

126 FERC ¶ 61,045  
UNITED STATES OF AMERICA  
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Joseph T. Kelliher, Chairman;  
Sudeen G. Kelly, Marc Spitzer,  
Philip D. Moeller, and Jon Wellinghoff.

Southwest Power Pool, Inc.

Docket No. PA08-2-000

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

(Issued January 15, 2009)

1. In this order, the Commission approves the attached Audit Report (Report) prepared by the Division of Audits in the Office of Enforcement (OE), with the assistance of staff from the Office of Electric Reliability. The Report contains staff's findings and recommendations with respect to Southwest Power Pool, Inc.'s (SPP's) Regional Entity (RE) function.<sup>1</sup> The audit addresses SPP's compliance with (1) the SPP, Inc. Bylaws, (2) the Delegation Agreement between the NERC and SPP, and the conditions included in the relevant Commission orders, and (3) other obligations and responsibilities directed by the Commission.
2. This audit was intended to enable the Commission to determine whether SPP's governance structure creates a "very strong" separation between its RTO and RE

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<sup>1</sup> As an RE, SPP is responsible for enforcing the mandatory electric reliability standards of the North American Electric Reliability Corporation (NERC) that the Commission approved. SPP also operates as a Regional Transmission Organization (RTO). *Southwest Power Pool, Inc.*, 106 FERC ¶ 61,110 (2004). For purposes of this order, we refer to SPP's RTO function as SPP (RTO) and SPP's RE function as SPP (RE).

functions, as required by the Commission in Order No. 672.<sup>2</sup> In subsequent orders addressing the NERC-SPP Delegation Agreement, we reserved our determination on this issue pending the conclusion of the audit.<sup>3</sup> Nevertheless, the OE staff took into account that SPP (RTO) is the newest organized electricity market approved by the Commission, and that this audit was conducted during a transitional period when SPP was establishing its RE operations for overseeing more than 120 registered entities in eight states in the southern and southwestern United States. Accordingly, the OE staff recognized that SPP (RE) faced many challenges to start up a new (reliability) function within SPP (RTO).

3. Staff informed SPP of their audit findings and recommendations in a draft audit report on September 10, 2008, as revised on November 19 and December 3, 2008, to reflect comments made by SPP. The Report found that SPP did not have an adequate separation between its RTO and RE functions during the audit period, May 18, 2007 through August 30, 2008. Specifically, during the audit, OE staff found three main areas of concern. First, SPP (RE) did not operate with sufficient independence of SPP (RTO). Second, SPP (RE) trustees' oversight of the SPP (RE) functions could be improved to prevent conflicts of interest and to ensure the RE's independence. Third, the SPP (RE)'s implementation of certain aspects of SPP's Compliance Monitoring and Enforcement Plan (CMEP) was inadequate.

4. While not agreeing with all of the principal findings and conclusions in the Report, SPP agreed to adopt all of the recommendations in the December 3, 2008 draft of the Report, with one exception. SPP requested that OE staff reconsider this single recommendation. In light of additional comments provided by SPP, OE staff removed this recommendation from the Report, which is now final, dated December 22, 2008, and attached to this order.<sup>4</sup> As a consequence, SPP has agreed or has already begun to undertake all of the recommended corrective actions. Of particular note, SPP will hire a

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<sup>2</sup> *Rules Concerning Certification of the Electric Reliability Organization; and Procedures for the Establishment, Approval and Enforcement of Electric Reliability Standards*, Order No. 672, FERC Stats & Regs. ¶ 31,204 at P 698-700, *order on reh'g*, Order No. 672-A, FERC Stats & Regs ¶ 31,212 (2006).

<sup>3</sup> *See, e.g., North American Electric Reliability Corp.*, 119 FERC ¶ 61,060 (Delegation Agreements Order), *order on reh'g*, 120 FERC ¶ 61,260 (2007) (Delegation Agreements Rehearing Order), *order on compliance filing*, 122 FERC ¶ 61,245 (2008) (Second Delegation Agreements Order), *order on compliance filings*, 125 FERC ¶ 61,330, (2008) (Third Delegation Agreements Order).

<sup>4</sup> The exception pertained to the registration of a particular user, owner or operator, a matter that on balance was unnecessary to consider in the audit.

Regional Manager dedicated solely to SPP (RE) and eliminate all reporting relationships between SPP (RE) and SPP (RTO) employees.

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

### **Background**

6. In Order No. 672, the Commission discussed the generic issue whether an RTO or ISO may have an inherent conflict of interest if it is also a Regional Entity. The Commission pointed out that such an entity would operate the Bulk-Power System and be responsible for overseeing its own compliance with Reliability Standards. The Commission found that "such self-enforcement is extremely difficult to carry out satisfactorily" and that a "system operator/Regional Entity in a single corporation -- absent a very strong separation between the oversight and operations functions -- should not oversee its own compliance with Reliability Standards."<sup>5</sup> Accordingly, while not prohibiting such an entity seeking to be a Regional Entity from "making its case" for adequate separation of its compliance oversight and operational functions, the Commission stated: "[A]n RTO or ISO that lies in whole or in part within the United States and applies to become a Regional Entity will have a heavy burden to show that it meets the statutory criterion that it be independent of the operators of the Bulk-Power System in its region."<sup>6</sup>

7. The Commission conditionally approved SPP as an RE on April 19, 2007, in the Delegation Agreements Order that, *inter alia*, approved NERC's Delegation Agreement with SPP and NERC's CMEP, subject to certain revisions to be accomplished through a compliance filing.<sup>7</sup> In the Delegation Agreements Order, we indicated that with respect to this approval, we were relying on SPP's assertion that "the SPP Regional Entity trustees will be the final arbiter regarding each of the reliability functions and duties

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<sup>5</sup> Order No. 672 at P 698.

<sup>6</sup> *Id.* P 699 (footnote omitted).

<sup>7</sup> Delegation Agreements Order at P 375-76.

delegated to SPP.”<sup>8</sup> We further indicated that we were not convinced of “the ability of the SPP RE trustees to act independently of the RTO in matters relating to their appointment, compensation, the preparation and control of budgets, the separation of personnel, the development of reliability standards and in other matters subject to the oversight and control of the SPP board.”<sup>9</sup> We directed SPP to modify its bylaws to ensure that “the independence of the SPP Regional Entity trustees in standards development and as otherwise discussed will not, in fact, be compromised, directly or indirectly, by the SPP board.”<sup>10</sup>

8. In the Second Delegation Agreements Order, issued on March 21, 2008, we approved SPP’s revisions to its bylaws submitted in response to the Delegation Agreements Order. However, we stated that we “remain concerned regarding the adequacy of the separation of functions between the SPP RTO and SPP Regional Entity.”<sup>11</sup> We observed that the RE’s organizational chart showed only four RE employees,<sup>12</sup> including the executive director for compliance, and stated that we are concerned “whether the full time staff dedicated to Regional Entity functions can support adequate reliability oversight in the SPP region.”<sup>13</sup> We stated further that “we are concerned about whether SPP Regional Entity’s reliance on shared professional employees, including engineers and attorneys, and potentially management, allows for a strong separation of functions as contemplated by the Commission in Order No. 672.”<sup>14</sup> Finally, we indicated that we had initiated the instant audit into “SPP Regional Entity’s organizational structure and practices” and that a final determination regarding the adequacy of the separation of functions between SPP (RE) and SPP (RTO) would remain pending the results of the audit.<sup>15</sup>

9. We recently reiterated in the Third Delegation Agreements Order that our final determination regarding the adequacy of the separation of functions between SPP

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<sup>8</sup> *Id.* P 397.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.* P 398.

<sup>11</sup> Second Delegation Agreements Order at P 212.

<sup>12</sup> SPP (RE) added a fifth full-time staffer in April 2008.

<sup>13</sup> Second Delegation Agreements Order at P 212.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

Regional Entity and SPP RTO will continue to remain pending until the results of the audit are complete.<sup>16</sup>

### **The Audit**

10. Against this backdrop, on October 4, 2007, OE staff issued a public letter to SPP in this docket announcing that they were commencing an audit to determine whether SPP was in compliance with: (1) SPP's Bylaws,<sup>17</sup> (2) the Delegation Agreement between NERC and SPP and the conditions included in the relevant Commission orders, and (3) other obligations and responsibilities, as approved by the Commission. In particular, in the ensuing audit, OE staff looked at the relationship between SPP (RTO) and SPP (RE). In this regard, they took into account that NERC had registered the SPP (RTO) as conducting numerous functions relating to the Reliability Standards, including Reliability Coordinator, the highest level of authority with responsibility for the reliable operation of the bulk-power system. NERC had also delegated to SPP (RE) the following major program functions:<sup>18</sup>

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

11. During the audit period, as OE staff auditors learned, the SPP (RE) staff performed and administered function 3 while SPP (RTO) staff and other stakeholders served as volunteer participants. Staff shared by SPP (RTO) and SPP (RE) exclusively performed three of these functions (5, 6, and 7); SPP (RTO) and SPP (RE) staff performed function 4; and the SPP (RE) staff solely performed function 2. Function 1, developing reliability standards, was performed initially by an SPP (RTO) stakeholder

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<sup>16</sup> Third Delegation Agreements Order at P 112.

<sup>17</sup> *Southwest Power Pool*, 108 FERC ¶ 61,003 (2004), Delegation Agreements Order at P 396-405, Delegation Agreements Rehearing Order at P 13-20.

<sup>18</sup> North American Electric Reliability Corporation, 117 FERC ¶ 61,091, at P 20, 38-39 (2006) (2007 Business Plan and Budget Order), order on reh'g, 119 FERC ¶ 61,059 (2007).

group, although the trustees must approve any proposed standard before it can be transmitted to NERC for consideration. During the audit period, standards development was limited to work on a regional “fill-in-the-blank” standard.<sup>19</sup>

12. In the course of the audit, OE staff issued data requests, conducted analytical work, performed site visits, examined over 1,000 emails, and held many meetings and interviews with SPP’s officials and staff. Subsequently, on September 10, 2008, OE staff sent SPP a draft audit report and gave SPP until September 25, 2008, to respond to the audit findings and recommendations. SPP requested, and OE staff granted, an extension until October 10, 2008, when SPP responded for the first time to the draft Audit Report. Representatives from OE and the Office of Electric Reliability then met with SPP officials and its outside attorneys on October 31, 2008, to discuss the draft audit report and SPP’s response. As a result of this meeting, OE staff sent SPP a revised draft audit report on November 19, 2008, with a December 1, 2008 deadline for SPP’s response. SPP requested more time to respond to the revised draft audit report and OE staff extended the response deadline to December 10, 2008. OE staff engaged in more discussions with SPP during late November and early December. Based on these discussions, OE staff made additional changes based on SPP’s comments and issued SPP a second revised draft audit report on December 3, 2008. SPP responded to the second revised draft audit report by the requested date of December 10, 2008. The SPP Response is also attached to this order.

### **The Audit Report**

13. In the Report, staff determines that during the audit period SPP did not have the strong separation between its RTO and RE functions as required by the Commission. The Report identifies three main areas of concern, discussed more fully below, involving (1) the SPP (RE)’s lack of independence from the SPP (RTO); (2) the need to improve trustees’ oversight of the RE functions to prevent conflicts of interest and to ensure the RE’s independence; and (3) the adequacy of SPP (RE’s) implementation of certain aspects of SPP’s CMEP.

14. The first major concern is whether SPP (RE) operated independently from SPP (RTO) during the audit period. The audit found that: (1) SPP (RTO) management had supervisory control over SPP (RE) employees, including influence over the hiring and

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<sup>19</sup> These standards require regional reliability organizations to develop criteria for use by bulk power system users, owners or operators within each region. *See Mandatory Reliability Standards for the Bulk-Power System*, Order No. 693, FERC Stats. & Regs. ¶ 31,242, at P 287, *order on reh’g*, Order No. 693-A, 120 FERC ¶ 61,053 (2007).

pay of SPP (RE) employees; (2) The Executive Director of Compliance for SPP (RE) participated in meetings of managers of SPP (RTO); (3) SPP (RTO) employees had influence over NERC compliance monitoring and enforcement policies; (4) SPP (RTO) management had the ability to influence the RE's expenditures; and (5) SPP (RTO) employees received confidential RE compliance information. For example,

- SPP (RTO) managers took part in the design of NERC's compliance monitoring and enforcement program in addition to serving as the day-to-day managers for all non-compliance related delegated RE functions. At the same time, one of those managers also supervised the RTO's compliance with NERC standards.<sup>20</sup>
- RE employees' 2007 performance bonuses were determined as part of the overall SPP bonus process. SPP senior managers commented that the RE trustees' initial performance ratings of RE employees were too high relative to similarly situated RTO employees. In response, the trustees reduced the RE employees' performance ratings, resulting in reduced awards.<sup>21</sup>
- Neither the trustees nor any RE employee can approve an unbudgeted expenditure greater than \$10,000. When expenditures exceed this limit, the expenditure must be authorized by the SPP Chief Financial Officer, Chief Operating Officer, Vice President, President or Board of Directors, depending on the size of the expenditure.<sup>22</sup>
- Between May and November 2007, an SPP manager regularly forwarded his notes from meetings of the NERC RE Managers to SPP officers, including SPP's Chief Executive Officer and Chief Operating Officer, who oversees SPP operations and thus shares responsibility for the RTO's compliance with NERC Reliability Standards. Among the subjects covered were interpretation of standards; hearing procedures; settlement principles and procedures; mitigation plans; the NERC Board of Trustees Compliance Committee agenda and compliance violations updates.<sup>23</sup>

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<sup>20</sup> Audit Report at 29.

<sup>21</sup> Audit Report at 25.

<sup>22</sup> Audit Report at 33 and 34.

<sup>23</sup> Audit Report at 39 through 42.

15. The second major concern is the sufficiency during the audit period of the trustees' oversight of the RE operations. The Report finds that the trustees' communications with key employees of SPP (RE) responsible for carrying out day-to-day operations were limited and infrequent. The trustees were unaware that the manager who served as the RE manager had responsibilities for SPP (RTO)'s compliance with the Reliability Standards. The Report states that this lack of awareness of a potential conflict of interest limited the trustees' ability to mitigate conflicts.<sup>24</sup>

16. The last major concern is SPP (RE)'s implementation of the CMEP. The Report describes concerns with mitigation plans, self-certifications, and audit staffing. For example, in one instance, SPP (RE) should have rejected a mitigation plan by a generator owner because the mitigation plan did not include a detailed schedule and timeline as required by the Commission.<sup>25</sup> With respect to a vegetation-related outage mitigation plan, the SPP (RE) failed to gather evidence to determine whether an outage caused by a tree contact resulted from a systematic problem with the registered entity's vegetation management plan.<sup>26</sup> With respect to self-certifications, the SPP (RE) extended the deadline for filing of self-certifications by its registered entities of compliance with certain Reliability Standard requirements three times in late 2007 and early 2008.<sup>27</sup> Additionally, SPP (RE) employed auditors who may have had a conflict of interest. Three consultants who assisted the RE on audits of Southwestern Public Service and Westar took part in the NERC audit of the SPP coordinator in October 2007.<sup>28</sup>

### **SPP Response**

17. In its response, SPP states that several findings of the Report imply that employees of SPP acted in an improper manner during the audit period. SPP disputes such implications. Additionally, SPP disputes the Report's characterizations of the trustees. SPP contends that the Report's factual findings regarding the trustees' performance are factually incorrect and beyond the authority of the Commission to address.<sup>29</sup>

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<sup>24</sup> Audit Report at 36 through 38.

<sup>25</sup> Audit Report at 45.

<sup>26</sup> Audit Report at 47.

<sup>27</sup> Audit Report at 45 and 46.

<sup>28</sup> Audit Report at 48.

<sup>29</sup> SPP's Response at 2 and 12. For example, SPP asserts that the "Commission's authority is to regulate the entities over which it has jurisdiction (such as public utilities and REs); it is not to regulate their boards and management." *Id.* at 12.



18. SPP maintains that the actions it and its employees took during the audit period violated neither the SPP Bylaws nor the Delegation Agreement.<sup>30</sup> Specifically, in regard to the Report's principal finding concerning the independence of the SPP (RE) operations that SPP did not ensure a "sufficient separation of functions between the RTO and RE," SPP asserts that any finding of a lack of separation should address only the separation of "oversight and operations" between the RTO and RE. In SPP's view, no such lack of separation existed. SPP further argues that SPP (RE)'s dependence on SPP (RTO) for staffing was appropriate as an efficient use of shared services. In addition, SPP disagrees with any conclusion that the use of shared services resulted in insufficient independence between SPP (RTO) and SPP (RE). Similarly, SPP disagrees with any conclusion in the Report that any individuals acted inconsistently with the approved shared services or SPP's Bylaws or Delegation Agreement or in any way unduly influenced the RE or exercised inappropriate control.<sup>31</sup>

19. In regard to the Report's findings regarding the trustees' performance, SPP contends that the findings fail to recognize the appropriate role of trustees and exceed the proper scope of an audit as well as the authority of the Commission. SPP argues that the limited contact between SPP (RE) employees and the trustees cited in the Report is entirely consistent with the proper functioning of a corporate board, which oversees but does not manage an organization. SPP further asserts that the role of the trustees in hiring decisions was appropriate because the trustees fulfilled their specific duty to approve all hiring, and they did so after interviewing the candidates they hired. SPP believes that the extent to which the trustees should consider one or more candidates, or utilize an outside consulting firm, is not within the prerogative of either the Commission or audit staff, but rather resides within the sound business judgment of the trustees.<sup>32</sup>

20. SPP's Response did not include any comments regarding the Report's principal findings pertaining to SPP (RE)'s compliance with the CMEP.

### **Discussion**

21. Notwithstanding its disagreement with the findings and conclusions in the Report, SPP has agreed to implement the Report's recommendations. Under these circumstances, while we believe that SPP may have failed to meet the expectations of the Delegation Order and other relevant orders, we will not conclude as a matter of law that SPP violated

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<sup>30</sup> SPP's Response at 2.

<sup>31</sup> SPP's Response at 12.

<sup>32</sup> SPP's Response at 19.

Commission's orders and regulations during the audit period. In particular, we are pleased that SPP has agreed to hire a Regional Manager and ensure that Manager and the RE Counsel keep the trustees apprised of all RE operations. We will, however, expect SPP to comply with the recommended actions in the Report, and we direct OE staff to report to the Commission any failure of SPP to comply.

22. Because SPP has agreed to implement the Report's recommendations, we conclude that upon implementation of the recommendations, SPP prospectively will satisfy the requirement that its governance structure creates a "very strong" separation between its RTO and RE functions, as Order No. 672 specifies for Regional Entities that include or that are affiliated with an RTO or an ISO. We condition this conclusion on SPP's timely and effective implementation of the Report's recommendations, including the submission of a compliance plan as specified below. In this regard, while we note that the Report does not recommend that SPP amend its bylaws to insert a description of the duties of the Regional Manager or how the Regional Manager will remain independent from SPP (RTO), we suggest that SPP consider whether to so amend its bylaws as an indication that SPP intends to retain the independent Regional Manager position permanently. We remind SPP that failure to create and maintain a very strong separation of the SPP (RE) functions from the SPP (RTO) functions may result in the Commission's reconsideration of SPP as the Regional Entity.<sup>33</sup>

23. The Report requires SPP (RE) to design a compliance plan that includes procedures to implement the exception-specific recommendations that are described in the audit report. The plan is to be submitted to OE staff for review and approval within 60 days from the date of issuance of this order. Thereafter, SPP (RE) must make non-public quarterly submissions in Docket No. PA08-2-000 to OE staff detailing SPP (RE)'s progress in implementing the corrective actions set forth in the report until all the corrective actions are completed. The submissions are to be made not later than 30 days after the end of each calendar quarter, beginning with the first quarter after the submission of the compliance plan and continuing until SPP completes all the recommended corrective actions. We direct OE staff to conduct a post-audit site visit when SPP states that it has completed all of the recommendations to ensure that all of the corrective actions taken as a result of implementing the recommendations were properly completed. We also direct OE staff to conduct another audit of SPP (RE) independence from SPP (RTO) in FY 2011.

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<sup>33</sup> The Commission conditioned its acceptance of SPP's 2009 budget on the outcome of the PA08-2-000 audit, based upon the Commission's observation that issues it raised about the 2009 budget may relate to topics of the audit. *North American Electric Reliability Corp.*, 125 FERC ¶ 61,056, at P 58 (2008). The Commission will address this matter in a subsequent order.

The Commission orders:

- (A) The attached Report is approved in its entirety without modification.
- (B) SPP is directed to implement the corrective actions recommended in the Report.
- (C) SPP is directed to submit a compliance plan outlining the steps it will take to implement the recommendations in the Report within 60 days from the date of issuance of the final report in this docket.
- (D) SPP must make non-public quarterly submissions in Docket No. PA08-02-000 detailing its progress in implementing the corrective actions until all the corrective actions are completed. The submissions must be made not later than 30 days after the end of each calendar quarter, beginning with the first quarter after the submission of the compliance plan and continuing until SPP completes all the recommended corrective actions.

By the Commission.

( S E A L )

Kimberly D. Bose,  
Secretary.