FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D.C. 20426

In Reply Refer To:
Office of Enforcement
Docket No. FA12-7-000
May 9, 2013

Tim Gallagher, President and CEO
Reliability*First* Corporation
320 Springside Drive
Suite 300
Akron, OH 44333

Dear Mr. Gallagher:

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

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

3. In its April 25, 2013 response, Reliability*First* stated its acceptance of the audit report and its commitment to implement the recommendations within the audit report. A copy of your verbatim response is included as an appendix to this report. I hereby approve the audit report.

4. Within 30 days of this letter order, Reliability*First* should submit a plan to comply with the recommendations. Reliability*First* should make quarterly submissions describing how and when it plans to comply with the recommendations, including the completion dates for each recommendation. The submissions should be made no later than 30 days after the end of each calendar quarter, beginning with the first quarter after this audit report is issued, and continuing until all the recommendations are completed.

[1] 16 U.S.C. § 824o (2012).

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

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

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

Sincerely,

Norman C. Bay

Norman C. Bay
Director
Office of Enforcement

Enclosure

Federal Energy Regulatory Commission

Audit of Reliability*First* Corporation for Budget Formulation, Administration, and Execution

Docket No. FA12-7-000
May 9, 2013

Office of Enforcement
Division of Audits

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I. Executive Summary

A. Overview

The Division of Audits (DA) within the Office of Enforcement has completed an audit of the Reliability*First* Corporation (Reliability*First* or Company). The audit was commenced to evaluate Reliability*First*'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 February 19, 2013.

B. Reliability*First* Corporation

On July 20, 2006, the North American Electric Reliability Corporation (NERC) was certified as the Electric Reliability Organization (ERO) in the United States, pursuant to section 215 of the Federal Power Act of 2005 (FPA). In this certification was a provision for the ERO to delegate authority for the purpose of proposing and enforcing reliability standards by entering into delegation agreements with Regional Entities (REs). On August 26, 2006, the Commission authorized Reliability*First* as one of eight approved REs in North America.

The region served by Reliability*First* was formed from three Regional Reliability Councils (RRCs): the Mid-Atlantic Area Council (MAAC), the East Central Area Coordination Agreement (ECAR), and the Mid-American Interconnected Network (MAIN). A fourth RRC, the Midwest Reliability Organization (MRO), at first participated in the project to form Reliability*First*, but ultimately did not join, electing instead to form its own RE. The other three RRCs consolidated into one regional entity to have consistent standards and procedures across a larger geographic area that encompassed multiple systems and market operators. Reliability*First* was organized as a Delaware corporation on June 15, 2005 in preparation for assuming responsibility for functions delegated to an RE by the ERO under section 215. Also as part of the organization, on January 1, 2006 Reliability*First* replaced ECAR, MAAC, and MAIN as the RRC under NERC for the combined regions.

Reliability*First* performs key NERC-delegated reliability functions, including: developing regional reliability standards, monitoring compliance with reliability standards for all owners, operators, and users of the Bulk-Electric System (BES) within its region, and providing seasonal and long-term assessments of BES reliability within its region. Reliability*First* stated that all programs and activities it engages in are statutory under section 215, i.e., undertaken pursuant to section 215.

Specific activities Reliability*First* engages in are:

- Development and proposal of regional reliability standards;
- Enforcement of compliance with reliability standards;
- Certification of BES entities;
- Registration of owners, operators, and users of the BES responsible for compliance with requirements of reliability standards;
- Reliability assessment and performance analysis;
- Event analysis and reliability improvement;
- Training and education; and
- Situational awareness and infrastructure security.

Headquartered in Akron, OH, Reliability*First* is bordered by the Midwest Reliability Organization (MRO), SERC Reliability Corporation (SERC), and the Northeast Power Coordinating Council (NPCC). As an RE, Reliability*First* oversees 370 registered entities in 13 states and the District of Columbia. The 13 states are New Jersey, Delaware, Pennsylvania, Maryland, West Virginia, Ohio, Indiana, Michigan, Wisconsin, Illinois, Kentucky, Tennessee, and Virginia.

C. Summary of Conclusions

Audit staff's findings related to enhancements are summarized below. A detailed discussion of these findings is included in section IV of this report. Audit staff found three areas in which improvements to Reliability*First*'s budget formulation, administration, and execution could be achieved, and one other matter that can enhance training to registered entities:

- *Remuneration Based on Total Compensation* – Reliability*First* did not use a total compensation approach as the basis to determine the appropriateness of compensation paid to its officers and staff.

- *Working Capital/Contingency Fund* – Reliability*First* had not established written policies and procedures for using working capital/contingency funds.

- *Budget Formulation* – Reliability*First*'s budget formulation process could be improved to consistently document the rationale used in budget formulation, including the initial estimates made by managers. Additionally, some of the justifications for adjustments to the initial estimates were inconsistently documented in the budget formulation process.

In addition to these enhancements, audit staff identified one other matter:

- *Assist Visit Program* – Reliability*First* developed an innovative program, the Assist Visit Program (AVP), in order to train registered entities in the region. However, Reliability*First* could improve its documentation of the AVP, enhancing its ability to effectively evaluate the program for broader implementation and develop lessons learned for the benefit of registered entities in the region. If this were done, stakeholders might benefit more from other stakeholders' experiences through lessons learned or frequently asked questions (FAQ).

D. Summary of Recommendations

This section summarizes audit staff's recommendations on Reliability*First*'s budget process. Detailed recommendations are in section IV of this report. Audit staff recommends that Reliability*First*:

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

2. 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 Reliability*First*'s mission as the RE;

3. Use total compensation as the relevant guideline for policies and compensation studies, and in assessing salaries, retirement benefits, bonuses, and other forms of compensation;

4. Develop corporate performance metrics upon which its Board can rely to justify a discretionary retirement plan contribution sufficient to compete with profit-sharing and stock option components of for-profit corporations, as supported by total compensation studies;

5. Develop and implement a policy for use of contingency funds which, at a minimum:

    a. Identifies who approves and needs to be informed of the use of the funds;
    b. Identifies criteria to determine the proper approval levels;

c. Includes procedures for approving the use of contingency funds and informing appropriate parties of this use; and
d. Identifies the purpose of, and the expected uses of, contingency funds;

6. Improve its budgeting and full-time equivalent (FTE) analysis spreadsheets already in use by adding fields to document:

   a. The rationale behind initial estimates; and
   b. Adjustments to the initial estimates with the rationale for those adjustments;

7. Develop FTE requirement projections for all departments during the budgeting process;

8. Develop and implement a policy for internally documenting the AVP training activities;

9. Develop a formal process for sharing the results of the AVP with stakeholders via lessons learned or FAQ.

E. Compliance and Implementation of Recommendations

Audit staff further recommends that Reliability*First*:

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

- Submit quarterly reports to the Division of Audits describing Reliability*First*'s progress in completing each corrective action recommended in the final audit report in this docket. Reliability*First* should make its quarterly filings no later than 30 days after the end of each calendar quarter, beginning with the first quarter after the final audit report in this docket is issued, and continuing until Reliability*First* completes all recommended corrective actions.

- Submit copies of any written policies and procedures developed in response to the recommendations in this audit report. These policies and procedures should be submitted for audit staff's review in the first quarterly filing after Reliability*First* completes them.

II. Background

A. Overview

Under section 215(e)(4) of the Federal Power Act (FPA), the Commission approved NERC's delegation of certain statutory functions to the REs.[2] Effective January 1, 2011, Reliability*First* executed an Amended and Restated Regional Delegation Agreement with NERC that delegated to Reliability*First* certain responsibilities and authorities pursuant to section 215 of the FPA. The duties NERC delegated include: certification of Bulk-Power System (BPS) entities; registration of owners, operators, and users of the BPS responsible for compliance with the requirements of Reliability Standards; reliability assessment and performance analysis; event analysis and reliability improvement; training and education; situational awareness and infrastructure security; the development and proposal of Reliability Standards to NERC; monitoring of compliance with Reliability Standards; and enforcement of compliance with Reliability Standards.

B. Statutory Activities

Reliability*First* carried out its statutory functions and responsibilities through seven functional units: Investigations & Compliance Services, Operations & Planning Audits, CIP Audits, Analytics & Enforcement, Reliability Assessment & Performance Analysis, Standards Development, and Security & Corporate Affairs. To support those program areas, Reliability*First* maintained employees in general and administrative programs including Legal and Regulatory Affairs, Human Resources, Information Technology, and Finance and Accounting.

Investigations & Compliance Services

The Investigations & Compliance Services unit: enforced compliance with the Reliability Standards; registered owners, operators, and users of the BPS responsible for compliance with the requirements of Reliability Standards; certified BPS entities; performed event analysis; and provided training and education. This activity included leading all investigations, handling all registration work and related issues, developing Board Compliance Committee updates, and developing all compliance training needs.

[2] 16 U.S.C. § 824o (2012).

Operations & Planning Audits and Critical Infrastructure Protection (CIP) Audits

The Operations & Planning Audits and CIP Audits units: monitored and enforced compliance with the Reliability Standards related to registered entities' planning, operational, and CIP compliance; and assisted with training and education. This work included developing risk assessments, conducting audits and spot checks, and verifying mitigation plans. The CIP Audits group also processed Technical Feasibility Exceptions.

Analytics & Enforcement

The Analytics & Enforcement unit: performed risk analysis, and enforced compliance with Reliability Standards by overseeing the verification of mitigation plans. This work included performing risk-harm assessments posed by violations, reviewing root cause analyses, and reviewing, approving, and verifying corrective actions.

Reliability Assessment & Performance Analysis

The Reliability Assessment & Performance Analysis unit: performed the delegated functions of reliability assessment and performance analysis, and situational awareness duties. This activity included conducting resource assessment reports and other studies, leading and participating in working and technical groups, monitoring the BES, and collecting and assessing compliance data.

Standards Development

The Standards Development unit: developed and proposed Reliability Standards to NERC. This included work on regional standards, coordination and submittal of NERC standards-related comments and voting, participation in NERC standards committees, and provision of standards-related guidance to the compliance groups.

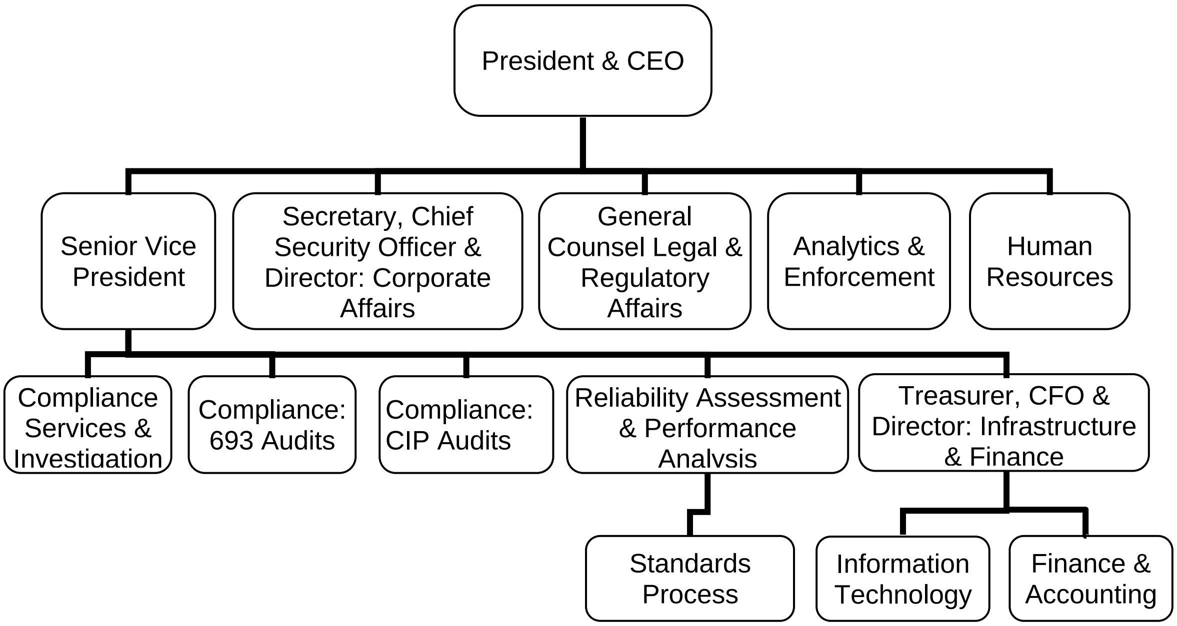
Security & Corporate Affairs

The Security & Corporate Affairs unit: performed the delegated functions of situational awareness and infrastructure security, and also provided a support function by overseeing Reliability*First*'s corporate security programs.

C. Organizational Structure and Staffing

Reliability*First* divided its delegated duties among its departments or functional units. For example, the Compliance Services group conducted most training and educational duties, but all departments assisted with training on subjects in their areas. Figure 1 illustrates Reliability*First*'s organizational structure as of December 31, 2012.

Figure 1: Reliability*First* Organizational Chart[3]



Reliability*First* underwent various organizational restructurings during the audit period. Changes included the creation of a Human Resources department, and the separation of the Compliance department into CIP Audits, Operations & Planning (Order No. 693) Audits, and Compliance Enforcement departments. Reliability*First*'s most recent organizational structure aligned with the program areas identified within its Business Plan and Budget (BP&B), with a few key differences. For example, in order to improve its management oversight and accountability for its Compliance Monitoring and Enforcement Program activities, Reliability*First* employed greater granularity by separating its compliance audits and spot checks from enforcement activities such as violation determination, settlements, and mitigation plan review. Where employees performed activities across program areas, the organizational structure reflected this fact by combining some program areas, such as the Reliability Assessment & Performance Analysis department performing delegated responsibilities for reliability standards, technical committees, and member forums, as well as situational awareness and infrastructure security.

In its 2012 BP&B, Reliability*First* budgeted for 73 FTEs. This staffing level reflected a significant increase from the initial 2007 staffing level of 34 FTEs. The

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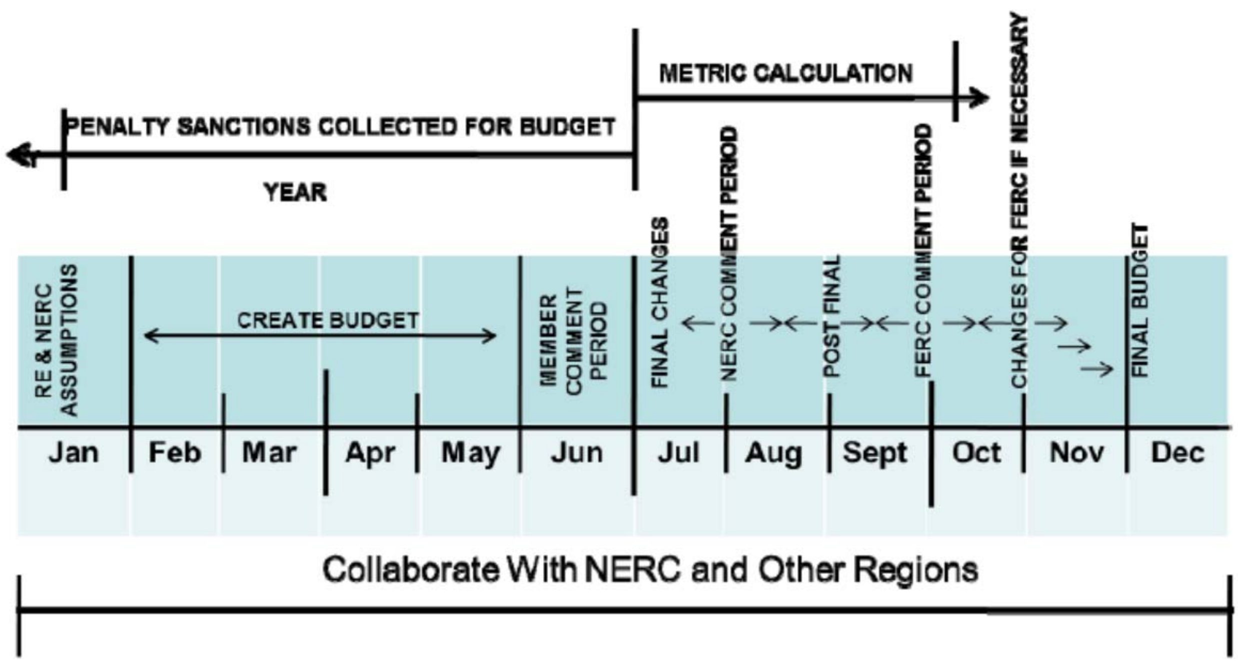
[3] Audit staff created this simplified organizational chart for this report based on an organizational chart Reliability*First* provided, dated December 31, 2012 (see Appendix A).

upward trend in staffing had continued since Reliability*First*'s formation but leveled off in 2012, and the 2013 staffing level was held constant. However, audit staff notes that as of December 2012 there were a total of seven vacancies. The significant number of vacancies resulted from attrition, and the difficulty in staffing positions added during 2011 and 2012 with qualified candidates.

D. Budget Formation

During the audit period, Reliability*First*'s budget development process began 14 months before the budget year started, when the financial heads from all regions and NERC met to discuss lessons learned in preparation for the next budget. This long budget cycle was necessary to provide adequate time for the Regional Entity Boards, the NERC Board, and FERC to review and approve the BP&B in succession. The graph below depicts a typical budget timeline. NERC worked with the regions to determine a more detailed timeline for each individual budget cycle.

BUDGET TIME LINE



The budget cycle began with the regions and NERC determining common business plan assumptions, after which the financial department created a budget timeline for each stage of the budget development process. Common business plan assumptions included ERO-wide assumptions about the business environment and major activities of program areas, and were guiding principles to the budget process. Reliability*First* also had a five-year tactical plan and a strategic plan, both of which were created to guide Company decision-making. These plans were designed to provide a clear five-year focus for Reliability*First*'s efforts, discuss Reliability*First*'s general plans for its programs, staffing, and internal structure, and guide its BP&B development.

Reliability*First* performed zero-base budgeting. The financial department produced a template draft spreadsheet for each department using the previous year's budget drafts as a model. The financial department then updated the draft BP&B templates with historical data from the general ledger for department head reference, and posted this information on the Reliability*First* intranet for each department head to access.

Each department head was responsible for creating his or her respective department's budget using the template spreadsheets. Department heads determined education and relocation costs, meeting and travel expenses, contractor and professional services expenses, asset purchases, office supply expenses, and miscellaneous expenses. They referred to prior-year expenditures as a basis, and made adjustments based on known issues or upcoming projects. Department heads also established FTE requirements, usually supported by an FTE manpower analysis based on prior-year timekeeping data. This analysis helped identify the FTEs required in the upcoming budget year to accomplish planned activities. Accounting and Human Resources staff developed the remaining portion of the budget, determining costs that were a function of FTE numbers, such as pension benefits and payroll, and expenses shared across the organization, like rent and telecommunication.

Reliability*First* consolidated individual department budgets into the draft BP&B, which then underwent an extensive review process. In March, department managers conducted a peer review of each draft, followed by meetings and discussions with senior management. After this peer review, the budget draft was discussed with the Board, modifications were made in response to any input, and the draft posted for public stakeholder comment in April. In May, after stakeholder comments were reviewed, the draft budget was presented to the NERC Board and to FERC staff. The final version of the budget was reviewed by the Reliability*First* Board and approved in July, at which point the budget was submitted to NERC. After any final comments by NERC, NERC combined all regional entity budgets with its own and filed the package with FERC in August. FERC evaluated the budgets and issued an order in November, two months before the budget year started. Upon Commission approval, Reliability*First* entered the new BP&B into the general ledger in preparation for the budget year.

E. Accounting and Recordkeeping

Reliability*First* used the NERC System of Accounts (NSOA) to classify income and expenses. The NSOA segregated income and expenses based on the functional categories within the NERC Rules of Procedure. For example, functional category 300, Reliability Standard Development, includes income and expenses for activities defined as functions required under section 300 of NERC's Rules of Procedure. Reliability*First* also used event codes in its general ledger, which allowed greater granularity by assigning expenses to specific projects or "events."

Audit staff notes that the event codes generally lined up with activity categories used for tracking employee time (discussed in Time Tracking below). This alignment allowed Reliability*First*, NERC, and the Commission to allocate or assign all expenses to activities within each functional category. For budgeting, FTEs were generally budgeted for groups of projects or activities (e.g., small, medium or large Operations & Planning audits). When budgeting for expenses, if an expense was for a specific activity or project, that activity or project was identified. The codes used to track expenses and employee time, and the categories used to budget for expenses and FTEs, generally align with the budgeting project or activity groups. However, Reliability*First* could benefit from fully aligning the codes and categories. Establishing set interrelationships between the four groups of event codes, timekeeping activities, budgeted expense categories, and budget FTE analysis categories would make it easier and faster to extract details for a specific project.[4]

F. Expense Reporting and Tracking

Reliability*First* used a manual expense system in which employees filled out an expense report cover sheet by hand, and attached all physical receipts to the report. Accounting staff reviewed the report and flagged unreasonable or anomalous entries, and tracked down missing receipts. Managers provided the next level of review and approved expenses based on a generic reasonableness standard. Finally, accounting staff entered the various expenses manually into the general ledger system by categories such as hotel, airfare, meals, and so on. In the general ledger, these expenses were assigned to a specific department, and were also assigned an "event code" that corresponded to individual projects, or groups of projects. The expense report was then filed in a filing cabinet at the Company. Also, to evaluate the reasonableness of employee expenses, Reliability*First* conducted comparative analyses in 2010 and 2012 of actual meal expenses incurred by employee versus a per diem system. These analyses showed that the reasonableness standard in place at Reliability*First* resulted in lower expenses than would have been incurred under a per diem system.

The expense reporting and tracking system in place was functional, though audit staff believes Reliability*First* could benefit from implementing an automated, electronic expense system that interfaces with the general ledger. An automated system would significantly reduce the time needed to compile future per diem analyses, which currently require manual aggregation of data from filed paper expense reports. Having these data

[4] This can be done either through establishing a one-to-one correlation, or though identifying a group of codes from one area as encompassing a single code in another area.

available in an electronic format would provide Reliability*First* with the ability to easily conduct a per diem analysis, or any other examination of expenditures deemed necessary. Additional efficiency would also be gained in processing the more than 100 expense reports Reliability*First* receives every month, would allow for automated flags to improve the approval process, and would eliminate the need for accounting staff to manually aggregate and enter expenses into the general ledger.

G. Time Tracking

To track and account for employee time, Reliability*First* has developed and implemented a timesheet system that is a web-based application. Reliability*First* required all employees to use the timesheet system to record their respective work time within the appropriate work activity categories, as established by their respective department heads. Each department has its own activity categories, and employees who work on projects in different departments report their time using those departments' activity codes. This process allows for accurate tracking of how much time is spent in each department by employees who contribute to projects throughout the organization. Activity categories used to track time have increased in granularity as the Company evolved, with categories for 2012 broken down to the individual project or major activity level.

Department heads also determined whether full-time employees tracked and reported hours worked, or recorded 40-hour work weeks even if actual hours worked exceeded 40 hours. Employees recording 40-hour weeks would allocate the time reported proportionately based on actual hours worked.[5] After employees recorded their time, the applicable department head performed a weekly review and approval of the time entries. Each department head used the timesheet system to analyze time expended on certain activities. This allowed all department heads to analyze staffing levels and the efficiency of processes implemented within their departments. The Human Resources department also used the timesheet system for payroll. Audit staff noted two cases in which Reliability*First's* efficiency and effectiveness were affected by its policies. First, the different time-tracking approaches among departments made Company-wide time analyses less valuable because the data were not comparable. Second, the practice of recording 40 hours worked per week for full-time employees did not accurately credit employee efforts when longer hours were worked, though this issue was mitigated during the audit by several departments switching to tracking actual hours worked.

[5] For example, an employee working 50 hours in a week and spending 40 hours on project A and 10 hours on project B would report 32 hours for project A and 8 hours for project B.

III. Introduction

A. Objective

The objective of this economy and efficiency audit was to evaluate Reliability*First*'s budget formulation, administration, and execution, and focused on the costs and resources used to achieve program objectives. The audit covered the period from August 23, 2006 to February 19, 2013.

B. Scope and Methodology

The procedures audit staff performed to evaluate Reliability*First* and its budget formulation, administration, and execution required audit staff to review Commission-related orders and criteria, NERC and Reliability*First* Business Plans and Budgets, NERC and Reliability*First*'s Delegation Agreement, and Reliability*First*'s Bylaws. Audit staff gathered and reviewed information through data requests, interviews, teleconferences, and a site visit. To address audit objectives, audit staff performed the following audit procedures and audit steps:

- Reviewed Public Information – To familiarize itself with Reliability*First*'s operations, audit staff reviewed publicly available materials, FERC's eLibrary for Company filings, Commission orders and formal complaints, the Enforcement Hotline for complaints made against the Company, and local newspapers and trade and academic press to identify significant developments and occurrences that arose during the audit period.

- Conducted Site Visit – Audit staff conducted a site visit to Reliability*First* in April 2012. During the site visit, audit staff obtained a thorough understanding of Reliability*First*'s processes, procedures, and controls. Audit staff conducted interviews with Reliability*First* management and staff to understand their job functions and learn about Reliability*First* operations and performance of its delegated functional responsibilities. On-site discussions included Reliability*First*'s management team, including the President and CEO, Senior Vice President, Treasurer and CFO, and other program managers.

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

To facilitate audit staff's evaluation of Reliability*First* as an RE and its economy and efficiency in fulfilling its delegated responsibilities, audit staff conducted extensive reviews and testing relating to Reliability*First*'s processes, policies, procedures, and controls. Specifically, audit staff conducted the following activities relating to major subject areas of the audit:

Objectives of Reliability*First, its Delegated Responsibilities, and Functional Organization*

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

- Examined how program managers responsible for delegated responsibilities assess and align resources to achieve program goals;

- Assessed coordination between Reliability*First*, NERC, and Reliability*First*'s Board to achieve goals and objectives of the ERO; and

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

Budget Development, Administration, and Execution

- Examined processes and procedures Reliability*First* used to develop its annual budget and how it identified resources to adequately achieve program goals and objectives;

- Ensured sufficient detail existed within Reliability*First*'s BP&B as presented to ensure the Commission is able to conclude delegated responsibilities are adequately funded;

- Examined how Reliability*First* used its budget throughout the budget year to support day-to-day operations and contingencies, as well as meet organizational and program goals;

- Examined and tested controls used to help ensure adherence to Reliability*First*'s BP&B;

- Reviewed Reliability*First*'s procedures for monitoring its budget and conducting budget variance analyses throughout the budget year; and

- Sampled and tested representations made within Reliability*First*'s BP&Bs to determine whether Reliability*First* adhered to the key deliverables presented within its budget and achieved program goals and objectives.

Accounting and Recordkeeping

- Reviewed policies and procedures for Reliability*First*'s accounting for income and expenses;

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

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

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

- Tested expenses and supporting documentation to assess the effectiveness of Reliability*First*'s internal controls over accounting and reporting.

Staffing and Organizational Responsibilities

- Reviewed Reliability*First*'s Bylaws and discussed them with management to determine the process for evaluating and assessing employee performance, compensation, benefits, and incentives;

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

- Reviewed the employee performance evaluation process and examined how it tied to the bonus allocation process.

IV. Conclusions and Recommendations

1. Remuneration Based on Total Compensation

Reliability*First* did not use a total compensation approach as the basis to determine the appropriateness of compensation paid to its officers and staff. Therefore, the Company lacked a strong metric by which to assess the reasonableness of the total amount of base salary, bonuses, benefits, and long-term incentive payments comprising total compensation paid to officers and staff.

Pertinent Guidance

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

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

> The Electric Reliability Organization shall file with the Commission its proposed entire annual budget … including the entire annual budget ... for each Regional Entity … 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 determined that Reliability*First* did not undertake a comprehensive compensation study inclusive of base salary, bonus, and benefits including retirement contributions and long-term incentive pay. Audit staff believes that, given the available information, the manner in which Reliability*First* determined compensation during the audit period was reasonable, but without a comprehensive study it lacked a strong metric upon which to base employee compensation.

Besides base salary and bonus, Reliability*First* had a defined contribution retirement plan for all employees, with a maximum company contribution of 16 percent of compensation, where compensation was defined as total compensation subject to income tax, (i.e., salary plus bonus). Reliability*First* fully budgeted for its retirement plan contribution obligations as a cost included in its annual budget that is funded by end-users. The plan included:

- Automatic employer contributions of 3 percent of total compensation for all employees;
- Employer matching contributions of 100 percent on a maximum of 6 percent of total compensation; and
- A "discretionary profit-sharing" under which Reliability*First* paid discretionary profit-sharing contributions of up to 7 percent of total compensation.

Seven percent profit-sharing plus 6 percent matching contributions plus 3 percent safe harbor contributions equals 16 percent total retirement contributions, which is applied to base salary plus bonuses.

Besides its retirement plan, Reliability*First* provides other noncash compensation benefits including insurance to its employees. The package of such benefits is normally considered when making comparative evaluations of employee compensation.

The final piece of Reliability*First*'s compensation is the long-term incentive bonuses granted to the CEO and Senior Vice President. These employees are under three-year employment contracts that include a long-term incentive. Audit staff does not object to this practice where it is based upon legitimate business needs (i.e., key employee retention). Reliability*First* does link this compensation to retention, but the manner in which these bonuses were considered as part of a total compensation approach to remuneration is unclear.

Reliability*First* contracted for several compensation studies during the audit period, but these studies failed to include all compensation elements in a comprehensive way. In 2008, Reliability*First* hired the Hay Group to conduct a study that analyzed base salaries, bonuses, and the present value of long-term incentives. The study also included a 401(k) retirement plan comparison and found that 401(k) benefits Reliability*First* offered were greater than those for comparable companies. The study also noted that while Reliability*First* based retirement benefits on base pay plus bonus, only 30 percent of comparable entities did so. The study noted that for comparable companies this component of compensation was between 8 and 9 percent of base pay while, as noted above, the Reliability*First* plan budgeted for 16 percent of base pay plus bonuses. However, the study did not analyze the monetary value of all components of the Reliability*First* benefits package such as insurance benefits in making its comparative analysis. Therefore, this study did not evaluate remuneration on the basis of total compensation to make relevant comparisons.

Another study done by Pay Governance in 2010-2011 only compared Reliability*First*'s base compensation and bonuses with comparable companies. Based upon this analysis, the study indicated that the level of compensation at Reliability*First* was below industry averages but at or above the level for non-profits. However, this study did not consider defined contribution plans, long-term incentives, and noncash benefits when making comparisons against the market groups in the study. Therefore, this study did not provide an adequate analysis of total compensation.

Although no comprehensive compensation study was performed, Reliability*First* has attempted to use its profit-sharing component as a means of providing competitive remuneration for its employees. Reliability*First* management stated:

> Staff annually provides the Board Compensation Committee with a summary of benefits, including the profit-sharing contribution benefit. The Committee considers the appropriate amount for the contribution in context of the staff's overall compensation and measures the profit-sharing contribution benefit against the other Regional Entities and NERC. The Committee then authorizes the appropriate amount for the contribution [to the profit-sharing plan].

However, audit staff is concerned about the rigor with which the Board was able to carry out this evaluation when a total compensation study, with comparable remuneration comparisons, had not been conducted.

Recommendations:

Audit staff recommends that Reliability*First*:

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

2. 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 Reliability*First*'s mission as an RE.

3. Use total compensation as the relevant guideline for policies and compensation studies, and in assessing salaries, retirement benefits, bonuses, and other forms of compensation.

4. Develop corporate performance metrics upon which its Board can rely to justify a discretionary retirement plan contribution sufficient to compete with

profit-sharing and stock option components of for-profit corporations, as supported by total compensation studies.

2. Working Capital/Contingency Fund

Reliability*First* had not established written policies and procedures for using working capital/contingency funds. While to date Reliability*First* has not needed to draw on its contingency fund, clear documentation and internal controls need to be in place to ensure Reliability*First* will use its funds appropriately in a contingency situation.

Pertinent Guidance

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

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

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

Background

Reliability*First* had a guideline that defined how the size of the contingency fund is established, and stated that the purpose of the fund is to "keep in reserve monies to cover any unforeseen or unbudgeted expenses." The size of the fund is recommended by the Board Audit Committee and set by the Board as part of the budgeting process. However, Reliability*First* had no written guidelines, policies, or procedures for approving the use of the fund, or for informing anyone that the fund was being used. The CFO orally explained to audit staff the process Reliability*First* would follow in the case of needing to use the fund. He stated that there is an understanding with the Board that it would be informed of, and need to authorize, any use of the fund. The CFO also noted that to date Reliability*First* had not needed to draw on its fund.

Reliability*First* stated that written policies governing the use of the fund were seen as unnecessary because the Board had to authorize any use, and because the fund had never been used. Such authorization was only requested once: In 2012 Reliability*First* asked its Board to authorize use of the fund for an office relocation. The Board approved the use of the fund, but the Company ultimately was unable to finalize the proposed move. Audit staff recognizes the rationale for not having established a written use policy to date, and noted in our review of the office relocation authorization that the process was in line with the verbally described process. However, audit staff believes that a lack of clear, written policies and procedures is a gap in controls.

This gap is particularly worrying since the purpose of the fund, as Reliability*First* has defined it, is to fund unforeseen or unbudgeted expenses; that is, expenses not approved in the BP&B. The BP&B development process exists to allow stakeholders, NERC, and FERC to direct Reliability*First* activities, and to evaluate the appropriateness of the expenditure of ratepayer funds. If the development process is not transparent, activities and expenses cannot be adequately reviewed. Even though by definition an unknown expense cannot be transparently presented in the BP&B, audit staff believes a written policy for the use of the fund, posted publicly and referred to during BP&B development, would at least make Reliability*First*'s process for unbudgeted and unforeseen expenses more transparent. It would also increase the transparency and robustness of the entire budget development process.

Written policies and procedures that clearly define the process of requesting, receiving approval, and expending contingency funds are a valuable internal control. Also, the transparency of Reliability*First*'s budget would improve with written policies that clearly identify how Reliability*First* handles unbudgeted and unexpected expenditures.

Recommendation:

Audit staff recommends that Reliability*First*:

5. Develop and implement a policy for use of contingency funds which, at a minimum:

    a. Identifies who approves and needs to be informed the use of the funds;
    b. Identifies criteria to determine the proper approval levels;
    c. Includes procedures for approving the use of contingency funds and informing appropriate parties of this use; and
    d. Identifies the purpose of, and the expected uses of, contingency funds.

3. Budget Formulation

Reliability*First*'s budget formulation process could be improved to consistently document the rationale used in budget formulation, including the initial estimates made by managers. Additionally, some justifications for adjustments to the initial estimates were inconsistently documented in the budget formulation process.

Pertinent Guidance

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

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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

As discussed in detail in the Background section on budget formulation, Reliability*First*'s current budget development process began 14 months prior to the start of the budget year. The budget was based on several documents that provide general guidance, including the ERO-wide common assumptions, and Reliability*First*'s five-year tactical and five-year strategic plans. Each year's budget was comprised of individual department-level drafts that were modified by multiple inputs during the budget formulation process. Audit staff review identified 10 different possible "levels" of inputs, though changes after the fourth level of input, the initial presentations to the Reliability*First* Board, were generally nonexistent.[6]

Budget development was a lengthy process, affected by a variety of inputs from different sources. Audit staff is concerned that there was no system for consistently

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[6] Initial department draft, peer review comments, senior management comments, initial Reliability*First* Board review, presentation to the NERC Board, presentation to FERC staff, stakeholder comments, final Reliability*First* Board review, NERC review, and FERC review.

tracking the initial inputs into the first budget drafts, and no system for tracking various changes to the initial drafts during the budget development process. Since Reliability*First* references and uses prior-year budgeting information at several points when developing its current year's budget, not maintaining a strong documented record may result in a loss of continuity over time. Audit staff believes that each application of budgeting data would be more productive and effective with better tracking of the initial estimates, any adjustments to those estimates, and the rationale for both those estimates and adjustments. This enhancement would create the opportunity to improve Reliability*First*'s own management functions, as well as make the NERC and Commission oversight more effective.

Specifically, audit staff noted four areas in which prior-year budgeting data were applicable:

- Prior-year budgeting data were reviewed at the start of the budgeting process to look for possible process improvements. Increasing the detail in prior budget formulation documents will provide a more accurate picture of the processes involved, and can result in better-informed process improvements.

- Prior-year budget draft data were used as a reference by managers for creating their current department level budget drafts. More information on prior drafts would increase awareness of any deferrals made or resources added as a result of outside input, and the reasons behind those changes. This would improve each manager's toolbox for constructing current year drafts by making it easier to anticipate potential outside inputs and track prior deferrals.

- Prior-year budgeting data were considered during the peer review, senior management review, and Board review stages; managers were expected to explain and provide support for major variances between their current-year budgets and prior-year data. Having clear records on prior drafts would ease the justification process for variances due to deferred projects or variances based on prior-year outside input. Systematically tracking the rationale for adjustments would also help ensure that any changes made in these reviews are well supported, and that possible bottlenecks and resource shortfalls or excesses are adequately evaluated.

- Finally, prior-year's budgeting data provide a record that can be referenced when compiling annual cost-to-actual true-up filings. A clear picture of the reasoning behind budgeted expenses is especially valuable for conducting variance analyses, improving Reliability*First*'s ability to identify when variances occurred due to incorrect budgeting assumptions, understanding why an assumption proved erroneous, and defending budget submissions to NERC and FERC. Documentation of prior-year budgeting data will also improve

FERC's ability to assess budget formulation, administration, and execution in any future budget audits that may be conducted.

During the audit period, the initial inputs into the first drafts are tracked in spreadsheets assembled by managers. These draft spreadsheets present different levels of detail depending on the manager compiling them. Audit staff noted general improvements in thoroughness of the budget development documents over time, with the best documented example being the 2013 CIP budget. Its documents identified expenses for specific activities, included notes on the CIP manager's rationale for the funding level for those activities, and included an FTE requirement analysis that also had notes for manager rationale for those staffing levels. Budget documents of other departments generally had abbreviated comments providing less information about underlying assumptions, though the development process described to audit staff included a lot of discussion that verbally supported funding figures. FTE analyses were provided to audit staff for most departments for 2013, but for less than half the departments for 2012. These analyses also varied in the level of detail presented to support time estimates.

The reasons for changes to manager drafts were more difficult to follow than the reasoning for the initial estimates. Again, most of these changes resulted from verbal, nondocumented discussions. The 2013 CIP budget had the most comprehensive records of all budget documents reviewed, maintaining the initial manager's estimates and notes and the rationale and a date for subsequent changes. Changes to the FTE analysis for this department were documented equally well. Documentation for changes in other departments tended to be less expansive, with some changes supported by vague notes that only stated "reduced/adjusted per conversation with …"

Audit staff also noted that FTE analyses were not consistently conducted at the department level. Analyses at the department level provided key support for all employee-related expenses in that department and helped internally identify activities to which managers expected to devote manpower – including both direct activities, such as audits, and support activities, such as recruiting. Analyses at this level also help determine areas with inappropriate staffing levels – either where additional staff is needed or where there may be overstaffing. Conducting such analyses for all departments might enhance Reliability*First*'s ability to identify its staffing needs more readily and provide the supporting rationale. Audit staff noted that Reliability*First*'s changes in the Standards Development department (in which it recently reduced FTEs) and the Human Resources department (in which it recently added a dedicated FTE) might have been more expeditiously identified and addressed had Reliability*First* conducted an FTE analysis at the department level as part of each budgeting cycle.

Audit staff believes tracking the rationale behind initial assumptions also assists NERC and FERC in carrying out its statutory oversight responsibilities by improving accountability and increasing the transparency of the Reliability*First* budget development process. Audit staff believes Reliability*First* can readily track these data by expanding the documents currently used by managers during the drafting process. The department-level budget spreadsheets and the FTE analyses spreadsheets can be expanded to include fields to track information that supports initial estimates, adjustments to those estimates, and the support for the adjustments.

Recommendations:

Audit staff recommends that Reliability*First*:

6. Improve its budgeting and FTE analysis spreadsheets already in use by adding fields to document:

   a. The rationale behind initial estimates; and
   b. Adjustments to the initial estimates with the rationale for those adjustments.

7. Develop FTE requirement projections for all departments during the budgeting process.

V. Other Matters

1. Assist Visit Program

Reliability*First* developed an innovative program, the Assist Visit Program (AVP), in order to train registered entities in the region. However, Reliability*First* could improve its documentation of the AVP, enhancing its ability to effectively evaluate the program for broader implementation and develop lessons learned for the benefit of registered entities in the region. If this were done, stakeholders might benefit more from other stakeholders' experiences through lessons learned or frequently asked questions (FAQ).

Background

Reliability*First* piloted a one-on-one training program, the AVP, in early 2011. The program emerged from stakeholder workshops that demonstrated that some entities could use additional training. The program did not include evaluating compliance or enforcement matters; it involved training a registered entity on what is expected of it during an audit or enforcement activity.[7] These visits were conducted by conference call and/or through onsite visits lasting no longer than one day, and addressed both CIP audit and Operations & Planning audit questions. Reliability*First* did not budget for AVPs as a separate line, but rather the incremental costs of this program were included in the overall training budget and consisted only of travel-related costs. Reliability*First* conducted six AVPs in 2011 and eight in 2012, and planned to expand and continue the program in 2013. The program is being governed by the original draft program outline, dated April 26, 2011.

Audit staff noted that the Reliability*First*'s corporate goals for 2011 included developing and completing the AVP pilot, and that the goals for 2012 again included work on the AVP pilot. Reliability*First* management stated that finalization of the AVP had been delayed again until 2013 so Reliability*First* could gain more experience and familiarity with the process. Also delayed until 2013 was the creation of a summary of the purpose, benefits, conduct, and goals of the program. Because the program was still in a fact-finding stage, no guiding documents, including the draft program outline, had been posted on the Reliability*First* web site. The program also had not contemplated a publication of lessons learned or similar information. Audit staff was also informed that while debriefings were conducted after each visit, these discussions were verbal, and no

[7] For example, during an Assist Visit Reliability*First* would state what kinds of documents and in what format evidence should be provided in response to a future audit data request. However, Reliability*First* *would neither* review a document *nor* evaluate whether or not the company was compliant with a standard.

written record was kept. A review of records about assist visits showed inconsistencies. For example, one visit's records included an agenda, a summary of the assist visit discussion, and entity feedback; another visit's records consisted only of an email from the entity requesting the visit. While audit staff is not questioning Reliability*First*'s decision that it needed more time and experience before finalizing the AVP pilot, we are concerned that Reliability*First*'s efficiency and effectiveness in implementing assist visits is hindered by the lack of developed lessons learned, and by the lack of internal records for each AVP.

Sharing lessons learned is a key part of registered entity training. Development of these lessons, as well as evaluation of the benefits of the AVP pilot and the program's finalization, are all affected by the quality of records available related to the execution of the program. Audit staff believes that maintaining inconsistent and incomplete written internal records to accompany any registered entity feedback may hamper Reliability*First* in developing all lessons learned, and in achieving its corporate goal of evaluating and summarizing AVP benefits.

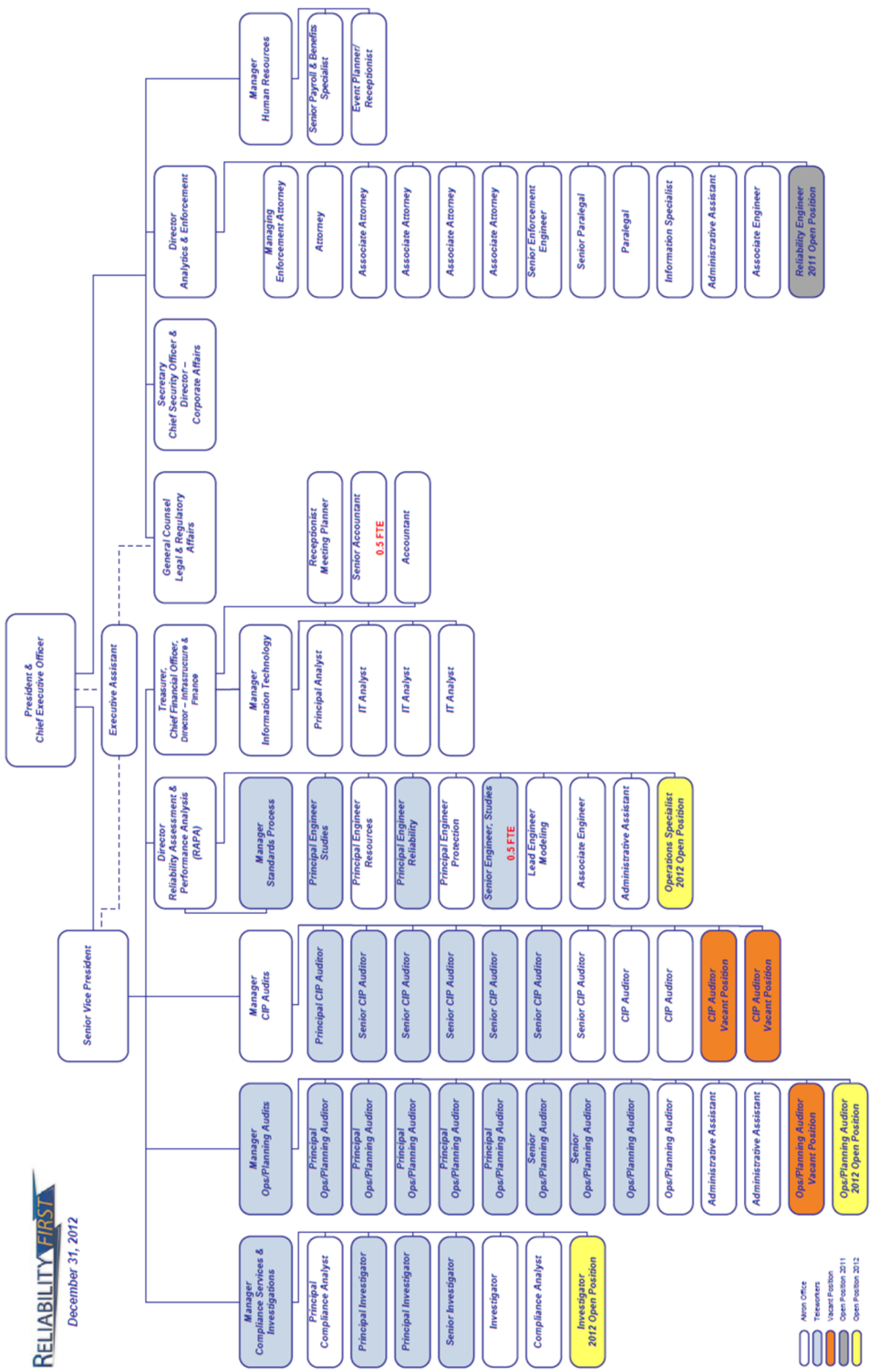
Recommendations:

Audit staff recommends that Reliability*First*:

8. Develop and implement a policy for internally documenting the AVP training activities.

9. Develop a formal process for sharing the results of the AVP with stakeholders via lessons learned or FAQ.

Appendix A – Reliability*First* Organizational Chart



RELIABILITY*FIRST*

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CONFIDENTIAL

April 25, 2013

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

**Re: Office of Enforcement
Docket No. FA12-7-000
April 10, 2013**

Dear Mr. Craig,

In accordance with your letter dated April 10, 2013, Reliability*First* Corporation (Reliability*First*) respectfully responds to the draft audit report issued in the above referenced docket. This draft audit report pertains to a financial audit performed by the Division of Audits (DA) within the Office of Enforcement for the Federal Energy Regulatory Commission (Commission or FERC) of Reliability*First*, over an audit period of August 23, 2006 through February 19, 2013.

In the draft audit report, DA recommends corrective actions on three areas of operational enhancements and one other matter. These areas concern the need for Reliability*First* to (1) commission a comprehensive compensation study with comparable remuneration comparisons to consider when determining employee compensation; (2) memorialize policies and procedures governing the use of its contingency fund; (3) better document its managers' rationale for initial estimates and the justification for subsequent adjustments to those initial estimates by its executives during the drafting of its budget; and (4) improve the documentation of its new Assist Visit Program so it may better evaluate the efficacy of the program and attempt to extrapolate generic lessons learned for the benefit of its stakeholders.

Reliability*First* has reviewed the draft audit report and does not contest the findings or recommendations contained within the draft. Reliability*First* believes that the draft audit report is a fair, thorough, and a complete summary of FERC's financial audit of Reliability*First*. Reliability*First* also believes that the implementation of the recommendations contained within the draft audit report will help further strengthen Reliability*First*'s operations.

Reliability*First* commends DA's transparency and openness throughout the audit process. This transparency and openness has enabled Reliability*First* to anticipate and understand the findings in the draft audit report prior to receiving the draft; which, in turn, has enabled Reliability*First* to already undertake efforts to address the recommendations contained in the draft audit report.

Reliability*First* looks forward to working with DA to develop an acceptable implementation plan to address the recommendations and memorialize the corrective actions already taken by Reliability*First* to address the recommendations.

If you have any comments or questions, please do not hesitate to contact me or Jason Blake.

Very truly yours,

RELIABILITY*FIRST* CORPORATION

Timothy R. Gallagher
President & CEO

cc:
L. Jason Blake – Reliability*First* Corporation, General Counsel

Document Content(s)