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March 10, 2008

VIA ELECTRONIC FILING

Honorable Kimberly D. Bose
Secretary
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, DC 20426

Re: ISO New England Inc., Docket No. RT04-2-017;
Independence Review of ISO New England Inc.

Dear Secretary Bose:

Transmitted electronically for filing in the referenced docket is the Motion for Leave to Answer and Answer of ISO New England Inc. to the February 22, 2008 Motion to Intervene and Protest of the Attorney General of the Commonwealth of Massachusetts.

If there are any questions concerning this filing, please call me at (202) 661-7640.

Very truly yours,

/s/ Jack N. Semrani

Jack N. Semrani
Counsel for
ISO New England Inc.

Enclosure

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

ISO New England Inc.

)

Docket No. RT04-2-017

**MOTION FOR LEAVE TO ANSWER AND ANSWER
OF ISO NEW ENGLAND INC. TO THE PROTEST
OF THE ATTORNEY GENERAL OF MASSACHUSETTS**

Pursuant to Rule 213 of the Rules of Practice and Procedure of the Federal Energy Regulatory Commission (“Commission”), 18 C.F.R. § 385.213 (2007), ISO New England Inc. (the “ISO”) hereby submits its answer (the “Answer”) to the February 22, 2008 Motion to Intervene and Protest of the Attorney General of the Commonwealth of Massachusetts (the “Protest”). The Protest addresses the Regional Transmission Organization (“RTO”) independence review performed by independent auditors and included as an attached report (the “Report”) in the ISO’s January 30, 2008 filing in this proceeding.

I. MOTION FOR LEAVE TO ANSWER

The ISO hereby moves, pursuant to Rule 212 of the Commission’s Rules of Practice and Procedure, 18 C.F.R. § 385.212 (2007), for leave to file the Answer. The Commission has the authority to waive the prohibition against answers to protests for good cause.¹ The Commission has found good cause to permit answers where they are otherwise prohibited in various circumstances, including where the answer would assure a complete record in the proceeding,²

¹ See 18 C.F.R. § 385.101(e) (2004).

² See, e.g., *Pacific Interstate Transmission Co.*, 85 FERC ¶ 61,378, at 62,443 (1998), *reh’g denied*, 89 FERC ¶ 61,246 (1999).

provide information helpful to the disposition of an issue,³ permit the issues to be narrowed or clarified,⁴ or aid the Commission in understanding and resolving issues.⁵ The ISO believes that its answer will assure a more complete record in this proceeding and otherwise assist the Commission in understanding and resolving the issues presented.

II. BACKGROUND

A. The Regulatory Requirement

Pursuant to 18 C.F.R. § 35.34(j)(1)(iv)(A)(2) (2007), an RTO such as the ISO must provide a compliance audit of the independence of its decision-making process two years after its approval as an RTO. Such review must indicate that the RTO's decision-making process is independent of control by any market participant or class of participants and, pursuant to subsection (iv)(B), must be performed by auditors who are not affiliated with the RTO or its members.

To date, the Commission has performed the independence audits of the other two RTOs that have been subject to the above-referenced requirement: PJM Interconnection and the Midwest Independent Transmission System Operator ("Midwest ISO"). In the only published report regarding these audits – regarding the Midwest ISO – the Commission indicated that it reviewed Board member independence, securities divestiture policies, prohibitions on affiliations with market participants, Board and RTO Committee policies, and RTO decisional processes.⁶

³ See, e.g., *CNG Transmission Corp.*, 89 FERC ¶ 61,100, at 61,287 n.11 (1999).

⁴ See, e.g., *PJM Interconnection, LLC*, 84 FERC ¶ 61,224, at 62,078 (1998); *New Energy Ventures, Inc. v. Southern California Edison Co.*, 82 FERC ¶ 61,335, at 62,323 n.1 (1998).

⁵ See, e.g., *ISO New England Inc. and New England Power Pool*, 110 FERC ¶ 61,202 at P 29 (2005); *Tennessee Gas Pipeline Co.*, 92 FERC ¶ 61,009, at 61,016 (2000).

⁶ Federal Energy Regulatory Commission Office of Market Oversight and Investigation, Division of Audits and Accounting, *Audit of Independence at the Midwest Independent Transmission System Operator, Inc.*, Docket No. RT01-87-009 (Jan. 20, 2006) ("Midwest ISO Audit").

On October 3, 2007, the ISO requested that Commission staff likewise perform the ISO's independence audit in conjunction with the Commission's next audit of the ISO. The Commission rejected that request, as the Commission is not scheduled to audit the ISO during the relevant time frame.⁷ Therefore, the ISO was required to retain an independent auditor to perform its two-year independence review.

The ISO retained an independent auditing firm, Meyers Brothers Kalicka ("MBK"), to fulfill the requirements of the independence audit regulation. Because this is not a financial statement audit, generally accepted auditing standards cannot be applied. Also, a detailed body of RTO independence standards does not exist, which is required for a compliance audit engagement. In these circumstances, the remaining mechanism provided by the auditing governing body – the American Institute of Certified Public Accountants ("AICPA") – is an "agreed upon procedures engagement" that can provide verification of a company's compliance with stated assertions.⁸ In this case, the relevant assertion was as follows: "The decision-making process of ISO New England Inc. is independent of control by any market participant or class of market participants."

The ISO management and its external counsel developed a proposed set of procedures to support verification of the aforementioned assertion from a number of different perspectives. In so doing, the ISO reviewed each of its governing documents and the key modes of interactions with its market participants and sought to identify objectively measurable criteria, as are required for purposes of an agreed-upon procedures review. The ISO also included procedures of the type

⁷ *ISO New England Inc.*, 121 *FERC* ¶ 61,109 (2007).

⁸ The agreed-upon procedures engagement for the ISO's independence review was conducted in accordance with attestation standards established by the AICPA.

referenced in the report on the Midwest ISO Audit performed by Commission Staff, including Board member independence, securities divestiture policies, prohibitions to affiliations with market participants, Board and RTO Committee policies, and RTO decisional processes.

The ISO also focused on the following factors it believes are hallmarks of its independence: the contractual acknowledgement by the ISO's market participants that the market participants' role is advisory and that the ISO Board of Directors is the governing body of the ISO; the ISO's maintenance of Section 205 rights under the Federal Power Act; and the approval of the ISO's budget by its Board of Directors and the filing of that budget with the Commission. Also, before MBK executed the procedures, the ISO presented the procedures (and the use of the "agreed upon procedures" methodology) to Commission Staff for informal feedback regarding whether the engagement was properly designed.

On January 30, 2008, the ISO filed the Report in the referenced docket with respect to the independence of the ISO's decision-making process as an RTO.⁹ The Report was prepared pursuant to the procedures outlined above.

B. The Protest

The Protest requests the Commission to "clearly specify audit criteria that RTOs should consistently use in future independence audits submitted pursuant to 18 C.F.R. §35.34(j)(1)(iv)(A); [and] [o]rder [the ISO] to supplement this filing with an audit that is performed using those criteria..."¹⁰ The Protest asserts that the Commission-performed Midwest ISO Audit should "set the bar for subsequent audits."¹¹ That audit report recommended

⁹ Independent Accountants' Report on Applying Agreed-Upon Procedures, Attachment 1 to the January 30 filing.

¹⁰ *Id.* at 9.

¹¹ Protest at 5.

that the Midwest ISO advisory committee use weighted sector voting in accordance with its charter,¹² and identified an inconsistency between Midwest ISO’s bylaws and its Transmission Owners Agreement and recommended that the bylaws be revised to cure the inconsistency.¹³ The Protest expresses the primary concern that the Report not only examine the existence of provisions, but also review whether the provisions are put into action.¹⁴

III. ANSWER

The Commission should accept the Report as compliant with the Commission’s RTO regulations, for the following reasons:

- the Report meets the standards required by the RTO regulations;
- the manner in which the review was conducted represented the only option available, as a practical matter, to the ISO;
- the ISO should not be held to future rules that were not in place when the independent auditor’s review was conducted for the ISO; and
- the ISO’s independence from market participants is not at issue in any pending proceeding.

A. The Report Meets the Standards Required by the RTO Regulations

For the reasons explained herein, the Report meets the standards required by the Commission’s RTO regulations.

As an initial matter, the ISO notes that the exact language of Section 35.34(j)(1)(iv)(A)(2) requires “a compliance audit of the . . . decision making *process*,”¹⁵ and not an audit of each and every instance in which the process was implemented. Moreover, as

¹² Protest at 6.

¹³ *Id.*

¹⁴ *Id.* at 7.

¹⁵ Emphasis added.

indicated above, the procedures were reviewed with Commission Staff prior to MBK's performance of the agreed-upon procedures review.

Regarding the substance of the Protest, ISO believes that the Protest's assertion that the Report simply confirms the existence of provisions and does not examine whether they were put into action is inaccurate. The Protest cites the two examples of noncompliance identified by Commission Staff in the Midwest ISO Audit as an implicit indicator of what an RTO independence audit should address. The work performed by MBK, as reflected in the Report, in fact conforms to the approach taken in the Midwest ISO on those issues.

First, the Midwest ISO Audit sought to verify that the required weighted voting was in fact being utilized by the Midwest ISO's advisory committee. In the case of the ISO, MBK similarly sought to verify the actual *implementation* of weighted voting by the ISO's stakeholder advisory body, the New England Power Pool ("NEPOOL") Participants Committee ("NPC"). As a result, MBK reviewed the official minutes of the NPC with respect to a sampling of three NPC meetings. As the Report indicates, MBK also followed up with NPC's counsel to obtain an answer to a clarifying question. The fact that, as noted in the Protest, MBK's "procedures did not include recalculating and verifying the accuracy of weighted sector voting in accordance with Section 1.1 of the PA"¹⁶ simply means that MBK did not attempt to reconstitute the raw voting data and recalculate the weighted voting but accepted the official minutes of the NPC. It is appropriate for MBK to rely on those documents in absence of any reason to believe they are untrustworthy.

Second, the Midwest ISO Audit identified an inconsistency between Midwest ISO's bylaws and its Transmission Owners ("TO") Agreement. This element of the audit was thus

¹⁶ *Id.*

something that was accomplished simply by reading and comparing the governing documents – the bylaws and the TO Agreement. In the ISO’s case, MBK performed the very same type of documentary review to confirm that the specified indicia of independence were present in the ISO’s governance documents. Therefore, the Report reflects consistency with the methodology followed by the Midwest ISO Audit and cited in the Protest.

In a number of other instances, the Report considered whether provisions have been put into action, in addition to examining their existence. For example, the Report includes verification not only that the Bylaws require the Board to elect officers and directors, but also that the Board minutes reflect that the actual election occurred. Additionally, MBK reviewed actual compliance certificates of employees and directors to confirm that a random sampling of these individuals certified in writing their compliance with the ISO’s Code of Conduct. Similarly, Code of Conduct training records were also reviewed.

Notwithstanding the Report’s compliance with the regulations and the approach taken in the Midwest ISO Audit, there is no doubt that the Report was limited by the types of engagements that are commonly undertaken by public accounting firms following the standards and guidance of the AICPA. As discussed below, an independent auditor is unlikely to commit to a more subjective engagement and, in any case, a requirement regarding the depth of the required review should be made by the Commission through an open and transparent process.

B. The Manner in Which the Independent Auditor’s Review Was Conducted Represented, As a Practical Matter, the Only Option Available to the ISO

After the Commission rejected the ISO’s request that Commission staff perform the independence audit, the ISO was required under the RTO regulations to retain an “auditor.” In order for an independent auditing firm to follow generally accepted auditing standards and issue a report expressing an opinion regarding the ISO’s compliance on the independence of its

decision making process, an extensive body of objective regulations or guidelines must be established. The Commission has not established a set of objectively measurable criteria against which an audit can be conducted.

Therefore, the application of “agreed upon procedures” was the only mechanism available under AICPA standards and processes to meet the independence audit requirement of the RTO regulations. The ISO followed the only approach practically available for an independence review by “auditors.”

While the Protest expresses concern that the Report included the following language, “[MBK was] not engaged to, and did not, conduct an examination, the objective of which would be the expression of an opinion on compliance with the guidelines,”¹⁷ this language is simply part of the standard AICPA language utilized in the application of agreed-upon procedures.

C. The ISO Should Not Be Held to Future Rules That Were Not in Place when the Independent Auditor’s Review was Conducted for the ISO

The relief sought in the Protest is premised on a request that “the Commission clearly specify audit criteria that RTOs should consistently use in future independence audits.” The ISO should not be held to future standards that did not exist at the time that its filing was made, or required to obtain additional auditor review based on future standards. This request for the imposition of additional audit-related requirements on RTOs should be promulgated, if at all, on a prospective basis, most effectively through a rulemaking proceeding¹⁸ with prospective application of the rules formulated in that proceeding. This would be consistent with the approach taken in the Commission’s Notice of Proposed Rulemaking in Docket Nos. RM07-19-

¹⁷ Report at 1.

¹⁸ That proceeding could, for example, consider the adoption of more specific standards and a broadening of the definition of an acceptable “auditor.”

000 and AD07-7-000, in which stakeholder suggestions for new standards for RTO and ISO performance are being proposed in the form of new and prospective rules.¹⁹

Therefore, the Commission should accept the Report, as it reflects a review performed in accordance with the standards that were in place at the time that it was filed.

D. The ISO's Independence From Market Participants is Not at Issue in any Pending Proceeding

A factor weighing in favor of acceptance of the Report is the fact that there are no pending complaints or other proceedings regarding the independence of the ISO's decision-making as an RTO, including with respect to any of the issues reviewed by the Commission's audit staff in performing the independence audit of the Midwest ISO. This factor, together with the absence of any other protests in the current proceeding, suggests that there is no current issue regarding the ISO's independence from market participants. Indeed, the Protest itself does not point to any particular basis for concern about the ISO's independence.

¹⁹ Notice of Proposed Rulemaking, *Wholesale Competition in Regions with Organized Electric Markets*, 122 FERC ¶ 61,167 (2008) (see attachment of proposed rules for RTOs and ISOs).

IV. CONCLUSION

For the reasons stated herein, the Commission should accept the Report as filed.

Respectfully submitted,

/s/ Maria A. Gulluni

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March 10, 2008

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in this proceeding.

Dated at Washington, D.C. this 10th day of March, 2008.

/s/ Pamela M. Higgins

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