transmission Forum, the Spare Transformer Equipment Program (STEP), transformer manufacturers and others. Under the direction of the PC, the asset owners will develop a project plan and communicate this plan to the NERC and to the Commission. The need to perform the studies sequentially is important. As Mark Lauby of NERC explained this morning, voltage instability caused by a severe GMD event takes place over a period of tens of seconds. Thermal damage to transformers takes longer – on the order of tens of minutes to hours. The two effects are interrelated and must be studied in sequence. Once more data is received from the analysis of transformer response, EPRI, manufacturers and STEP also can develop transformer specifications regarding GMD.

Partnership with Government

As part of the NERC GMD report recommendations for improving education and training, and for improved information exchanges, EEI believes the Joint Statement of the Prime Minister of the United Kingdom and President Obama (May 25, 2011) promising collaboration on assessments of mitigating effects of space weather is an important step. In this country, EEI looks forward to continued collaboration among government and the electric sector, and other affected infrastructure industries, including transportation and

communications. In addition, improvements in space weather prediction and monitoring are needed. One example of such collaboration was the tabletop exercise, Secure Grid '11, conducted in conjunction with Department of Homeland Security and US Northern Command. These exercises, and exchanges of information and learning from such exercises, must continue.

Potential NERC GMD Standard

As I have discussed above, system-wide studies are needed to determine the impacts of severe GMD events, in particular on transformers. Until those studies are completed, it is premature to determine whether NERC should advance development of mandatory requirements to address GMD-related issues. While the analysis is taking place, there is merit in embracing a "do no harm" approach to ensure that various potential solutions do not inadvertently cause new problems. Especially with regard to geomagnetic induced current (GIC) blocking devices, we believe that additional analysis discussed above is required to ensure that any such devices both are effective and do not cause additional reliability problems, especially if applied to selective transformers. Even where such devices or other solutions are shown to be effective, the cost and the practicality of such potential solutions needs to be addressed.

Industry Actions Already Underway

While longer term or standards-related activities are an important part of the overall plan, in the shorter term it is important for the Commission to realize that companies, ISOs and RTOs, and NERC regions, have already developed communications and mitigation procedures

for this vulnerability, as shown in the NERC interim report. A number of companies have installed or are installing GIC monitoring equipment. In addition, a number of asset owners have or are in the process of modeling and analyzing their transformers to assess their vulnerabilities. It may be useful for the Commission to seek in a final NERC report a more detailed listing on the broad range of activities already underway or in place to address GMD vulnerability.

Thank you and I look forward to the question and answer period.



Policy Input to the NERC BOT and MRC – May 8, 2012

The Electricity Consumers Resource Council (ELCON) and Occidental Energy Ventures Corp., Members of the MRC representing the Large End-Use Electricity Customer segment (herein, Large Customers), are pleased to offer the following policy input to the NERC Member Representatives Committee and the Board of Trustees for their May 8 and May 9 meetings.

Standards Process Input Group –Large Customers strongly support the intent and efforts of the Standards Process Input Group (SPIG). We believe that the standards development process can and should be improved and that some standards can be written in a shorter length of time than under the present process. However, we do caution that all standards are not created equal. Some will take much longer to draft than others. Forcing complex standards through any process in a short time may compromise stakeholder input. It is much better to take the appropriate amount of time and get a quality standard than to rush and end with a flawed standard. Large Customers recommend that the Board of Trustees approve the recommendations of the SPIG, including the creation of the Reliability Issues Steering Group (RISC), but carefully monitor the new process and Committee over the next year and make changes as necessary.

2013 NERC and Regional Entity Common Business Plan and Budget Assumptions – Large Customers generally agree with EEI in their March 9, 2012 Comments on the Budget and Business Plan. We believe that NERC should move more aggressively to develop a plan to implement results-based standards. We also believe that NERC should engage both regulators and stakeholders in considering how to realign the compliance and enforcement program to focus on building strong performance incentives, and away from sole reliance on the penalty-based enforcement model. We strongly urge NERC to aggressively pursue a plan to achieve processes that are both efficient and sensitive to costs and rate impacts on consumers. This requires NERC to make much more significant efforts to understand the costs of both participation in the NERC process and the end-use costs of implementation of both standards and compliance.

Definition of Adequate Level of Reliability – Large Customers recognize that NERC has created a task force to provide input on the definition of ALR. Large Customers generally support the efforts of that task force – with one exception. The task force seems to propose that the new ALR is identified as a "definition" which then would be added to the NERC Glossary, making it mandatory and enforceable. Specifically, Items #4 and #5, even though marked with an asterisk indicating a special status, blur the lines between what is an ERO reporting function and what is fair game for reliability standards. Large Customers believe that both Items #4 and #5 can be re-written in a manner which characterizes the reliability aspects of transfer and resource

capacity without including them in the Glossary. A document setting forth our detailed concerns is attached to this Policy Input.

GO/TO Project: Increasingly, Large Customers are experiencing significant problems with NERC Reliability Standards, intended to apply to Elements and Facilities of electric utilities (including merchant generators) and the more complex industrial facilities that may include some form of industrial generation (CHP or cogeneration) and / or other facilities rated 100 kV or higher. This is certainly the case with FAC-003. Large Customers seek NERC BOT support for a general policy that the reach of Standards does not interfere with the manufacturing processes or attempt to control the operation of facilities located within the perimeter fence of an industrial complex. The terms and conditions of a reliable interface with the BES where behind-the-meter generation is present are appropriately defined by each facility's interconnection agreement with the local TO/TOP and therefore there is no risk of a "reliability gap." This does not waive from any compliance obligations such facilities that are outside the perimeter fence. The attached document explains this concern in more detail.

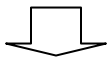
Suggestions to the MRC for the Updated Definition of ALR
Adequate Level of Reliability
Submitted by the Electricity Consumers Resource Council (ELCON) and
Occidental Energy Ventures Corp.
April 19, 2012

Background

The Task Force assigned to re-write the current NERC BOT-approved characteristics of a system with an Adequate Level of Reliability is looking for the MRC's feedback before posting their output for industry-wide review. The current ALR statement was adopted by the Board in February 2008 and filed for informational purposes with the Federal Energy Regulatory Commission afterwards. A snapshot of the changes are shown below:

Characteristics of a System With an Adequate Level of Reliability

1. The System is controlled to stay within acceptable limits during normal conditions.
2. The System performs acceptably after credible Contingencies.
3. The System limits the impact and scope of instability and cascading outages when they occur.
4. The System's Facilities are protected from unacceptable damage by operating them within Facility Ratings.
5. The System's integrity can be restored promptly if it is lost.
6. The System has the ability to supply the aggregate electric power and energy requirements of the electricity consumers at all times, taking into account scheduled and reasonably expected unscheduled outages of system components.



Definition: Adequate Level of Reliability for the Bulk Electric System

1. The BES is free from instability, uncontrolled separation, Cascading, and voltage collapse under normal operating conditions and when subject to predefined Disturbances.
2. BES frequency is maintained within defined parameters under normal operating conditions and when subject to predefined Disturbances.
3. BES voltage is maintained within defined parameters during normal operating conditions and when subject to predefined Disturbances.
4. Sufficient transfer capability of the BES transmission system is provided and maintained to meet required BES demands during normal operating conditions and when subject to predefined Disturbances.*
5. Sufficient resource capability on the BES is provided and maintained to meet required BES demands during normal operating conditions and when subject to predefined Disturbances.*
6. Adverse Reliability Impacts on the BES resulting from conditions beyond the scope of predefined Disturbances (e.g., multiple contingences, unplanned and uncontrolled outages, cyber security events, malicious acts) are minimized.
7. The system has the ability to recover from major system Disturbances, such as blackouts and widespread outages, by restoring BES Facilities in a controlled manner that rebuilds BES integrity and restores supply to load.

Observations and Suggestions

Overall, we support the format and intent of the updates to the ALR. The reliability expectations under "normal operating conditions" and "predefined Disturbances" (Items #1 through #3) is solid and it tracks the philosophy used in the associated NERC standards. In addition, the performance is measurable and will not impact the in-place ALR-tracking metrics.

We also agree that it is prudent to address high-impact low-frequency events (Item #6) even while acknowledging that the impact may not be predefined and lead to major impacts despite the industry's best efforts to avoid them. This naturally funnels into Item #7, requiring Registered Entities to be prepared to restore the BES from a catastrophic event.

The assignment of performance outcomes associated with each item is helpful –as is the Technical Document describing the underlying thought for each. Lastly, we are very supportive of the use of the term "BES" instead of "System" or "BPS". It is important to the continued credibility of the regulatory framework that the CEA's scope of authority is well defined and consistent.

That same line of thinking leads us to our single concern. Included in the modified ALR are items addressing sufficient transfer capability and resource capability (Item #4 and #5 respectively). The ERO has an ongoing responsibility to assess and report on transfer and resource capability, but the Federal Power Act does not allow them to develop standards related to adequacy and safety. This is captured in the following footnote from the draft document:

> [1] Adequate level of reliability is a term used in Section 215 (i)(2,3) of the Federal Power Act specifying what standards the ERO can develop and enforce. Section 215 specifically does not authorize the ERO to develop standards related to adequacy and safety. However, this definition is meant to encompass all the duties of the ERO including obligations to perform assessments of resource and transmission adequacy. Provisions marked with an asterisk denote objectives not related to NERC's standards development and enforcement activities.

However, the new ALR is consistently identified as a "definition" in the title and throughout the document – which makes it appear as though it will be added to the NERC glossary. (The existing ALR does not appear there.) If the intent is to add it to the glossary, CEAs will consider them mandatory and enforceable. A very good example is the definition of the five components of "Protection Systems" – which must be clearly identified and addressed under the PRC standards. Many violations have been assessed where the linkage to each of the five components has not been made clearly.

Even though both item #4 and #5 are marked with an asterisk indicating their special status, this may blur the lines between what is ERO reporting function and what is fair game for reliability standards. This tie is further reinforced in NERC's Reliability Principals – which could virtually assure that capability standards will be a fundamental part of enforceable reliability regulation. (Also, notice that the term "bulk power system" is used throughout the statement of Reliability Principles on the following page. An ancillary goal of this effort should be to change that if possible.)

It is our belief that both Item #4 and Item #5 can be re-written in a manner which characterizes the reliability aspects of transfer and resource capability. Both of these are factors considered in the near-term operations and long-term planning horizons – which asset owners and operators must support by forecasts, outage notifications, and regular capacity validations. It would seem

that these functions could be incorporated into the ALR language without taking away from the fundamental intent to assure sufficient transmission and generation capacity when it is needed.

Reliability Principles

NERC Reliability Standards are based on certain reliability principles that define the foundation of reliability for North American bulk power systems[1]. Each reliability standard shall enable or support one or more of the reliability principles, thereby ensuring that each standard serves a purpose in support of reliability of the North American bulk power systems. Each reliability standard shall also be consistent with all of the reliability principles, thereby ensuring that no standard undermines reliability through an unintended consequence.

1. Interconnected bulk power systems shall be planned and operated in a coordinated manner to perform reliably under normal and abnormal conditions as defined in the NERC Standards.
2. The frequency and voltage of interconnected bulk power systems shall be controlled within defined limits through the balancing of real and reactive power supply and demand.
3. Information necessary for the planning and operation of interconnected bulk power systems shall be made available to those entities responsible for planning and operating the systems reliably.
4. Plans for emergency operation and system restoration of interconnected bulk power systems shall be developed, coordinated, maintained, and implemented.
5. Facilities for communication, monitoring, and control shall be provided, used, and maintained for the reliability of interconnected bulk power systems.
6. Personnel responsible for planning and operating interconnected bulk power systems shall be trained, qualified, and have the responsibility and authority to implement actions.
7. The reliability of the interconnected bulk power systems shall be assessed, monitored, and maintained on a wide-area basis.
8. Bulk power systems shall be protected from malicious physical or cyber attacks.

[1]The intent of the set of NERC reliability standards is to deliver an Adequate Level of Reliability. The latest set of characteristics associated with an Adequate Level of Reliability are posted on the Reliability Standards Resources Web Page.

Policy Input of the Electricity Consumers Resource Council
Dated May 1, 2012

The BES Interface at Industrial Complexes
The Example of FAC-003

On behalf of the members of the Electricity Consumers Resource Council (ELCON), we welcome this opportunity to offer the following Policy Input in advance of the May 9, 2012 NERC Board of Trustee meeting.

Summary

The purpose of this Policy Input is to highlight the growing conflict between the Applicability of NERC Reliability Standards that are generally intended to apply to Elements and Facilities of electric utilities (including merchant generators) and the more complex industrial facilities that may include some form of industrial cogeneration and/or other facilities rated 100-kV or higher. NERC's "one-size-fits-all" approach to drafting Reliability Standards and Requirements must not result in the application of Requirements to the internal operations of complex industrial facilities. ELCON seeks NERC BOT support for a general policy that the reach of Standards does not interfere with the manufacturing process or attempt to control the operation of facilities located within the perimeter fence of an industrial complex. The terms and conditions of a reliable interface with the BES where behind-the-meter generation is present are appropriately defined by each facility's interconnection agreement with the local TO/TOP and therefore there is no risk of a "reliability gap." This does not waive from any compliance obligations such facilities that are outside the perimeter fence.

Discussion: The Example of FAC-003

ELCON supports the Trade Associations recommendations as contained in the Joint Trades' Policy Input: "Bulk Power System Reliability – Role of Generator-Transmission Interconnection Options and Recommendations" (Date May 1, 2012). However, ELCON takes exception to Joint Trades support for FAC-003-X and FAC-003-3 because while the Applicability section of these Standards may be suitable for Transmission Facilities and Generation Facilities owned by utilities, it is wholly unsuitable for industrial cogeneration facilities and related interconnection facilities that are integrated with a complex manufacturing plant.

FAC-003 presupposes a utility-like configuration of assets inside the fence of large industrial complexes, particularly where industrial cogeneration is deployed. The primary purpose of industrial cogeneration is to produce steam in support of the manufacturing process. It is an integral component of the manufacturing plant. Electricity is produced as a by-product so as to maximize the efficient utilization of fuel. The Applicability section of FAC-003-x and FAC-003-3 assume a GO owns a stand-

alone generator (with one or more units), a single "fenced" switchyard or substation, and a relatively lengthy right-of-way to the point of interconnection with a TO's Facility. As written, the same section requires industrial complexes with cogeneration facilities to develop Transmission Vegetation Management Programs for generator lead lines that are within the manufacturing facility and not otherwise exposed to vegetation.

Modern manufacturing processes are highly electrified and often operate at voltages in excess of 100-kV. It is not uncommon for conductors within the plant to exceed a one-mile threshold supported by multiple towers. These design elements are dictated by the needs of the process equipment and the site configuration, and totally unrelated to the electrical characteristics of the BES. Electric utilities are not the sole users of high voltage equipment, and it is naïve to assume that the use of such equipment is necessary for the reliable operation of the interconnected transmission network.[1]

Industrial cogeneration is typically deployed at an industrial site to accommodate the availability of fuel, the need for process steam, and the configuration of the property. This may result in the generation facilities (including the Generator Step-Up transformer substation) being located deep within the plant with long cable routes and multiple substation connections between the GSU transformer substation and utility interconnection facility located near the perimeter of the industrial complex's fence line.[2] Additionally, the routes of cogenerator lead lines fundamentally differ in nature from a typical merchant generator's lead line route. Since they are located within the fence line of an industrial complex, the routes:

- Rarely contain vegetation and are graveled or paved;
- Are frequently travelled by plant personnel;
- Rarely run in straight lines (*i.e.*, no single line of sight) as necessary to maneuver around factory buildings and equipment; and
- Frequently terminate at a facility located at the fence line of the industrial complex where the local transmission company takes ownership of the power lines that leave the industrial complex.

Furthermore, the use of the term "generating station switchyard" in the Applicability section may result in inconsistent enforcement of the Standard as the use of the term implies there is only one substation located within an industrial Generator Owner's complex. Typically, there are multiple substations that connect an industrial complex's cogenerator lead line to the utility interconnection facility located near the perimeter of

[1] Industrial facilities are not the only non-utility applications of high-voltage technologies. Large commercial facilities and the high energy physics laboratories at major research universities and government labs are other examples.

[2] Professional bias often skews how auditors view the interior of industrial facilities. They try to relate what they're seeing to what they're used to seeing at other facilities, and, as such, they have difficulty separating equipment used for local distribution to load and equipment that is utilized for generation or transmission.

the industrial complex's fence line. The two obvious interpretations for the "generating station switchyard" are the substation that is directly connected to the cogenerator's GSU, and the utility interconnection facility. The transmission-like assets owned by the industrial GO originate with the conductors that leave the fence line of the industrial complex, and travel some distances down conventional transmission right-of-ways, and, therefore, the Applicability of any Reliability Standards that apply to Transmission Facilities should start at the fence line. Reliability concerns related to the Facilities between the GSU transformer substation and utility interconnection facility should be covered by those that apply to GOs and GOPs.

In order to account for the different nature of industrial complex's cogeneration facilities, the SDT should consider re-phrasing the Applicability section of FAC-003-X and FAC-003-3 to start counting the length of a cogenerator lead line at the fence line of the industrial Generator Owner's manufacturing complex and not the cogenerating station switchyard.

Conclusion

The issues raised in this Policy Input need to be resolved. Major manufacturing facilities exist throughout the NERC footprint and were planned and operated under the assumption that the local utility—often with the words "public service" in their name—were responsible for assuring an adequate, affordable and reliable supply of electricity. Customers do not cause outages.[3]

While members of the Industrial End User Customer sector bear a responsibility to carefully monitoring the development of Standards that directly address their relatively limited interface with the BES, as end-use customers they cannot and should not commit the resources to participate on the drafting teams of all Standards that are under development to defend themselves against any unwitting interference with the operation of their manufacturing processes. A general policy is needed that stops the reach of Applicability provisions at the perimeter fence of industrial complexes.

This Policy Input does not change ELCON's continued support for the treatment of behind-the-meter generation in the revised definition of BES that was filed with FERC in January 2012 and awaits FERC approval. However, even the application of the new BES definition is most appropriately exercised by always terminating the BES at the perimeter fence.

[3]On the other hand, it is customers who are harmed by actions beyond their control. Estimates of the total cost of the 2003 Blackout in the United States range between $4 billion and $10 billion (U.S. dollars). In Canada, gross domestic product was down 0.7% in August, there was a net loss of 18.9 million work hours, and manufacturing shipments in Ontario were down $2.3 billion (Canadian dollars). *Final Report on the August 2003 Blackout in the United States and Canada,* US-Canada Power System Outage Task Force, April 2004, at 1.

Electric Power Supply Association
Advocating the power of competition

NERC Board of Trustees
Arlington, Virginia
May 9, 2012
Policy Input of the Electric Power Supply Association

On behalf of its member companies, the Electric Power Supply Association ("EPSA")[1] appreciates the opportunity to provide policy input for the upcoming NERC Member Representatives Committee ("MRC") and Board of Trustees ("BOT") meetings in Arlington, Va. EPSA supports the recognition by the BOT, NERC management and MRC leadership of the value of stakeholders' policy input in advance of the MRC and BOT meetings and how that input can play an important role in informing the BOT leadership on issues impacting the Electric Reliability Organization's ("ERO") evolution.

In his April 5 letter, BOT Chair John Q. Anderson identified for MRC Chair Scott Helyer three items on which the BOT is interested in receiving comments. Herein, EPSA responds to those noted issue areas and includes additional comments on the "GOTO" issue. EPSA continues to emphasize that NERC, as an organization, should be focused on programs and processes that materially support reliability and increase the ERO's efficiency and effectiveness. Program and process development and deployment should be supported by material evidence of their need and value. The Joint Trades comments on the GOTO White Paper and its recommendations reflect such an evaluation and recommendations that will enable an efficient outcome with future benefits.

Standards Process Input Group

EPSA supports the work of the Standards Process Input Group (SPIG) which represents a collaborative effort to increase the efficiency of the ERO work on standards. Establishing and maintaining effective implementation of reliability standards is a bedrock ERO activity for ensuring reliability. The SPIG has been working to expeditiously meet the February BOT request of the MRC for policy input for May BOT meeting. The SPIG's goal of increasing the pace while maintaining the quality of standards development, will achieve a more efficient and

[1] EPSA is the national trade association representing competitive power suppliers, including generators and marketers. Competitive suppliers, which, collectively, account for 40 percent of the installed generating capacity in the United States, provide reliable and competitively priced electricity from environmentally responsible facilities serving power markets. Each EPSA member typically operates in four or more NERC regions, and members represent over 700 registered entities in the NERC registry. EPSA seeks to bring the benefits of competition to all power customers. The comments contained in this filing represent the position of EPSA as an organization, but not necessarily the views of any particular member with respect to any issue.

effective use of ERO resources, and is therefore laudable. The SPIG's emphasis on expediting quality standards is the appropriate priority.

The inclusive SPIG makeup, the Group's respect for existing processes and willingness to engage the full breadth of concerned stakeholders, will yield better standard development. The SPIG's inclusion of NERC representation from different levels from within the ERO and from stakeholders provides the appropriate balance for success.

The SPIG Report should reveal valuable information about the ERO's streamlining the Standards process. It should be recognized that the Report and its changes are not a single or static action. Measuring progress and identifying areas that impede the process will maintain constant improvement. EPSA asserts that the BOT should provide guidance regarding how it believes the Standards process can be measured and maintained.

Find Fix, Track and Report Initiative and the NERC Budget

Chairman Anderson has requested comments on the 2013 NERC and Regional Entity Common Business Plan and Budget Assumptions. Competitive suppliers believe that others more impacted by the NERC budget can best comment on specifics associated with the budget. However, EPSA does believes that the Find Fix and Track ("FFT") initiative has budget implications that the ERO must consider and is important to furthering the ERO's success. Therefore, EPSA provides policy input on the FFT and its budget impacts.

EPSA appreciates the ERO and the BOT for supporting and acting on the FFT initiative as it is a critical process improvement that increases organizational efficiency, allowing for more emphasis on reliability. The March 15 Commission Order sets the stage for Phase II FFT initiative specification. It is through Phase II that the full range of efficiencies associated with the initiative can be realized. Obtaining the full range of FFT efficiencies will enable NERC and the regions to dedicate more resources to areas most critical to maintaining reliability.

The FFT initiative is a positive step that should support future steps to build on and improve the initiative. Building on the initiative in Phase II is key to increasing the efficiency of the budget. Because the compliance resource commitment makes up half of the NERC budget, initiatives that will bring compliance spending more in balance with the other five ERO goal areas is the right approach. Strong FFT evaluation for continued improvement and detailing the plan for implementation of Phase II will inform decisions to build on successes and improve the program. EPSA believes that ensuring consistent coordination of this program will be the cornerstone of its success. EPSA encourages the ERO to continue to provide and stress training for compliance program area personnel. This should be considered a priority area for resource commitment.

Definition of Adequate Level of Reliability (ALR)
The recently posted Discussion Paper Risk Tolerance for Widespread BES Outages with Significant Socio Economic Impacts white paper and position paper from the ALR Task Force does a good job in outlining the challenges in establishing a risk tolerance metric. The Discussion Paper fairly presents the issues associated with establishing metrics, recognizing the necessity to do so, while accepting that the goal is not ensuring perfect reliability.

EPSA looks forward to the further discussion on ALR at the board meeting.

Generator (GO)/Transmission Operator (TO) Issues

EPSA has long been engaged on the "GO/TO" issue, noting in its May 2009 BOT policy input the need for the ERO to make the issue a priority; we therefore support the Joint Trades GOTO Issue White Paper (attached to the EEI Policy Input). EPSA members supported and participated in the Standards process that drew on technical expertise and honored comments from the breadth of industry segments and stakeholders. We applaud the work of the Standards Drafting Team ("SDT") for completing Project 2010-07 with consensus support across Bulk Power System segments. Competitive suppliers are pleased that Project 2010-07, Generator Requirements at the Transmission interface (GO/TO project) and the revisions of four standards is before the BOT for approval. Approving these four revised standards is the appropriate next step. The Project 2010-07 Standard Drafting Team (SDT) analyzed and identified reliability-based areas of improvement but also reviewed the related FERC decisions and NERC Compliance Directive in its Technical Justification. The SDT's resulting standard revisions and technical assessment present well founded approaches to resolving the identified reliability issues. The approval and implementation of these revised standards will extend the applicability of TO/TOP standards to all registered GO/GOP entities, reduce processing and ensure due process for NERC, Regions, and registered entities.

In addition to approving the GO/TO package the Joint Trades believe that the BOT should also endorse as a policy matter that NERC seek to eliminate the current case-by-case process for determining entity registration and, in turn, applicability of standards. Upon approval of the GO/TO package by FERC, NERC will have addressed virtually all TO/TOP –related issues for GO/GOP entities who own generator interconnection facilities.

In short, EPSA emphasizes here what is recommended in the Joint Trades' White Paper requesting that the NERC BOT:
1. Approve Project 2010-07, Generator Requirements at the Transmission Interface Package of Standards.
2. Direct NERC management and the Regions to remove the TO/TOP registrations for all GO/GOP entities that neither own nor operate other BPS transmission facilities upon FERC approval of Project 2010-07.

3. Direct NERC management to cancel the draft NERC Compliance Process Directive which is unnecessary in the wake of the Project 2010-07 package.

Sincerely,
/s/
Jack Cashin
Director, Regulatory Affairs
Electric Power Supply Association
May 1, 2012

ISO/RTO Council's (IRC) Policy Input to Board of Trustees

Standards Process Input Group Report

The IRC would like to discuss the policy implications of the Standards Process Input Group (SPIG) report regarding recommendations concerning the **Quality of Standards** and the **Process**.

The subject report provides recommendations for improving the existing NERC standards development process. The recommendations are fundamentally sound. As to the question of Policy implications the IRC suggests discussion of the following recommendations:

Quality of Standards

- The Technical Issues Steering Group (TISG) – (*its role and scope of activities*)
- Introduction of Cost Effectiveness Analyses – (*the meaning as well as the potential impact on standards development process*)
- Elimination of requirements with minimum value – (*first steps vis-à-vis coordination with FERC*)

Process

- The proposed role of Subject Matter Experts – (*its impact on Industry role*)
- Counting ballots – (*basis for evaluating "No Vote" comments*)
- Time limits on Projects – (*impact on NERC resources*)

Discussion

1. Quality of Standards

TISG

The proposed activities of the TISG range from conducting high-level "triage analysis" of emerging reliability issues, performance gaps, directing the initiation of a standards project or other activities, to setting Project priorities. It is unclear what its role is in relation to other existing committees and established processes.

A review of which SPIG proposals fall within the scope of existing standing committees and other processes will help to facilitate effective implementation of individual recommendations. Where there is potential overlap, a clear decision on which group is to take the lead will be necessary to avoid overlapping effort. A charter for the TISG would provide the industry with a transparent documentation of the TISG role and responsibility versus those of other committees.

In our view the TISG should be a policy/strategy decision maker at a very high level, deciding on which issues to be addressed, and the proposed avenues to address them, but it should leave the

implementation and project management tasks to the executing arms, namely the staff, the SC and the appropriate standing committees. The TISG should not be the one to also take care of the implementation and management aspects.

Cost Effectiveness Analyses Process (CEAP)

As the MRC and the Board consider what constitutes an "Adequate Level of Reliability", the manner in which the ERO and industry take into account costs requires further discussion.

The proposed CEAP appears to be a necessary step for some issues (e.g., evaluating Defence-in-Depth initiatives); valuable for others (e.g. situational analysis proposals); complex for others (e.g., security issues and CIP mandates); and potentially unneeded for others (e.g., core reliability concerns, such as preventing cascading outages and instability).

Different proposals may require different methodologies to be used: for example, should the evaluation focus on the incremental change in cost or on total cost? A discussion by the SPIG in conjunction with the Standards Committee on how to best ensure the right process is used for the right Project should be held to clearly identify the specific process that is best suited for assessing each type of proposal.

Finally, the CEAP work effort will need to achieve consensus on the appropriate questions for consideration as part of what constitutes cost-effectiveness and the methods for addressing those questions. Examples of such questions are: how is the cost of loss of load calculated? Should the CEAP take into account other societal costs, such as environmental costs: e.g., should the cost associated with the removal of a ton of NO_x be more than simply the direct cost of removal?

With regard to costs related to bulk power system operation, questions arise, such as: what is the impact of doubling the reserve obligation? For a large entity that has many "unloaded" generators, the cost may be minimal; but for a small entity such a requirement would put them in a spot market with much higher impacts. Is the impact considered high or is the impact low?

The IRC understands that the above may be regarded as implementation details and a discussion on such details may not be necessary at this time. Nonetheless, we suggest that the SPIG consider addressing such details as it finalizes the report and begins developing implementation proposals and schedules.

Elimination of Standards

The FFT Order acknowledged that elimination of certain Standard requirements might be appropriate. The industry must discuss a roadmap for such an initiative. Identifying "low hanging fruit" is not always as simple as it might first appear. Some issues that should be considered are:

- Does the current Standards Process already provide for steps that facilitate the elimination of Standards?

- Does the Industry need new "non-standard" categories defined before eliminating requirements? (i.e. to address requirements that need to be retained but not retained in the form of a standard)
- What priority should be given to the removal of Standards?

2. Process

Subject Matter Expert teams

The concept of small task oriented teams to prepare Standard Authorization Requests (SARs) is fundamentally a good idea. For this concept to be implemented effectively, the SPIG should provide guidance on:

- How does this differ from the current Standards Process?
  - Many standard requests have been prepared by a single SME
  - There is no prohibition on any group getting together to better formulate its requests
- Will this new group reduce/replace the role of the Industry participants?
- What constitutes an expert? Knowledge of the topic? Knowledge of NERC? Knowledge of the Functional Model?

Ballot counting

The SPIG report proposes several changes in the balloting process. The concept of not counting "No votes that do not include valid comments" is a sound recommendation. A policy issue is:

- Who or what defines "valid"?
  - No comment at all is obviously Not valid
  - Should *any* comment be acceptable, and if not, what criteria/process should be used to establish validity?
  - Will this speed up the process by helping the Drafting Teams?
  - Will this discourage some registered balloting bodies from submitting a ballot due to time constraint that does not allow for crafting a detailed or substantiated comment?

Time limits on Projects

The proposal to set up project completion targets appears to be overly prescriptive and may be counter-productive. Some Projects take longer than others. But, what causes one to go faster than another may be more than just a scheduling issue.

A recent impact on NERC resources caused by comments to a single set of standards has impacted all other Projects.

- Does creating a new Team every 24 months help or hurt the process?
- Can the ERO better highlight their needs? The proposed recommendation does not include the ERO impacts on NERC's resources. Collecting statistical data on the ERO's internal processes will help identify the location and areas of such needs. Such statistics would be a step in improving timely communications.

The Large Public Power Council

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MEMORANDUM

To: Holly Mann, Secretary
NERC Member Representatives Committee

From: Bill Gaines, Director of Utilities and CEO, Tacoma Utilities, on behalf of the Large Public Power Council

Date: May 1, 2012

Subject: Response to April 5, 2012 Letter Requesting Input

On behalf of the Large Public Power Council (LPPC)[1], I have reviewed and concur in the response submitted today by the State and Municipal Utility Sector to NERC Board Chair John Q. Anderson's April 5, 2012 letter.

[1] LPPC represents 26 of the largest state and municipal utilities in the nation, with members that own approximately 90% of the transmission assets owned by non-federal public power utilities.

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POLICY INPUT TO NERC BOARD OF TRUSTEES

MAY 1, 2012

Pursuant to the NERC Board of Trustee's request for policy input from the NERC Member Representative Committee for the upcoming May 9, 2012 meeting, the Midwest Reliability Organization ("MRO") Board of Directors respectfully submits the following for consideration by the NERC Board of Trustees.

Standards Process Input Group *— The Board looks forward to hearing from the MRC Standards Process Input Group (SPIG) on their findings and policy recommendations for improving the existing NERC standards development process and to active discussion of these recommendations by the entire MRC.*

MRO commends the NERC BOT for designating a team to review the standards development process. In previous comments to the NERC BOT, MRO noted the need to delivery better, faster results while continuing to leverage the technical expertise of the industry. To leverage the technical expertise of the industry on standards drafting teams, membership needs to be based on the individual's qualifications to serve as an industry subject matter expert and availability, not his or her company affiliation. To improve the speed of development, MRO supports establishing and adhering to time lines for standards development, including shorter comment periods. We must maintain integrity in the process by ensuring that the standards development process rises above parochial interests of individual participants and remains a technical endeavor. Therefore, MRO supports developing a code of conduct that requires the Registered Ballot Body members and standards drafting team members to vote and work for the overall benefit of the reliability of the bulk electric system not merely the interests of any individual or organization.[1] A corollary to this in the balloting process would be to treat a negative vote without comment as an abstention for the purposes of determining whether a standard has received sufficient support to be approved.[2]

We must also recognize that the proliferation of standards tends to negatively impact reliability. Winston Churchill observed: "If you have ten thousand regulations you destroy all respect for the law." MRO believes that if you have ten thousand requirements, you lose respect for

[1] ISO's Conduct has seven principles, with "Work for the net benefit of the international community" being the first. See http://www.iso.org/iso/codes_of_conduct.pdf.

[2] This is consistent with the ANSI approved process Underwriters Laboratory employs. See paragraph 2.3.4.4(c) at page 15, http://www.ul.com/global/documents/corporate/standards/ApprovedRevisionstoULsAccreditedProcedures.pdf.

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reliability – resulting in an ERO focused on compliance, documentation and process, rather than a risk management focus on reliability through demonstrated performance. Therefore, we must also establish a process to eliminate and collapse standards that are administrative in nature and truly have no impact on reliability. Data from the Find, Fix, Track and Report process, is a good starting point for potential candidates.

In the course of developing the standards, we should be encouraging the industry to develop application guides for the standards. Like the standards themselves, application guides should come from industry subject matter experts and be designed to assist industry in implementing the standards. Engaging industry subject matter experts in this manner will result in a more reliable system.[3]

In the end, our goal should not be to adopt standards that will eliminate all errors or operating anomalies – a zero defect model will not work and the ratepayers cannot afford it. The hallmark of reliability is NOT that errors or operating anomalies won't occur on the system, but that errors and operating anomalies won't result in a cascading event. Our primary focus needs to be on prevention and resiliency – errors and mistakes will happen, we need a system that can withstand them without a cascading outage. This is the essence of risk management. While compliance and enforcement of regulations is a necessary tool and activity, our primary focus must be on working collaboratively with the industry to identify, understand, address and prevent risks thereby creating highly effective reliability organizations or HEROs. [4]

2013 NERC and Regional Entity Common Business Plan and Budget Assumptions — *NERC and the Regional Entities jointly developed Common Business Plan and Budget Assumptions for the 2013-2015 planning period and posted them for comment on February 21, 2012. The assumptions are being updated in response to comments received from EEI, which have also been posted on the NERC website. Additional comments on the common assumptions are welcome, and will be appropriately considered in business plan and budget review and approval process. As always, it will be most helpful if these comments are as specific as possible. In*

[3] In the MRO region, subject matter experts have published application guides on PRC 005/008. Following the publication of the application guides, MRO experienced and increase in self-reported violations of these standards, followed by a decrease in violations and the severity level of the violations.

[4] Similarly, a former head of the Transportation Security Administration (TSA) wrote in the Wall Street Journal: "First, the TSA's mission is to prevent a catastrophic attack on the transportation system, not to ensure that every single passenger can avoid harm while traveling. * * * Second, the TSA's job is to manage risk, not to enforce regulations." Quoted from "*Why Airport Security Is Broken-And How to Fix It,"* by Kip Hawley, April 15, 2012 Wall Street Journal, http://online.wsj.com/article/SB10001424052702303815404577335783535660546.html.

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addition, since the actual draft business plan and budget document will be released after the agendas are posted but prior to the MRC meeting, there will be an opportunity to discuss it at the MRC meeting, thereby providing additional input to the Board.

MRO supports stabilizing costs in the 2013 Business Plans for NERC and the Regional Entities. MRO has proposed a budget with an increase of approximately 2.5%. MRO believes that we must continue to clarify roles among NERC, the Regions and the industry. Greater role clarity will allow resources in the ERO to be used efficiently and allocated appropriately. MRO also supports allocating resources to support NERC's efforts to develop training as well as to adopt credentials and frameworks such as the Department of Defense Directive 8570 and those being developed by the National Initiative for Cybersecurity Education (NICE)[5] which includes over twenty United States federal departments and agencies for CIP professionals. Existing frameworks can be supplemented adding specific subject matter such as real time systems security (e.g. SCADA). MRO believes this work can be done in a cost effective manner.

Definition of Adequate Level of Reliability *— As part of the request to the MRC to provide policy input to the Board on the definitions of Bulk Electric System (BES) and Adequate Level of Reliability (ALR), a task force of the Planning, Operating, Critical Infrastructure Protection and Standards Committees has been working on the definition of ALR (see ALR Task Force website) and expects to post by the end of April for industry review and comment a draft definition document, a supporting technical reference document, a discussion paper on risk tolerance, and a mapping of ALR reliability objectives to NERC's Reliability Principles. While we are still not at the stage where the Board will be asked to take action, we would welcome any initial comments and discussion by the MRC members.*

The definition of an adequate level of reliability is an important policy matter for the NERC BOT; MRO appreciates the opportunity to comment. As previously noted the hallmark of reliability is not the absence of errors or operating anomalies. The hallmark of reliability is the absence of errors or operating anomalies that lead to cascading events. As we define "adequate level of reliability", we need to be mindful that we are only as strong as our weakest link and through the definition of the ALR, we must not ignore the importance of individual entity systems – we are after all, a system of systems and therefore, ALR must be considered on an interconnection-wide basis as well as an individual- system basis.

[5] See http://csrc.nist.gov/nice/framework.

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NPCC Board of Directors Policy Input to the
May 8, 2012 NERC Member Representatives Committee
and May 9, 2012 NERC Board of Trustees Meetings

1. Standards Process Input Group

a. Recommendation 1: American National Standards Institute (ANSI) process

- NPCC supports NERC's continuing to meet the minimum requirements to maintain ANSI accreditation as a means of fulfilling the statutory requirements set forth in Order 672.

b. Recommendation 2: Reliability Issues Steering Committee (RSIC)

- NPCC supports the formation of a RSIC to conduct front-end, high level review of nominated reliability issues, and to direct the initiation of standards projects or other solutions that will address reliability issues. NPCC also believes that merging the Standards Committee roles and responsibilities with the RSIC could be beneficial and encourage efficient use of scarce resources.

c. Recommendation 3: Interface with Regulatory and Governmental Authorities

- NPCC encourages NERC, working through existing committees, to develop a strategy for improving the communication and awareness of effective reliability risk controls to increase input and alignment with state, federal, and provincial authorities.

d. Recommendation 4: Standards Product Issues

- NPCC recommends that the standards development process address: the use of a results–based approach; assessment of cost effectiveness of standards and standards development; alignment of standards requirements/measures with Reliability Standards Audit Worksheets (RSAWs) used in compliance assessments; and the retirement of standards no longer needed to meet an adequate level of reliability.

e. Recommendation 5: Standards Development Process and Resource Issues

- NPCC encourages the NERC BOT to require quality review within the standards development process, versus a back-loaded quality review, to improve timely, stakeholder consensus in support of new or revised reliability standards. The Board is also encouraged to require standard development resources to achieve and address: formal and consistent project management; and efficient formation and composition of Standard Drafting Teams.

2. 2013 NERC and Regional Entity Common Business Plan and Budget Assumptions

- NPCC believes that the collaborative development process between NERC and the eight Regional Entities in developing the Common Business Plan and Budget Assumptions will lead to more consistency and efficiency in the development of all 2013 Business Plans and Budgets.

- NPCC supports the continuing re-prioritization of resources, the implementation of efficiency initiatives and risk-based approaches in both the standards and compliance areas, the inclusion of expanded explanations of the reasons behind certain program expenditures, and the recognition of the synergies between situation awareness and events analysis within the initial draft NERC 2013 Business Plan and Budget

3. Definition of Adequate Level of Reliability

- NPCC supports the industry-wide process for the development and review of an enhanced definition of Adequate Level of Reliability (ALR) for the Bulk Electric System as a means of focusing NERC's Reliability Standards and assurance efforts
- NPCC supports the impact based reliability performance outcomes for the design, planning and operation of the BES objectives proposed in the revised ALR Definition

Approved by the NPCC Board of Directors
at its May 1, 2012 Meeting

National Rural Electric Cooperative Association (NRECA)
Policy Input to the NERC Board of Trustees (BOT)
May 1, 2012

NRECA appreciates the opportunity to provide policy input to the NERC BOT regarding several issues that will be discussed at the May 8/9 MRC and BOT meetings.

Standard Process Input Group (SPIG)

- NRECA commends the SPIG for its efforts in developing their report on potential improvements to the NERC standards development process.
- At this time, NRECA is concerned with the potential of a lesser role for industry stakeholders, and a larger role for NERC staff, as outlined in the SPIG report.
- NRECA is still reviewing the SPIG report and will provide further comments at the MRC and SOTC meeting.

2013 NERC and Regional Entity Common Business Plan and Budget Assumptions

- NRECA is not providing policy input at this time. We will submit comments in future budget comment periods.

Definition of Adequate Level of Reliability

- NRECA is not providing policy input at this time. We will submit comments in the formal ALR comment period that is currently open.

GOTO Issues

- NRECA encourages the BOT to approve the GOTO-related standards that are before them at the May 9 meeting.
- NRECA is a signatory and supports the GOTO issue paper that EEI has attached to its policy input.

FFTR Issues

- NRECA requests that the BOT engage NERC management to gain a better understanding of when future phases of the CEI/FFTR initiative will be implemented. Phase 1 has been implemented; however, most of the significant benefits have focused on NERC and RE resources.
- Phase 2 and 3 of this initiative will potentially provide significant benefits to industry stakeholders. At the present time NRECA is not aware of a formal plan to implement Phase 2 and 3, and we encourage the BOT and NERC to put the necessary focus on this work to provide industry stakeholders confidence that this is being addressed as quickly as possible.
- NRECA is also concerned with the varied implementation of FFTR by the REs and urges NERC and the REs to fully implement the FFTR initiative.

- In addition, NRECA is concerned that NERC may not have the ability to require the REs to implement the FFTR initiative. We request that NERC review the CMEP to determine if changes are needed to ensure full implementation of this important initiative.
- NRECA is very supportive of the ERO, in collaboration with industry stakeholders, being responsive to the opportunity provided by FERC in P81 of the FFTR order to review and eliminate standards that provide no or minimal reliability benefits. NRECA believes this opportunity should be aggressively pursued.

Barry R. Lawson
Associate Director, Power Delivery & Reliability
National Rural Electric Cooperative Association (NRECA)
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SERC Board of Directors Policy Input to NERC
May 2012

SERC Reliability Corporation (SERC) continues to be pleased with and supportive of the continued advances being made by the Electric Reliability Organization (ERO). The SERC Board of Directors appreciates the opportunity to provide policy input to NERC for the May 2012 Board of Trustees and Member Representatives Committee meetings.

Standards Process Input Group

- SERC supports the direction being taken by the Standards Process Input Group (SPIG).
- SERC is in favor of actions that could ensure that standards fill a reliability performance gap and are cost justified.
- SERC is supportive of creating more efficiency and timeliness in the standards development process, but SERC also acknowledges that developing technically superior standards leveraging the expertise of many experts will, by definition, take time. Care should be taken to avoid improving timeliness at the expense of a quality consensus product.
- SERC suggests in future standards development activities an increased focus on feedback loops from compliance, reliability performance, event analysis and other information sources.
- SERC is also very supportive of the ERO being responsive to the opportunity provided by FERC to review and eliminate standards that provide no or minimal reliability benefits.
- SERC will reserve judgment on the formation of a Technical Issues Steering Group until the relationship of that group to the existing Standards Committee and other NERC technical committees is better defined.

2013 NERC and Regional Entity Common Business Plan and Budget Assumptions

- NERC and the eight Regional Entities have collaborated in the development of a common set of business planning goals, objectives and assumptions for the 2013-2015 planning period. These assumptions provide guidance to NERC and to the Regional Entities in the preparation of budgets and work plans.
- SERC acknowledges and greatly appreciates the progressive improvements that have been made to ERO business planning over the last couple of budget cycles.
- SERC generally supports the common business plan and budget assumptions.
- SERC does provide a couple of observations.
    - SERC believes that the ERO needs to have properly trained and credentialed resources performing statutory functions. At the same time, too much training and credentialing can be time-consuming and expensive, and may not have commensurate value for BES reliability. It is important to SERC that the training and credentialing not result in discouraging the participation of industry subject matter experts on the audit teams. SERC suggests that the ERO proceed judiciously and cautiously in this area. Furthermore, SERC recommends that this initiative be pursued only after development of a proper business case defining scope, activities, estimated cost and commensurate value. The business plan should give consideration to staging implementation with the initial focus on providing an

exceptional training experience to audit team leads.
    - SERC strongly supports NERC and Regional Entity collaboration to implement the BES exception process in a clear, unambiguous, and efficient manner to avoid the need for substantial ERO and industry resources to implement.
- SERC appreciates that good oversight and approval of budgets are important for proper business rigor in the ERO model. SERC is concerned, however, with the multiplicity and duplicative reviews given the Regional Entity budgets. While NERC should be expected to review Regional Entity budgets, conducting three or four public reviews after review, posting, and approval at the Regional Entity level is an unnecessary use of resources. NERC's role has moved from one of oversight to duplication of the Regional Entity's consideration and approval; this adjustment seems to ignore the organizational decision making responsibility and fiscal responsibility of the regional entity and its board of directors.

Definition of Adequate Level of Reliability

- A task force of the NERC standing committees (the Adequate Level of Reliability Task Force (ALRTF)) has prepared and posted a draft definition of Adequate Level of Reliability (ALR) for the BES as well as a supporting technical report.
- SERC is supportive of the ALRTF draft definition and the draft technical report. The draft definition and report provide clarity and document the intent of the definition.
- SERC is keenly aware that definitions for both ALR and BES are needed to support pursuit of results based standards. In that regard, SERC continues to support efforts to seek resolution of these definitions.
- SERC will reserve its final judgment on ALR definition until the final definition is prepared.

MEMORANDUM

TO: Holly Mann, Secretary
NERC Member Representatives Committee

FROM: Tim J. Arlt
John DiStasio
Bill Gallagher
John Twitty

DATE: May 1, 2012

SUBJECT: Response to Request for Policy Input

The MRC's State and Municipal and Transmission Dependent Utility Sectors ("SM-TDUs") appreciate the opportunity to respond to the April 5, 2012 letter from NERC Board Chair John Q. Anderson to Mr. Scott Helyer, acting in his capacity as the Chair of the NERC Member Representatives Committee ("MRC"), requesting policy input on topics to be discussed by the NERC MRC and the NERC Board of Trustees at the upcoming May meetings.

This response addresses all three topics raised in Mr. Anderson's April 5 letter: (i) the findings and policy recommendations of the Standards Process Input Group ("SPIG"), (ii) the 2013-15 NERC and Regional Entity Common Business Plan and Budget Assumptions, and (iii) the draft definition document of Adequate Level of Reliability ("ALR"). We also address several other policy issues raised in the MRC and BOT Agendas, including NERC's Compliance Enforcement Initiative, NERC's critical infrastructure resiliency and cyber-security initiatives, including the Coordinated Action Plan, and the Board's pending approval of the GO-TO standards project.

I. Standards Process Input Group

SM-TDUs strongly support the SPIG's *Recommendations to Improve the NERC Standards Development Process* and commend the SPIG for its systematic approach to diverse industry views on the NERC standards process. The SPIG Report is responsive to concerns we and other industry groups have raised in comments on NERC's Three Year Assessment, the ERO Strategic Plan, and Policy Input submitted by the trade associations prior to the February 2012 Board meeting. We support each of the SPIG's five major recommendations and offer the following additional thoughts and concerns about the path forward toward implementation:

> *Recommendation 1: American National Standards Institute* — SM-TDUs agree NERC should ensure its continued accreditation as a standards development organization, while seeking out process efficiencies that adhere to ANSI principles. This path helps ensure continued stakeholder and regulatory authority confidence in NERC.

Recommendation 2: Reliability Issues Steering Committee — SM-TDUs support NERC Board formation of a Reliability Issues Steering Committee ("RISC") to conduct front-end, high-level review of nominated reliability issues and recommend the initiation of standards projects or other solutions that will address these reliability issues. Care must be taken, however, to ensure that the RISC does not duplicate the work of other NERC committees and task forces. The RISC should focus on development of strategies and work plans to address emerging reliability issues and strategic risks to the bulk electric system. SM-TDUs suggest that the Board direct development of an interim RISC scope document and membership plan and then reassess the RISC in summer 2013.

Recommendation 3: Interface with Regulatory and Governmental Authorities — SM-TDUs fully agree that NERC must work with stakeholders to develop a strategy for improving the communication and awareness of effective reliability risk controls. A common, shared view of reliability risks and cost-effective controls is essential to ensure that NERC, the Regions and stakeholders do not work at cross purposes with state, federal, and provincial authorities. At its core, this combined risk management and communications strategy encompasses the ERO's entire program, not just the development and approval of reliability standards.

For example, the Board is slated to adopt revisions to the remaining reliability standards identified in Project 2010-07, Generator Requirements at the Transmission Interface. SM-TDUs agree with other industry stakeholders that approval of these standards revisions will fill the potential gap created by generator ownership and operation of certain limited transmission interconnection facilities operating at BES voltage levels, without requiring such generators to be registered by NERC and its Regional Entities as Transmission Owners and Operators. NERC, the industry and regulatory authorities should embrace this approach because it provides clarity to new and existing generators on their regulatory obligations without imposing regulatory burdens that are disproportionate to any potential reliability benefits. This approach also avoids the regulatory uncertainty associated with case-by-case registration by requirement. It will also make more efficient use of NERC, Regional Entity and regulatory authority resources.

Recommendation 4: Standards Product Issues — SM-TDUs fully support the SPIG's recommendations and encourage the NERC Board to direct the Standards Committee and NERC staff to accelerate programs and procedures to develop Results–Based Standards ("RBS"), assess the cost effectiveness of standards, align standards requirements/measures with Reliability Standards Audit Worksheets ("RSAWs"), and consider the retirement of compliance elements such as Violation Severity Levels that are time-consuming to develop and have limited validity in the field. SM-TDUs strongly support an initiative to identify and retire specific standards and requirements that are no longer needed to meet an adequate level of reliability. The outlines of such a plan are set out under Standards Oversight and Technology Committee Agenda Item 4b, concerning P 81 of the FERC's order conditionally accepting NERC's Find, Fix and Track ("FFT")

proposal, where FERC noted that perhaps some current requirements provide "little protection for Bulk Electric System reliability or may be redundant."[1]

Recommendation 5: Standards Development Process and Resource Issues — SM-TDUs encourage the NERC Board to direct the Standards Committee and staff to develop and propose specific revisions to the standards process and develop new tools that will foster timely stakeholder consensus in support of new or revised reliability standards. For example, Standard Drafting Teams ("SDTs") should focus on understanding and addressing all *substantive issues* raised during formal comment periods, rather than on ensuring that each commenter receives a unique response. The Board is also encouraged to allocate standard development resources to achieve better project management. The Standards Committee and staff should ensure that all SDTs have the regulatory, legal and writing resources and leadership skill sets needed to make efficient progress toward industry technical consensus.

We appreciate the SPIG's efforts and look forward to supporting these much needed reforms.

II. 2013-15 NERC and Regional Entity Common Business Plan and Budget Assumptions

SM-TDUs are encouraged by the March 26, 2012 shared business plan and budget assumptions developed by NERC and the Regional Entities.[2] The assumptions are a good step toward controlling the costs associated with the operations of NERC and the Regional Entities. These regulatory costs have increased at a double-digit rate since certification of NERC as the ERO, placing tremendous pressure on the SM-TDUs to mitigate rate impacts on our customers, who continue to struggle with their own financial constraints and a slow-recovering economy.

As SM-TDUs have stated before, we believe that NERC must make prudent decisions regarding its budget to ensure that excessive costs are not passed on to utilities and their customers. NERC and its regions must also be more cognizant of the regulatory cost burden that the ERO business plan imposes on each Registered Entity. To this end, SM-TDUs urge the Board to adopt additional business plan assumptions on the efficiency and effectiveness of NERC and Regional Entity programs.

In the area of compliance and enforcement, the assumptions should make clear that the efforts expended by NERC, Regional Entities, and *Registered Entities* on the paperwork associated with enforcement actions must be reduced. We continue to believe that most of the process efficiencies to date reduce the FERC filing requirements borne by NERC, without creating corresponding cost savings for Registered Entities. Each Regional Entity should be held accountable for expeditious implementation of the FFT program, including the identification of specific requirements that are pre-determined to be eligible for FFT when submitted as part of a Registered Entity self-report. We support the allocation of sufficient budgetary resources to the

[1] *North American Electric Reliability Corporation*, 138 FERC ¶ 61,193 (2012).

[2] Go to: http://www.nerc.com/filez/business_plan_2013.html

Regional Entities to hire and train field audit staff, such that these auditors have the subject matter expertise and professional auditor training required to distinguish between entities that have robust, systematic internal controls that evidence a culture of compliance, and those entities that have room for improvement. In return, the Board should insist that NERC staff and the regions actually execute this risk-informed allocation of NERC and regional staff enforcement resources.

In the area of cyber-security and critical infrastructure protection, the Board should adopt a business plan assumption that NERC will fully execute the plans that are now in place and avoid at all cost further "mission creep" that is not offset by curtailment of current projects. SM-TDUs continue to be concerned that NERC – and by extension, the electric utility industry – may become overextended in its efforts to manage the core mission as the ERO, which is to develop and enforce reliability standards, and its broader roles in government-industry coordination, information sharing, and education. These other responsibilities include the Electricity Sector Information Sharing and Analysis Center ("ES-ISAC"), the National Cyber-Security Information Center, development and operation of the new bi-directional communication portal between government and industry, various multi-sector training exercises such as the Grid-Ex 2012, and implementation of the Coordinated Action Plan. As just one example, the Coordinated Action Plan proposes implementation of over 50 specific recommendations during 2012-13 and beyond. During this same multi-year period, the industry will adopt and begin implementing Version 5 of NERC's Critical Infrastructure Protection ("CIP") Standards. Bottom line, something has got to give: if NERC and the industry are going to successfully adopt and implement new CIP standards *and* implement the information sharing and infrastructure resiliency programs outlined above, we will need to integrate and prioritize the action plans, insist on actual results and radically reduce the documentation burden imposed by the current CIP standards program, with its emphasis on checkbox compliance and processing of Technical Feasibility Exceptions.

III. Definition of Adequate Level of Reliability

At this time, SM-TDUs will refrain from detailed comments on the ALR definition and technical document until we have discussed these documents with our colleagues.[3] From our initial review, the revised definition does a sound job of refocusing the current Board-approved definition on core reliability objectives and performance outcomes for the reliable design, planning and operation of the Bulk Electric System.

SM-TDUs have also reviewed the *Discussion Paper: Risk Tolerance for Widespread BES Outages with Significant Socio-Economic Impacts*. The ALR Task Force proposes that NERC investigate the use of a probabilistic risk management framework to establish reliability objectives and performance expectations that will manage the socio-economic impacts of widespread outages on the bulk electric system. The Discussion Paper raises important issues which require significant discussion and thought before we endorse the concepts discussed therein, including further development of the proposed probabilistic risk management

[3] The ALR Definition and associated documents have been posted for a 60-day comment period beginning on April 25, 2012. http://www.nerc.com/filez/alrtf.html

framework. SM-TDUs close their Policy Input to the NERC Board with the following excerpt from pages 2-3 of the draft Discussion Paper:

> The ALR Reliability Objectives and Performance Outcomes do not operate in isolation. Rather, reliable planning and operation of the BES is governed by: 1) the statutory framework established by Section 215 of the Federal Power Act and by corresponding obligations established by Canadian provincial authorities, 2) the expectations of numerous other institutions, including state and local regulators which have jurisdiction over rates charged to ultimate consumers, 3) public and consumer expectations that they will receive reliable yet affordable electric service, and 4) the industry's broader public interest obligation to ensure reliable operation of one of modern society's most critical infrastructures. Indeed, it is widely recognized by electric sector policymakers, and by government and industry generally, that wide area outages of the electric power system, due to major BES events or to extreme events affecting local distribution systems (which are generally weather-related), impose a substantial burden on modern society.
>
> Hence, the basic question is, are we using the standards to manage local, customer-centric risks, or macro/socioeconomic risks? The ALRTF believes that the larger purpose of NERC Reliability Standards and the NERC statutory construct is to manage socioeconomic risks, e.g., risks to the "common good" of an unreliable BES.

SM-TDUs agree.

Thank you for the opportunity to provide this input.

NERC Finance and Audit Committee
Notes de Sylvain

May 8, 2012 | 9:30-10:30 a.m. Eastern
Westin Arlington Gateway

Audited Financial Statement

- Recommended for Approval.
- Questionnaire on external auditor performance.

1st Quarter Consolidated Results

- The results are to be looked in parallel with Gerry's remarks on the performance. NERC is trying to use this information for the 2013 budget.
- The results show that NERC is running under budget mainly due to personnel expenses (in great part related to the change in the staff benefit) and to travel and conference (decrease travel due to consolidation of staff and more meetings in Atlanta). This trend should continue.
- Some variances are related to timing of spending and revenue.

Working Capital Policy

- The policy is broader than just working capital policy. It addresses operating reserves, how to handle excess fund, cash flow policy, reallocation of funds during year, unfunded FTE during the year, etc.
- The 2nd draft of the Business Plan and Budget will show details.

Sylvain Clermont
8 mai 2012