

**ERCOT Board**  
**Special Committee**  
*Presented to the Board August 16, 2005*

**Background and Charge**

At its June, 2004 meeting, the ERCOT Board of Directors established a Special Committee to address contracting irregularities that came to light in May 2004. The following motion was made at the June 2004 Board meeting to ratify the Special Committee:

The ERCOT Board of Directors ratifies the appointment of Mike Espinosa as Chairman, Bob Manning, David Baggett, Bob Kahn and Mark Armentrout to serve on a Special Committee, reporting to the full Board, to review the auditing activities and develop recommendations for the Board regarding any further action as a result of the audits, including any needed improvements in internal ERCOT processes and controls.

Essentially, the Special Committee was asked to investigate and report back to the full board on the cause of, and prevention of future, ethics code violations and contract irregularities, including employee hiring practices, procedures for hiring/engaging contractors, and procurement procedures for engaging vendors. This Report serves as the final step in that process.

Members:

Mike Espinosa (Chair of Special Committee), Independent Director  
Mark Armentrout, Independent Director  
Bob Kahn, Chair H.R. and Governance Committee  
Bob Manning, Vice-Chair of ERCOT Board of Directors  
Clifton Karnei,<sup>1</sup> Chair of Finance & Audit Committee

ERCOT Staff Support:

Ed Ettorre, Internal Auditor  
Margaret Pemberton, former General Counsel  
Andrew Gallo, Senior Corporate Counsel

**Summary**

On March 29, 2004, ERCOT received information from a third party of possible unethical employee conduct at high levels of the organization. ERCOT immediately hired an independent outside counsel to assist the CEO with an investigation. The initial investigation to identify specific facts evidencing fraudulent acts by several of ERCOT's employees took approximately forty nine days. On May 19, 2004, ERCOT obtained discovery of specific facts indicating improper relationships between three vendors and

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<sup>1</sup> Mr. Karnei was not an original member of the Special Committee; he replaced David Baggett, an Independent Director who resigned from the Board in the Fall of 2004.

three ERCOT employees. Upon discovery of possible criminal conduct, ERCOT immediately (on May 19, 2004) brought the facts of the situation to the Texas Department of Public Safety (DPS). Once DPS agreed to conduct an investigation, ERCOT began assisting them by providing information to support the prosecution of the people suspected to be involved in the conduct. ERCOT continued to review internal information to learn of any additional suspected criminal conduct, turning over all information discovered to DPS as ERCOT learned additional facts.

ERCOT has been committed to supporting law enforcement and prosecutors in their investigations from the beginning. ERCOT acted quickly to terminate the employees who abused their positions and betrayed the trust of ERCOT and the public and has supported all efforts of the authorities in their investigations by providing all information and support requested.

### **Issues**

**Q.** How did ERCOT identify the questionable vendors and determine which vendors were involved in criminal behavior?

**A:** ERCOT learned of relationships between several ERCOT employees and vendors that violated ERCOT's Ethics Agreement as well as Texas law during an initial investigation reported originally through the Human Resources Department and later through ERCOT's internal auditor.

Subsequently, ERCOT continued to review contracts and invoices, looking for unusual billings and, when available, comparing invoices to timesheets provided by vendors. ERCOT also reviewed Secretary of State and Dun and Bradstreet records.

Also, within the constraint of not interfering with the criminal investigation, ERCOT interviewed certain people within the organization with information related to the vendors.

**Q:** How many employees within ERCOT had relationships with the questionable vendors and how is ERCOT sure that all involved employees have been identified?

**A:** The five indicted employees allegedly had relationships with the questionable vendors. To ensure that all involved employees were identified, ERCOT performed a detailed review of all vendors providing staff augmentation with active contracts in the second quarter of 2004. ERCOT provided to DPS and the Attorney General ("AG") the information it obtained through its internal investigation and continues to assist them, as requested. Both DPS and the AG agreed that they would notify ERCOT if they learned of additional criminal conduct by employees and/or vendors still at ERCOT.

**Q:** What procedures (or lack thereof) allowed the vendors to contract with ERCOT and what procedures (or lack thereof) allowed the relationships to continue?

**A:** ERCOT has been a typical start-up company since the passage of Senate Bill 7 in 1999, which gave ERCOT its charge and mission of establishing the first retail electric market of its kind. ERCOT's charge was to "get it done; make it work." The deadlines set by the Legislature and the Public Utility Commission of Texas ("PUC") were tight; ERCOT's focus was on the mission and meeting the deadlines. Under such demanding deadlines and extremely critical mission, ERCOT had to grow its labor force from approximately 55 employees in 1999 to its current approximately 500, at the same time it was expected to deliver the market on time. Additionally, the design of the market was not complete when ERCOT began building the computer systems to implement the Texas electric market. Organizations with this type of growth normally rely heavily on contractors to augment staff, as ERCOT did. While the auditors concluded that it is difficult to eliminate fraud where multiple people on the inside intend to commit fraudulent activity for personal gain, in this case in the hiring of contractors, better controls might have exposed the alleged fraudulent activity at ERCOT sooner.

In early June 2004, the PUC ordered ERCOT to undergo immediate audits to ensure security of the Texas Electric grid and to evaluate the vulnerabilities at ERCOT. The three vendors included CanAudit (to test the security perimeter of the ERCOT I.T. system), Deloitte & Touche ("D&T") (to review the internal controls at ERCOT) and Ernst & Young ("E&Y") (to review the security of the entire technology system at ERCOT). In reporting to the Board and Special Committee, D&T advised that it is impossible to stop all rogue behavior and very difficult to catch such behavior when bad employees act in collusion - either within reporting relationships or across departments. However, sufficient internal controls enable a company to discover most problems in a timely fashion.

The audits determined that ERCOT had failures in its internal controls in many areas including a lack of documented policies and procedures and a lack of separation of duties.

**Q:** What has ERCOT done to stop the relationship with the questionable vendors?

**A:** ERCOT terminated contracts with vendors suspected of having improper relationships with the rogue employees or shown to have questionable business practices. ERCOT requires greater use of competitive bidding and Requests for Proposals to obtain additional vendors with competitive bids. ERCOT has instituted a policy allowing consultants to work as staff augmentation for only six months unless an exception is approved by both an officer over the department and the CFO. Project-based consultants may work on the project until it is complete.

**Q:** What has ERCOT done to prevent further abuse by others?

**A:** ERCOT has identified several key areas that it believes support an anti-fraud environment:

- **Internal Controls/Policies and Procedures:** ERCOT is building fraud prevention and detection controls into the internal controls of its day-to-day activities and functions. The anti-fraud measures focus on the areas of the organization most vulnerable to fraudulent activity, enabling management to actively identify and deter fraud. The PUC and ERCOT retained D&T to assist in the development of this program, which is built upon the COSO<sup>2</sup> framework and industry best practices.<sup>3</sup>

ERCOT has tightened controls in its contracting and procurement practice through:

- Stronger competitive bidding requirements
- Requiring two signatures for payment of invoices
- Conducting a more extensive background check of organizations and people
- Performing rigorous contract reviews prior to executing contracts by:
  - Reviewing Secretary of State records for all new vendors
  - Reviewing Dun & Bradstreet information for new vendors
  - Developing a Vendor Information Form for vendors to fill out when beginning work for ERCOT
- Enforcing a strict limitation on using contractors to augment staff
- Separating the duties of procurement from negotiation and administration of the contract
- Separating the Cyber Security function from the I.T. department.

ERCOT has tightened its hiring practices through:

- Conducting a thorough check of references and background without exception prior to beginning employment
- Significantly reducing the number of contract labor contracts

- **Enterprise Risk Assessment.** ERCOT is conducting an ERCOT-wide risk assessment, using the internal control review conducted by D&T as a foundation, with the goal of understanding risks and potential inside and outside threats that affect the organization. ERCOT is developing and implementing action plans to prevent, detect and mitigate these risks.

- **Internal Audit.** ERCOT has strengthened its internal audit function, adding (in January 2005) an Anti-Fraud Specialist with over 10 years of fraud investigation experience to conduct fraud reviews. ERCOT has also hired one additional staff person in the Internal Audit Department and implemented a monitoring program to identify and follow up on potential areas of risk for fraud

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<sup>2</sup> Committee of Sponsoring Organizations of the Treadway Commission.

<sup>3</sup> Attached hereto as Exhibit "A" is a list of forty-three action items developed by ERCOT management and made public on November 9, 2004.

and abuse. The reviews focus on analyzing transactions and investigating anomalies. In addition, the internal audit staff and management periodically review, identify and assess risks related to ERCOT's business processes.

- **Ethics Hotline.** In March 2004, ERCOT executed a contract with EthicsPoint, Inc., to provide a third party employee hotline (phone and web-based) available to employees and any other concerned party to report anonymously issues about ERCOT, including suspected fraud. On April 1, 2004, the hotline was activated and the employees were notified of its availability and trained in its use by the end of April. EthicsPoint monitors the reports and forwards the information to the ERCOT Legal, Human Resources and Internal Audit departments for investigation and resolution. Reports are logged and tracked by the Internal Audit Department and confidentially reported monthly to the ERCOT Board's Finance and Audit Committee.

- **Ethics Agreement and Business Conduct.** In addition to employees executing an Ethics Agreement upon employment, all employees are required to reaffirm their compliance and adherence to ERCOT's ethics policies on an annual basis by signing an Ethics Reaffirmation. Ethics issues are covered in detail during new employee orientation. The Ethics Policy has been modified to make it abundantly clear that neither employees nor their household members may receive any financial incentives from vendors. A new Ethics Policy for all board members is being developed with an emphasis on the public nature of ERCOT's duties and the need to avoid any appearance of impropriety. A Code of Conduct was established for all ERCOT employees and incorporated into the Ethics Agreement reaffirmation process in June 2005.

- **Zero-tolerance policy:** Employees found to have violated policy or exhibited poor judgment are disciplined to include written warnings, suspension without pay or termination. Employees now know that upper management is watching their conduct and making them accountable for that conduct.

- **Training:** All people who authorize payment of invoices were required to attend mandatory training by September 30, 2004, making them accountable for knowing that the vendor, consultant or anyone providing goods or services to ERCOT actually worked the hours and provided an acceptable product or service. All employees will be trained on the importance of internal controls and their responsibility for specific policies and procedures as part of the Internal Control Management Process being developed with the assistance of D&T. Additionally, in August 2004, ERCOT Executive Staff made mandatory a contracting procedure training for all employees authorizing contracts and approving invoices. Employees who did not go through the training by August 31, 2004, were not allowed to authorize contracts or approve invoices until they went through the training.

- **New Executive Management:** ERCOT has hired new executive management with the criteria that they understand the high level of accountability that ERCOT has to the public and the scrutiny under which it exists and is expected to perform. The Executive Team has committed to the Special Committee that it will adhere to the new policies and enforce a zero-tolerance for those who choose not to follow the policies.
- **Stable Organization:** Furthermore, the organization is transitioning from a startup to an on-going operating organization. With core business systems in place, the pace of change is more manageable. The schedules expected for the market redesign should allow ERCOT to be well along in its transition prior to a major system change.

The Special Committee has also suggested that the ERCOT Vice President of Human Resources & Organization Development arrange for Business Ethics Training as part of the new Code of Conduct training. This training should begin by September and be completed by the end of the year, with new employees receiving training as part of the employment process or at least through a semi-annual training program.

### **Conclusion**

ERCOT conducted a thorough investigation of its consultants and employees using a risk management approach. It did not identify any further misconduct beyond the vendors originally identified with the former employees. ERCOT provided all information to DPS and the Office of the Attorney General. The authorities have received the full cooperation of the ERCOT Staff. Additionally, to this date, the authorities have not identified any other misconduct by any current employees. They also affirmed that, had they found any misconduct by current employees, they would have (and will) notify ERCOT so that it can protect itself.

At this time, the Special Committee considers its assignment concluded.