



Item 3: Committee Education on Board Governance Issues

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Partner, Baker Tilly

Finance & Audit Committee Meeting
ERCOT Public
October 12, 2015



Current Issues in Board Governance

ERCOT Board of Directors Meeting

October 12, 2015

Agenda



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**Baker Tilly's focus on
the utility industry**

**General expectations of
Board members**

**Roles of the Board of
Directors and Finance
and Audit Committee**

**Internal Audit and the
Board**

Current board topics –

Financial analysis

Succession planning

Current board topics –

Sustainability reporting

Technology

Baker Tilly overview

80
years

80 year history of focusing on client needs and providing outstanding service

12th
largest

12th largest accounting and advisory firm in the United states – deep resources to serve you!

400
utilities

Energy and Utilities Group serves nearly **400 utilities** nationwide

Baker Tilly offers an independent perspective to evaluating and implementing efficient business processes, financial analysis, and managing risk

Russ Hissom, CPA, CIA, CISA, Partner

Over 30 years of industry experience in



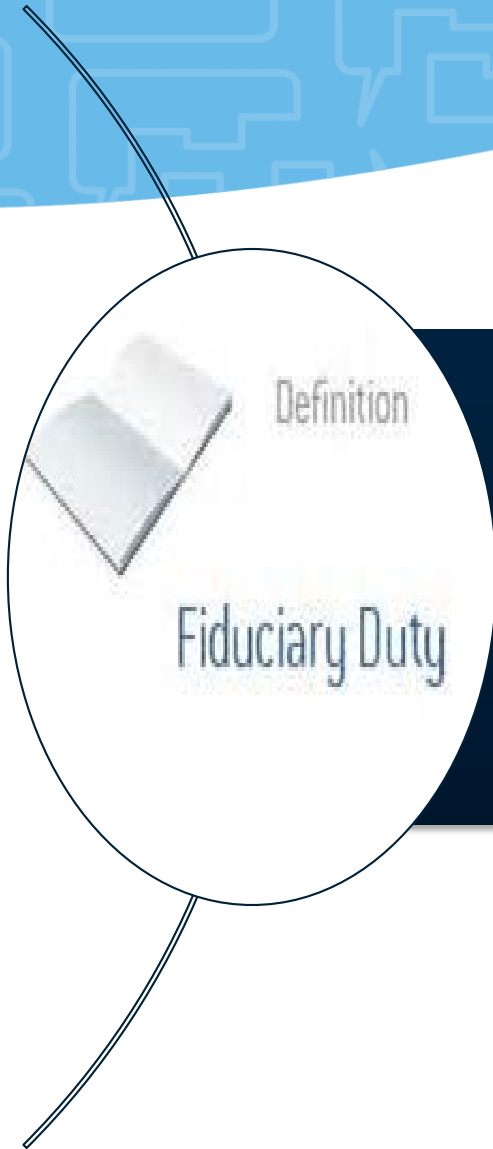
- > Providing business advisory and internal audit services
- > Business process and controls reviews
- > ERP needs assessments, system selection and implementation support
- > Financial audits
- > Scorecard and metrics reporting
- > Succession planning program implementation
- > Risk assessments
- > Financial and operational training for utilities.

General expectations of board members

Fiduciary duties



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Directors must meet their fiduciary duties in regard to risk management, ethics, policies, procedures, and organizational leadership.

Fiduciary Duties



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Care and loyalty



Act in good faith



Consistent with oath of office

Fiduciary Duties



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Learn and follow best practices



Avoid conflicts of interest



Pay attention to Board matters



Draw on expertise

Trends in Board membership



Financial, industry and operational expertise seen as most important attribute

Evolution of gender diversity on boards continues

Board trends

Composition of boards is currently 18% female

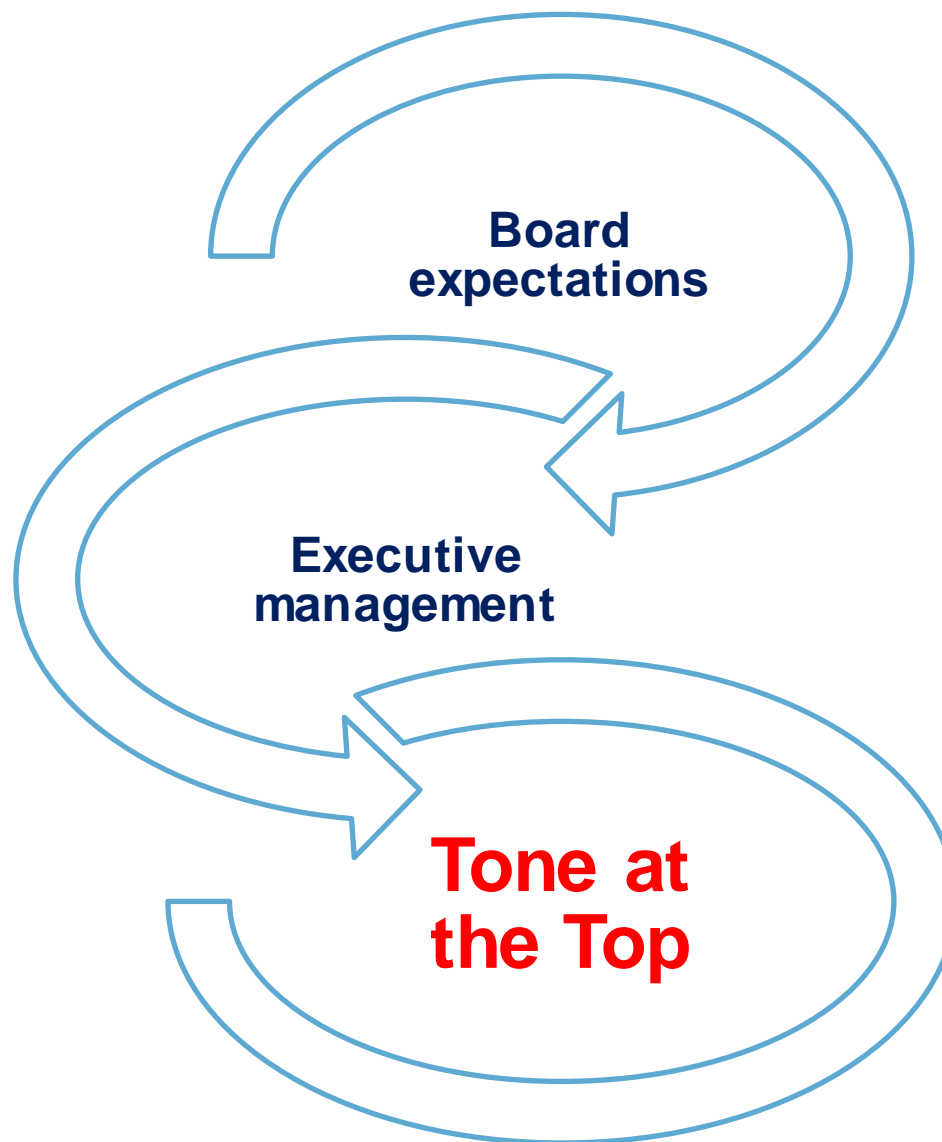
24% of all new S&P directors in last two years have been women

Roles of the Board of Directors and Finance and Audit Committee

Tone at the Top



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What is the Finance and Audit Committee's Role?



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- **Financial reporting**

Oversight



- **Policies & Procedures**
- **Risk management**
- **Controls**
- **Compliance**
- **Management**

Oversight



- **Internal audit**
- **External audit**

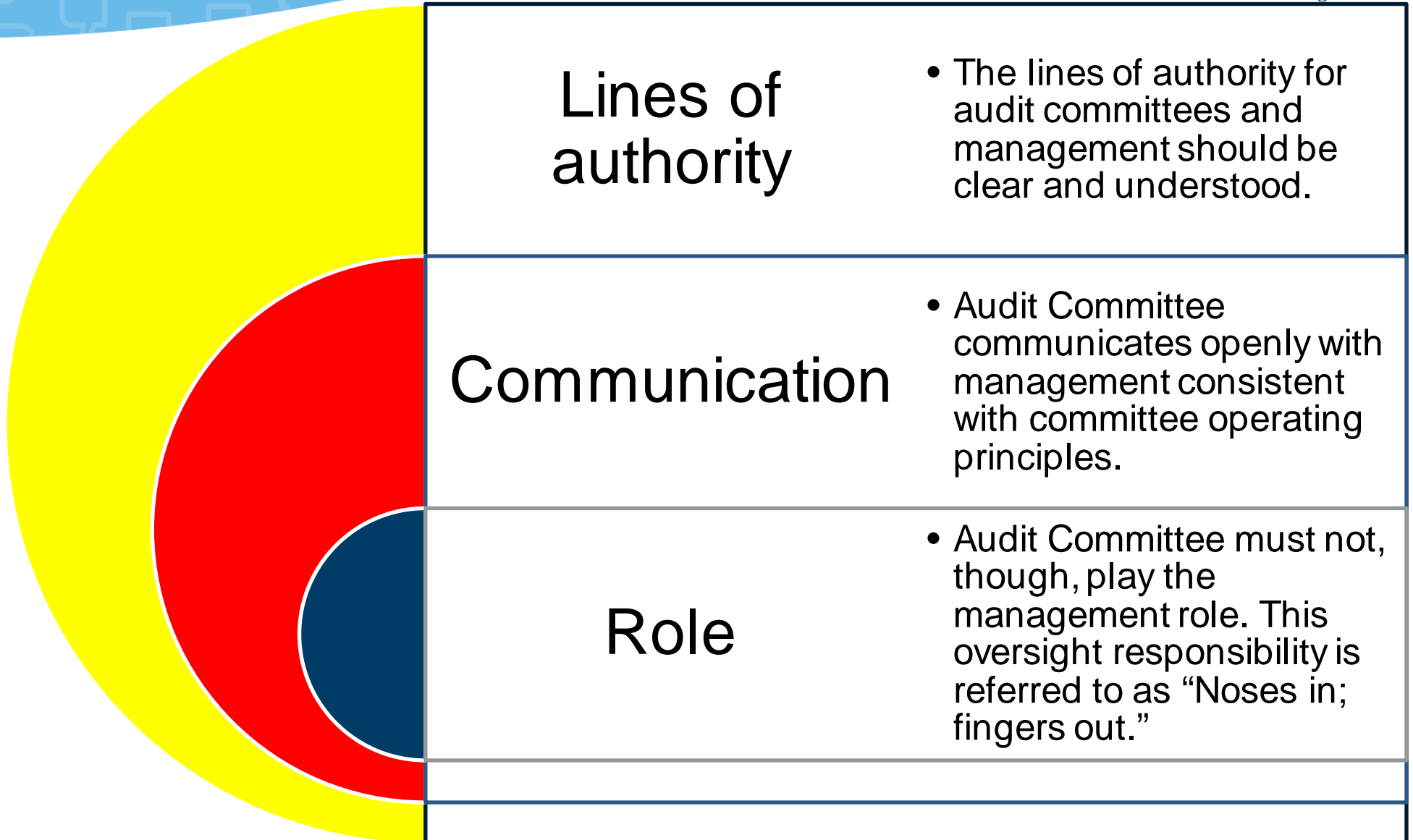
Oversight



Noses In. Fingers Out. Balancing the Role of the Board and Management



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ERCOT's Finance and Audit Committee's Role



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The role of the Finance and Audit Committee from the ERCOT Charter:

1. Oversee the development of and adherence to a Company budget;
2. Provide recommendations to the Board for financing Company needs, including both debt and revenue financing;
3. Review and make recommendations to the Board regarding investment and financial guidelines for the Company;
4. Evaluate the adequacy and effectiveness of the Company's risk assessment and mitigation policies and practices;
5. Review and make recommendations to the Board regarding credit standards, procedures, governance, ERCOT Protocols and other market rules which impact credit risk;
6. Ensure that the Company's financial statements are timely audited by qualified accountants who are independent;
7. Assist the Board in fulfilling its oversight responsibility with respect to the Company's maintenance of an effective internal audit function;
8. Establish and maintain procedures for the receipt (including anonymous submission), retention and treatment of complaints regarding accounting, internal controls, and auditing;
9. Perform such other duties and responsibilities enumerated in and consistent with this Charter.

ERCOT's Human Resources and Governance Committee's Role



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The role of the HRG&C – the review and oversight of:

1. Human resource matters, including:
 - a. Compensation of ERCOT's Chief Executive Officer ("CEO"), all other ERCOT officers and employees;
 - b. Performance of the CEO and all other ERCOT officers;
 - c. Organizational planning, including succession planning;
 - d. Employment agreements;
 - e. Staffing-level risks; and
 - f. Key performance indicators;
2. Governance matters, including:
 - a. All matters pertaining to the Unaffiliated Directors except those reserved by the Nominating Committee;
 - b. ERCOT's governing documents and Board policies and procedures;
 - c. Board-training opportunities;
 - d. Organizational strategic planning;
 - e. Ethics policies;
 - f. Overall governance structure of ERCOT;
3. External affairs matters, including:
 - a. Development of policy messages for ERCOT; and
 - b. Governmental relations.

The Committee will review and oversee any other matters as assigned by the Board.

Communications Checklist



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A Communications Checklist can help the Finance and Audit committee understand the level of communications it should expect.

- ☐ Management is easily accessible.
- ☐ Management reaches out to the audit committee regularly.
- ☐ Management answers audit committee questions fully and completely.
- ☐ Management provides factual information to support responses.

- ☐ Management admits not knowing an answer.
- ☐ Management supports the audit committee by contacting additional resources and specialists.
- ☐ Management advises the audit committee of significant issues in a timely manner.

Tone at the top

Ethical behavior

**Strong
internal
controls**

Reliability

**Strategy for
tomorrow's
grid**

**Power of
ERCOT
people**

Finance and Audit Committee Self-Evaluation



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	ERCOT Finance & Audit Committee Self-Evaluation	Yes	No	Not Sure
1.	Does the committee have the appropriate number of members? The committee should not be so large that: <ul style="list-style-type: none"> its ability to operate efficiently and effectively is reduced members' ability to raise issues is hampered it is difficult to get a quorum when a time-sensitive issue arises 			
2.	Committee members demonstrate their objectivity during meetings through behaviors such as driving agendas, rigorous probing of issues, consulting with other parties, and hiring experts, as necessary.			
3.	Differences of opinion on issues are resolved to the satisfaction of the committee.			
4.	Committee members challenge the Chair as appropriate.			

What keeps you up at night?

Financial accuracy

**Risk
management**

**Control
assessment**

**External
auditor
oversight**

**Effective use
of internal
audit**

The ERCOT code of conduct



Results.

Shared
responsibility

Individual
responsibility

Code of
conduct

Reporting
violations

Management
responsibility

The ERCOT code of conduct



cults.

Do what is right

Respect the rights of others;
Uphold the law

Principles

Avoiding conflicts of interest;

Conduct ourselves
appropriately

Maintain integrity and
confidentiality of information

The Value of Internal Auditing



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A large blue pyramid is positioned on the left side of the slide. To its right, three light blue rounded rectangular boxes are stacked vertically, each containing a text element. The pyramid's right edge aligns with the left edge of the top box.

Independent
reporting

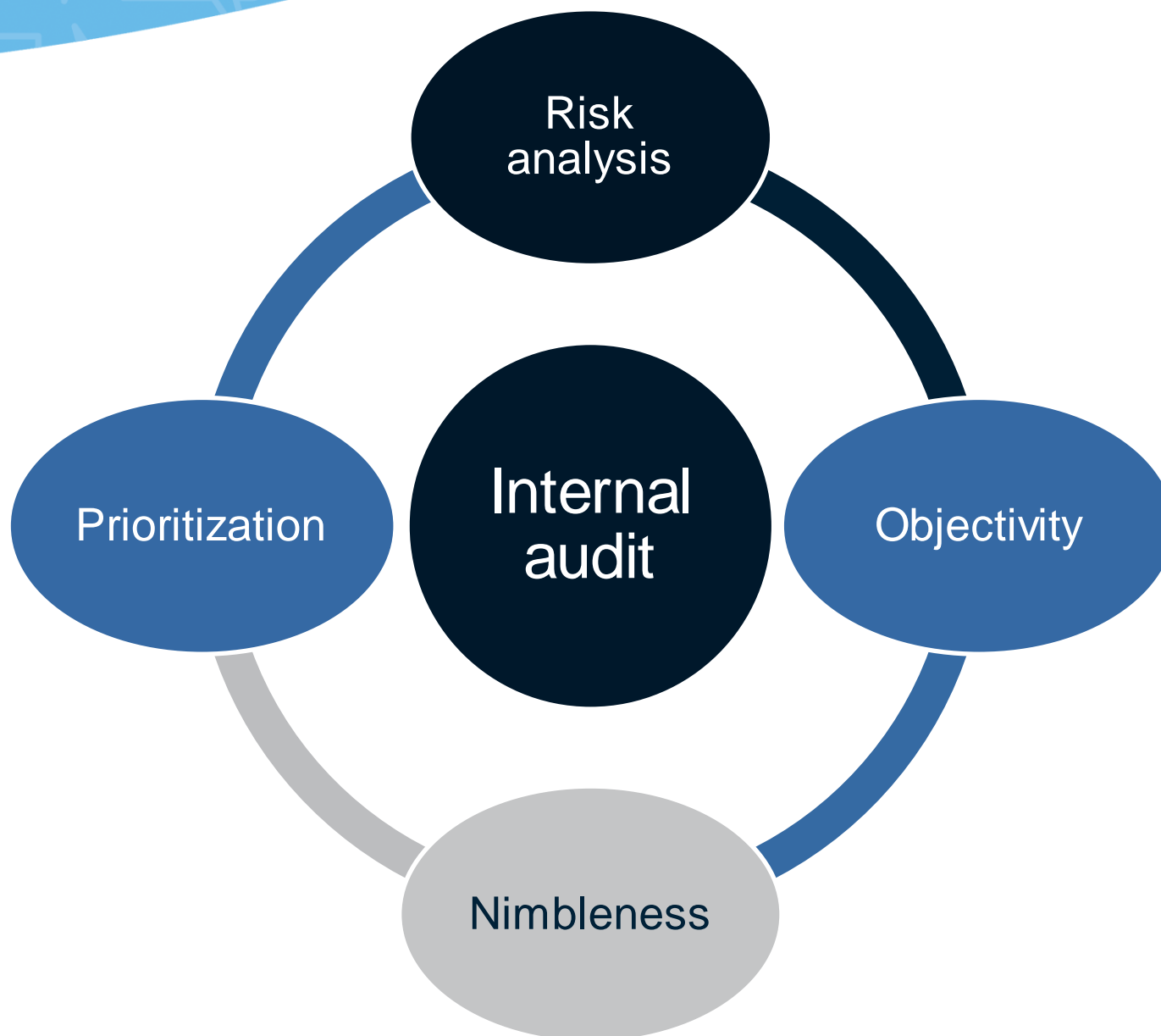
Interdependence
with Board

Foundation of
governance

Understanding Internal Audit



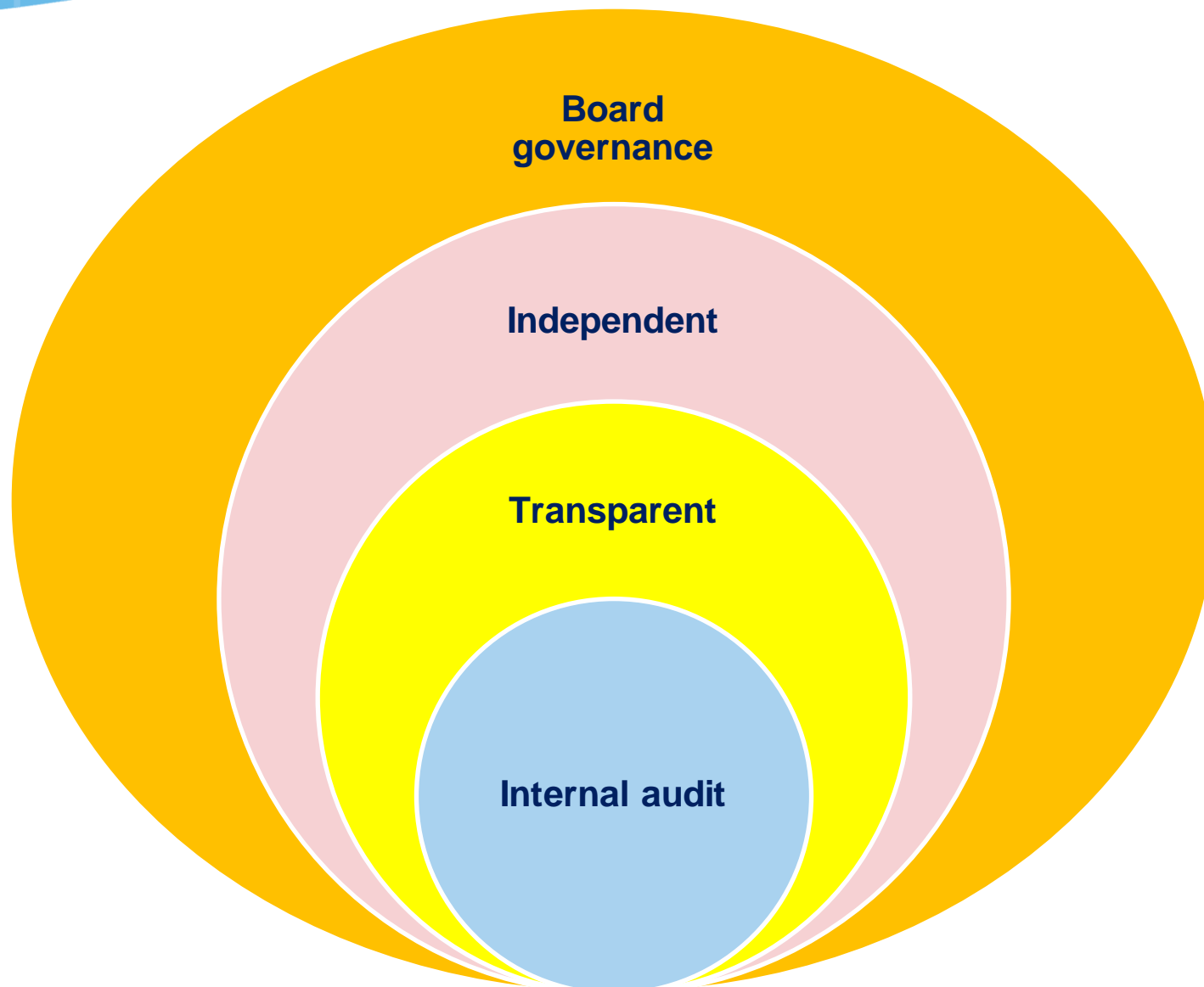
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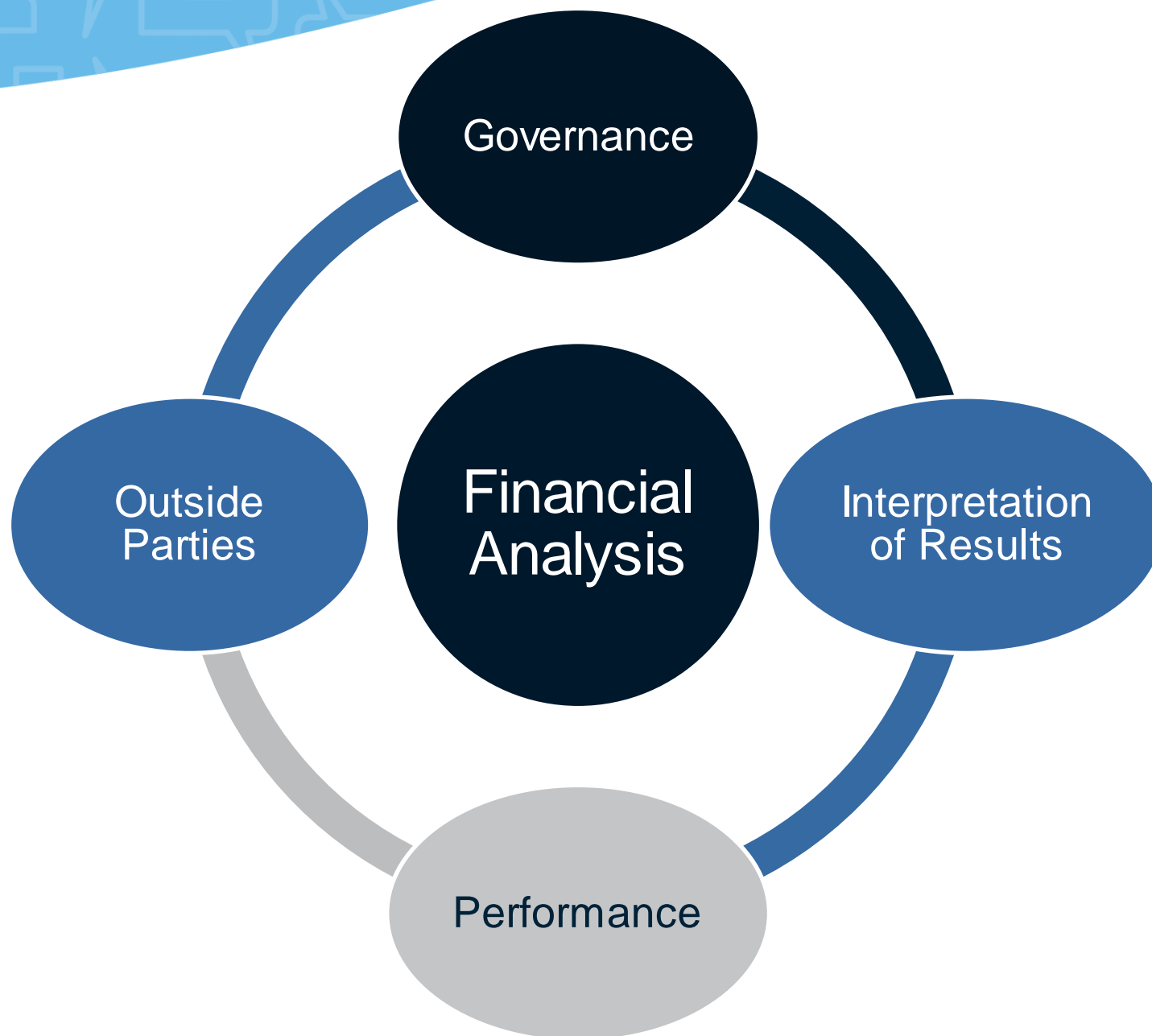
Overall relationship with Internal Audit



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Financial analysis



This is one of the most important
jobs of the CFO

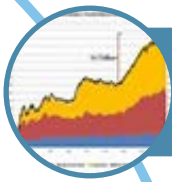
Difference between AAA
and A rated bonds is
100 basis points (1%)

**\$10 million = \$100,000
annually in interest**

Bond ratings – S&P – *Top Ten Ways to Improve or Maintain Your Utility's Credit Rating*



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Enhance or establish stabilization reserves



Establish regular economic and revenue reviews to identify potential budget problems early



Prioritize spending plans and establish contingency plans for operating budgets as a fallback strategy



Have a formalized capital improvement plan



Establish a debt affordability model

Bond ratings – S&P – *Top Ten Ways to Improve or Maintain Your Utility's Credit Rating*



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Develop a pay-as-you-go financing strategy



Develop a long-range financial forecast to predict future spending and financing needs



Develop plans for funding long-term obligations (such as post-employment benefits)



Establish and maintain effective management systems (including enterprise risk management)



Have a well-defined rate strategy

Reader's Objective

Bond coverage is met

Rating agencies are informed and satisfied

Loan covenants are maintained

Liquidity and cash flows meet needs

Reader's Objective

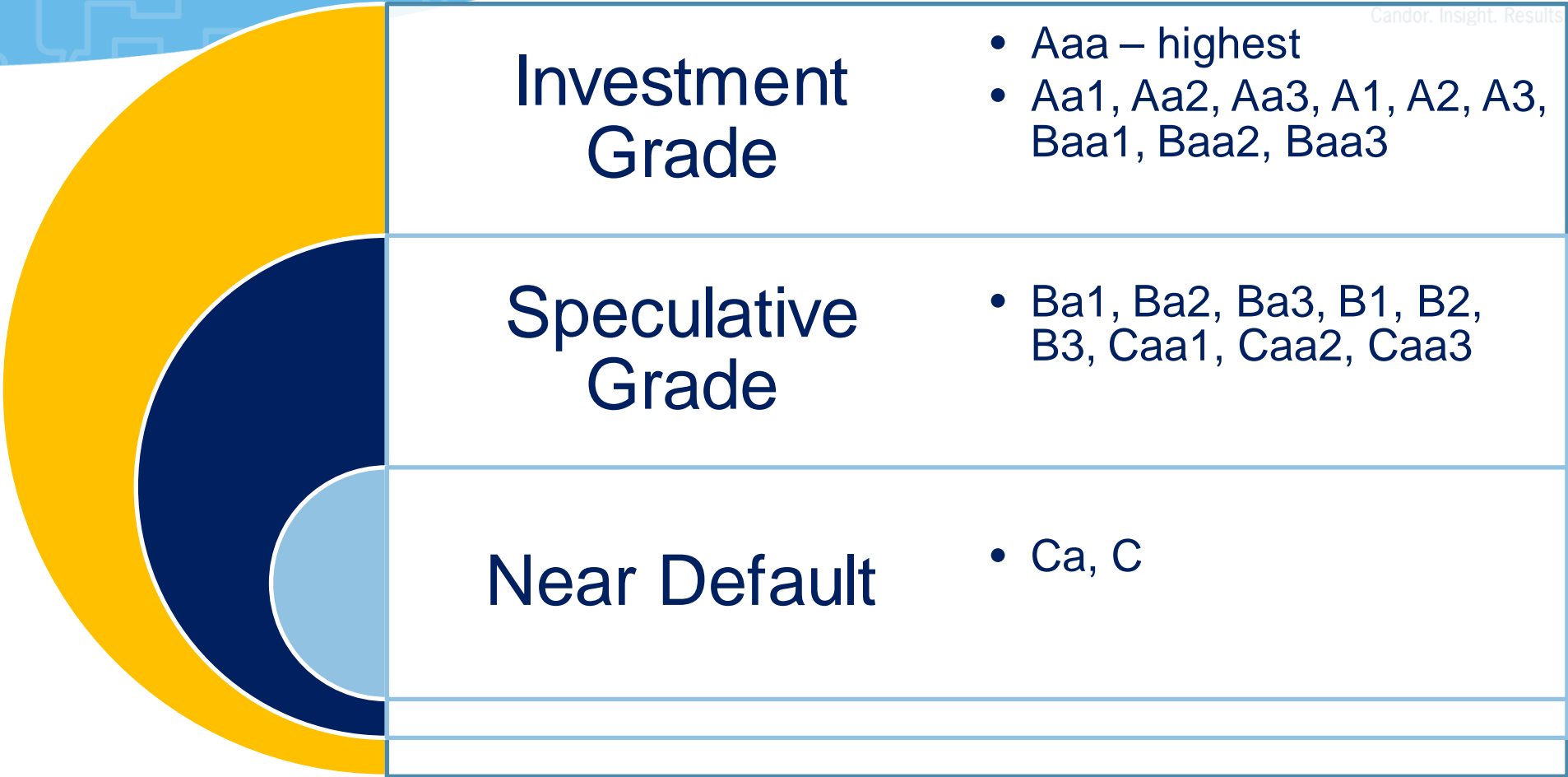
Strategic goals are on track and properly financed

Reports are understandable and usable in reviewing progress towards strategic objectives

Bond rating system – Moody's



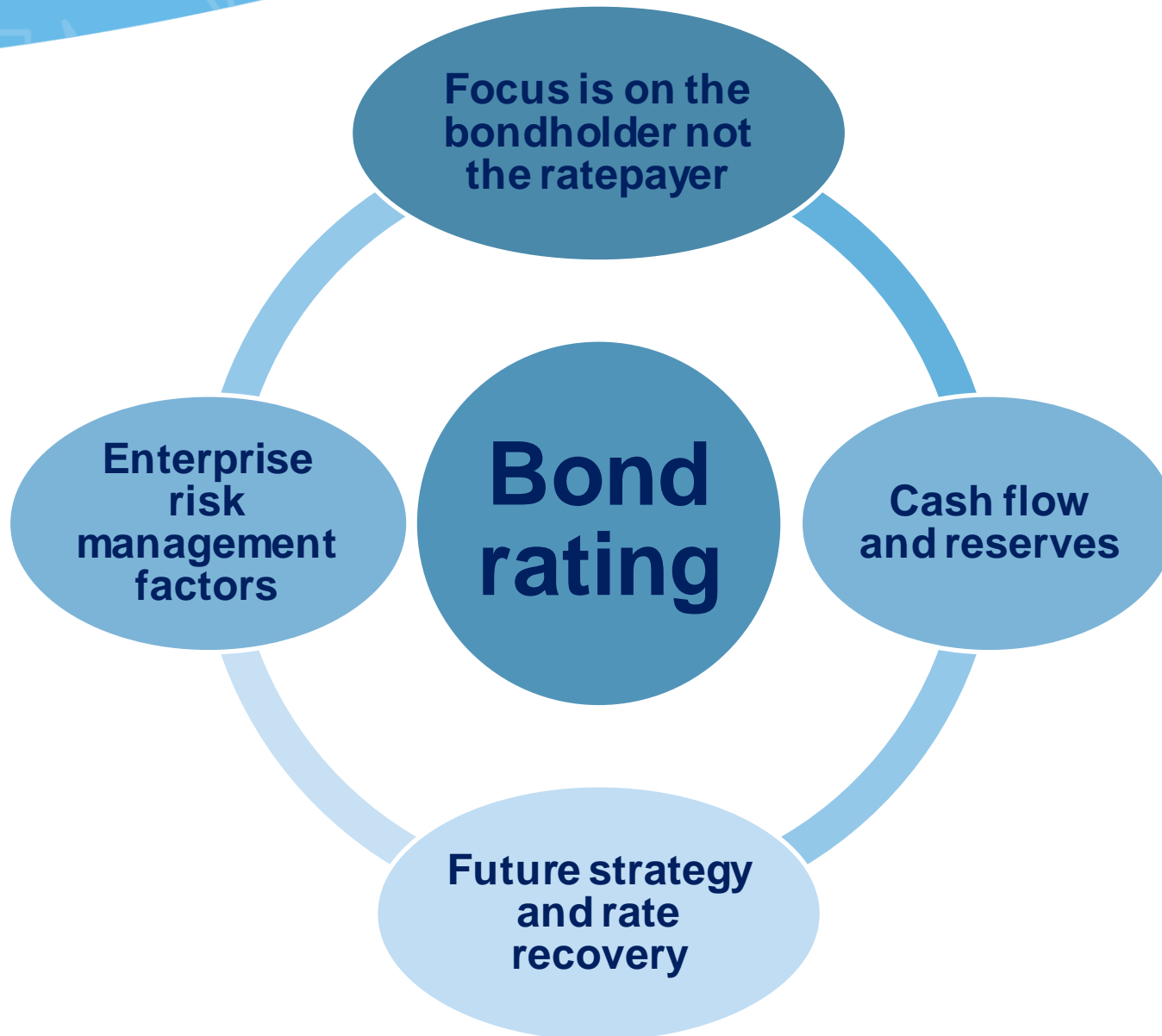
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Bond rating lessons learned



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Rating Factors

Cost recovery framework

**Willingness to
recover costs**

**Management
of generation
risk**

Competition

**Financial
strength**

Bond ratings measurement specifics



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Rating factor	Influences
Cost recovery framework	<ul style="list-style-type: none">• Monopoly power• Service area characteristics• Customer base stability
Cost recovery willingness	<ul style="list-style-type: none">• Political risks• Timeliness of recovery and history• Local government supportiveness• General fund transfer policy
Management of generation risks	<ul style="list-style-type: none">• Diversity of supply• Reliability and cost of supply & distrib• Resource planning
Competitiveness	<ul style="list-style-type: none">• Rate competitiveness
Financial strength	<ul style="list-style-type: none">• Liquidity (reserves)• Leverage (debt ratio)• Operating resiliency (debt service coverage)



What do the rating agencies consider adequate?

**Think of one month's expenditures –
Capex, payroll, O&M**

Unique to each utility

Liquidity

> 250 days – Aaa

**> 150 days to
249 days - Aa**

**> 90 days to
149 days - A**

**> 30 days to
89 days - Baa**

**Less than 30
days - Ba**

Succession planning

What is succession planning?



Succession planning is the process of identifying high-potential employees, evaluating and honing their skills and abilities, and preparing them for advancement into positions which are key to the success of business operations.



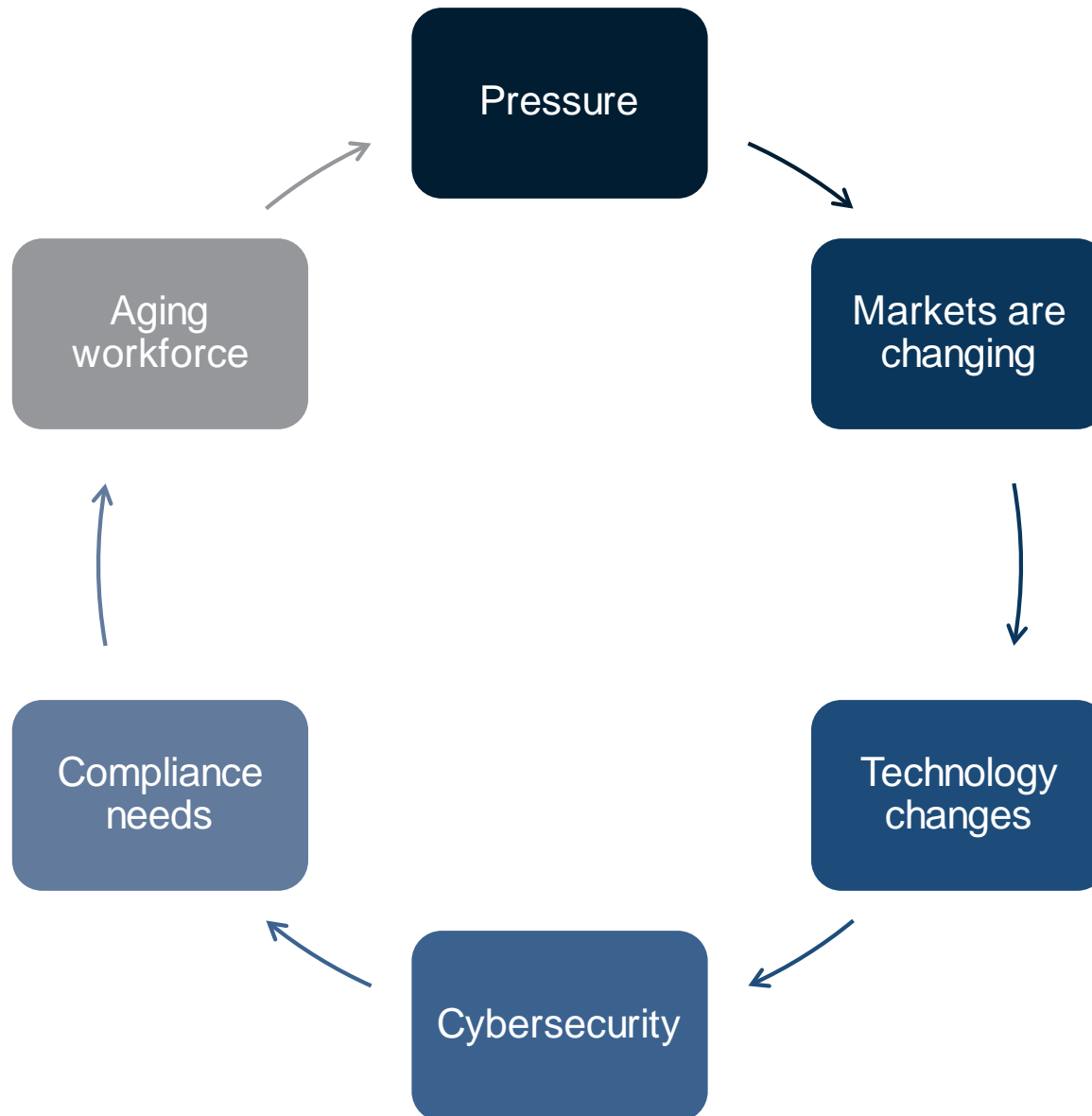
Succession planning involves:

- Understanding the organization's long-term goals and objectives.**
- Identifying the high-potential candidates and their respective developmental needs.**
- Determining workforce trends and predictions.**

State of the union



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Utility employment statistics



Utility industry employment

**1.2
million**

Utility industry unemployment rate

3.9%

Average hourly earnings

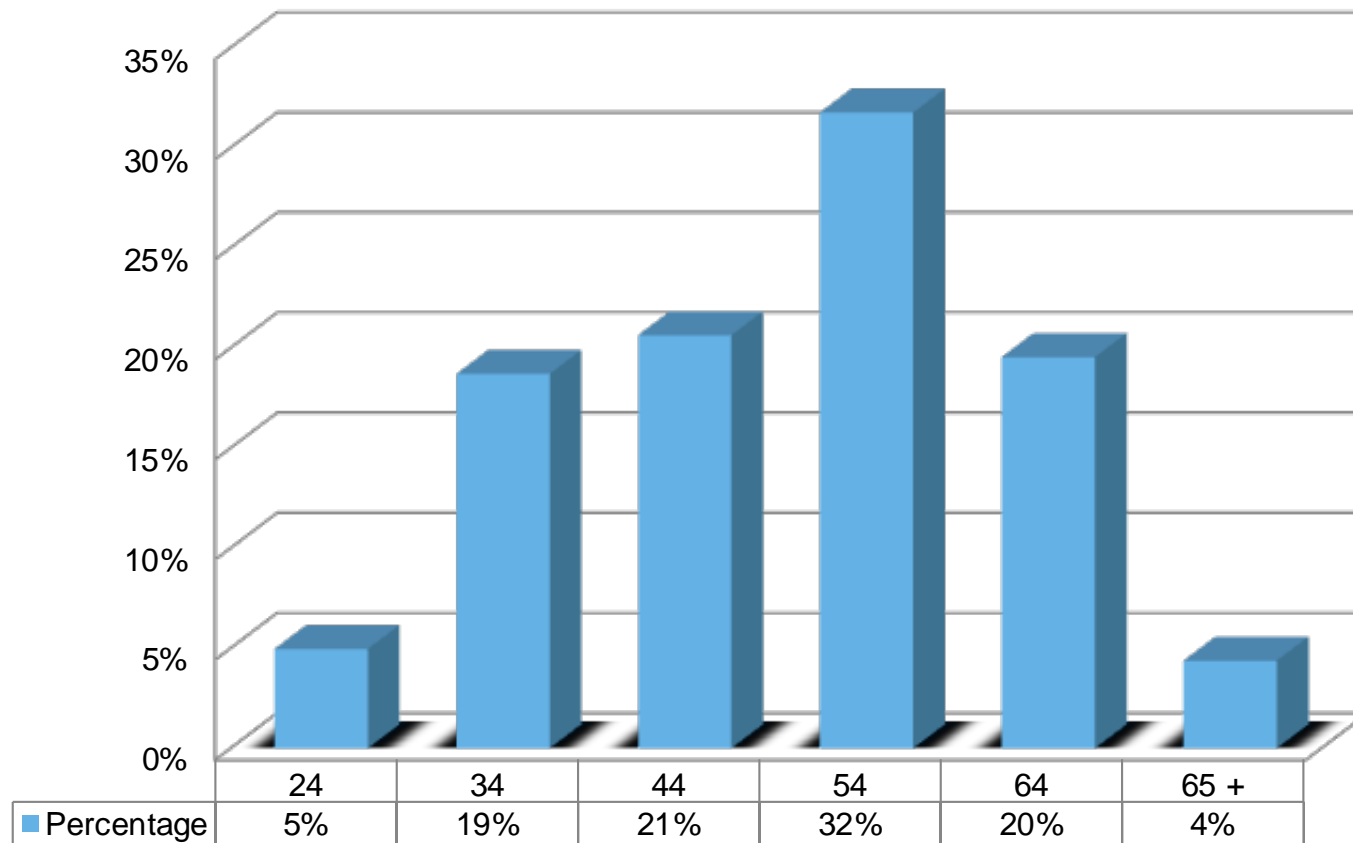
Bureau of Labor Statistics

\$36.98

Cost of replacing a skilled worker:

\$150,000 - \$200,000

Utility Industry Age Distribution



Knowledge capital needed



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Demand for intellectual capital:

Infrastructure capital expansion

Supply: Fracking and LNG

Transmission

Distribution

Aging infrastructure

Information Technology

Regular obsolescence

Financial planning and rates

Strategic and resource planning

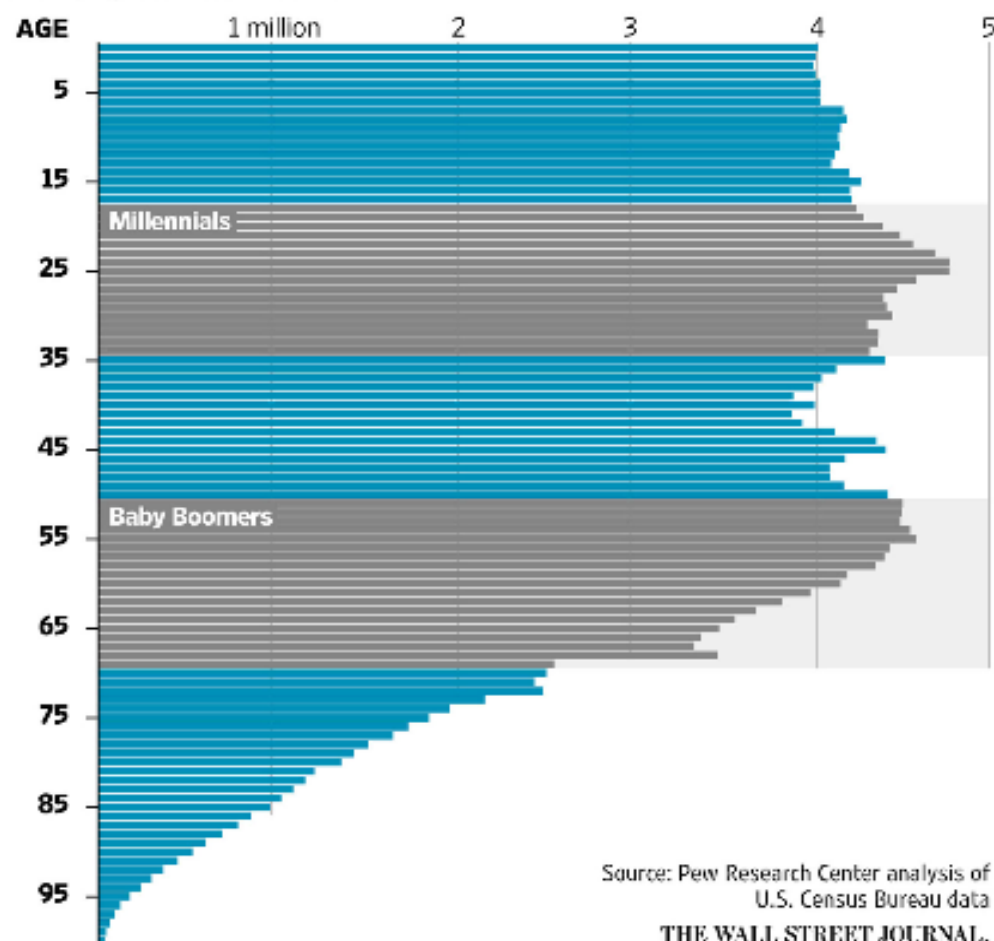
2015 Population estimates



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Baby Bumps

2015 population estimates



Source: Pew Research Center analysis of
U.S. Census Bureau data
THE WALL STREET JOURNAL.

Goals of a Workforce Succession Planning program



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Create an ongoing supply of well-trained, broadly experienced, well motivated employees who are ready to step into key roles as needed

Integrate desirable candidates into the utility with individual goals established

Establish a balanced and diverse workforce

Enable a flow of these candidates through various departments for a well-rounded experience

Goals of a Workforce Succession Planning program



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Align the future utility staffing needs with the availability of resources

Using a WSP to implement strategy and drive business efficiencies

Establish positive goals for key personnel

Define employee career paths, leading to enhanced training for a pool of qualified employees

Once implemented – what are the benefits?



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1. Link strategic goals and priorities with staff planning

2. Identify future training and employee development efforts

3. Proactively address future staffing shortages

4. Identify the need for specific positions (e.g., from expected retirement, growth in service demand, change in technology or equipment, etc.)

Once implemented – what are the benefits?



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5. Project changes to functional areas and the related changes to job requirements



6. Identify gaps between future job requirements and available workforce



7. Help utility focus on recruitment efforts and target retention incentives

Succession planning



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Over one-half of our workforce is seeking to retire in the next 10 years

Our business is changing, technology skills will have a greater need in the future

Our pool of candidates rests in millennials, we need to work to make this an attractive career

Sustainability reporting

Sustainability Reporting



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**Goes beyond
environmental
reporting**

Totality of business activities

- Supply chain procurement
- Health and safety of employees
- Community impacts
- Social impacts
- Employee morale
- Work/life balance

**ESG
(Environmental,
Social,
Governance)**

ERCOT 2014 *Power Forward – State of the Grid Report*



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Contains ES&G factors

Renewable energy and the grid

**Employee's work in the
community**

**Governance and strategic
planning**

23

Wind Generation

- Wind generation record: 10,957 MW (December 25, 2014)
- In 2014, wind provided 36.1 million MWh of energy in the ERCOT region.
- Wind generation in the ERCOT region in 2013 represented about 20 percent of the total wind generation in the United States.
- Wind in the ERCOT region typically blows more during the shoulder months — October, November, March, April and May — and can vary quite a bit due to weather events and time of day.

ERCOT 2014 *Power Forward* – *State of the Grid Report*



Bringing energy to the community

Employees have many opportunities to make a difference in the community. Some examples from 2014 include:

- ERCOT's Military/Veterans Services team volunteered about 200 hours and helped raise more than \$4,000 to sponsor Honor Flight, sending five World War II veterans to Washington, D.C.
- Volunteers played Santa, providing toys, shoes and socks for 102 children through the CASA and Thrall Giving Tree programs.
- Employees raised \$7,670 for the March of Dimes and participated in the Annual March for Babies event.
- The highly competitive ERCOT Annual Holiday Food Drive garnered donations of 2,590 bags of food for Shepherd's Heart Food Pantry in Taylor.
- United Way of Williamson County recognized ERCOT as Volunteer Partner of the Year in recognition of \$26,500 it received in employee donations.

31



lts.

Why Sustainable Reporting?



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Should be a seamless part of strategy and measured through a KPI's/Benchmark program with improvement goals

Corporate image and branding

Marketing tool for economic development

Good governance – 53% of S&P companies report some level of ESG and 71% of reports discussed corporate responsibility

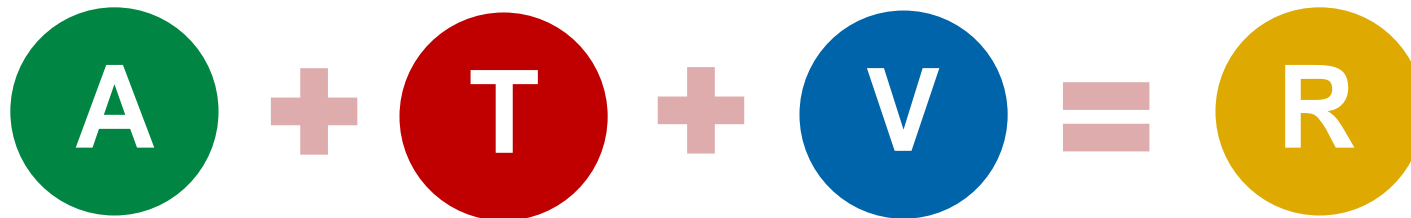
The regulatory environment of the industry will continue to demand this

Sustainability reporting is a proactive approach to telling your organization's story

Sustainable planning captures costs and programs that are being done as a normal part of strategy

Technology risk

What is Risk?



A = Asset

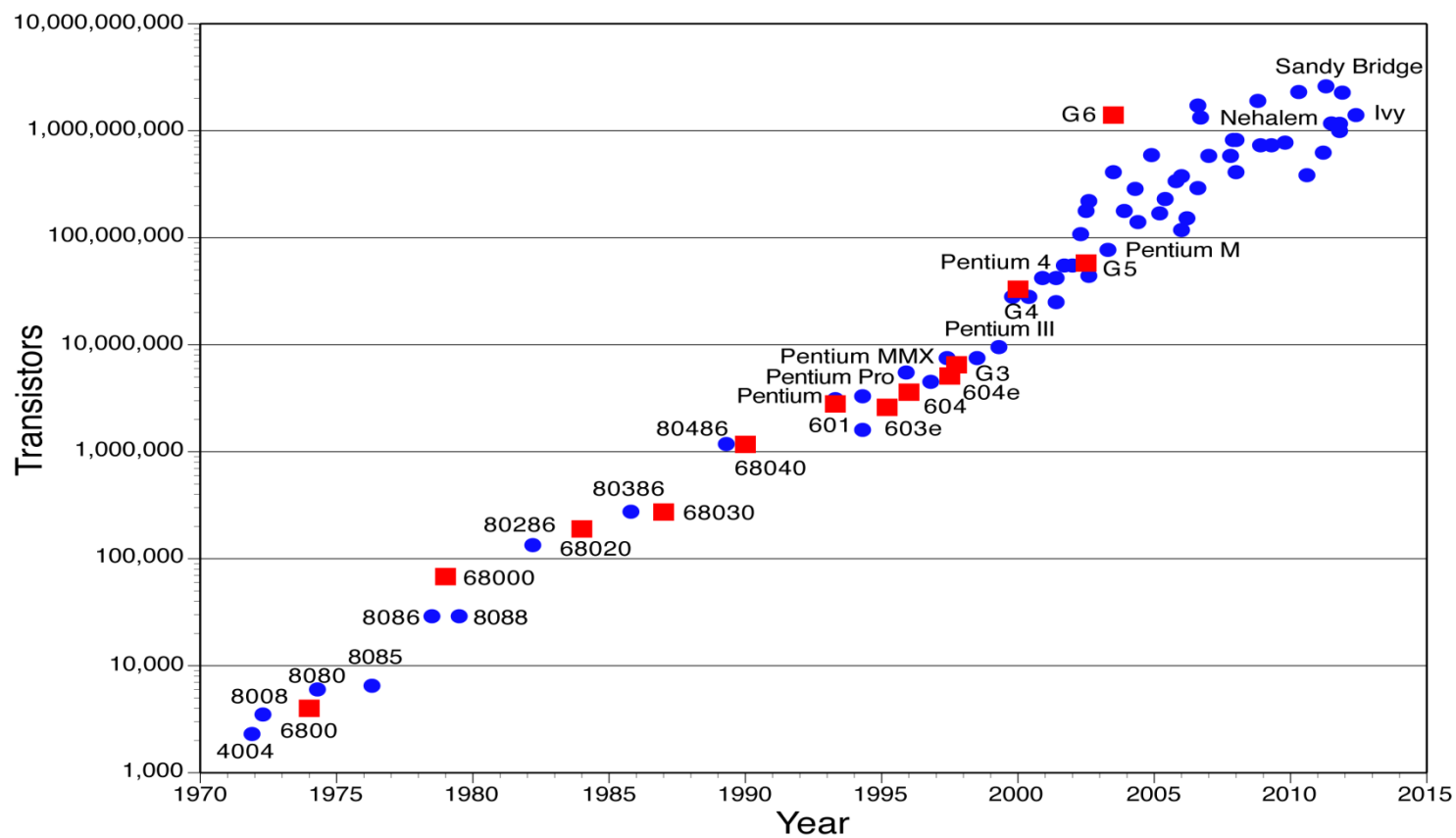
T = Threat

V = Vulnerability

R = Risk

Technology Advancement

Moore's Law



Information technology risk



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Meeting the NERC CIP standards doesn't mean all other IT areas are covered

The pace of external threats at times outpaces security measures

Obtaining financial data are one of the goals of outside intruders

Summary

Summary – Key issues in our industry



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Effective Governance Culture



Board governance

Expectations of board members and audit and finance committee

Governance

Using internal audit in the governance model

Current areas of importance

IT Risk

Financial reporting/bond rating

Current areas of importance

Sustainability reporting

Succession planning

Contact Info



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