

MINUTES OF THE NINETIETH MEETING OF THE
AUDIT AND FINANCE COMMITTEE
HELD ON SEPTEMBER 19, 2005

Pursuant to notice and an agenda dated September 9, 2005, and a revised agenda and notice dated September 19, 2005, copies of which are annexed hereto, the ninetieth (90th) meeting of the Audit and Finance Committee of the NEW YORK STATE ENERGY RESEARCH AND DEVELOPMENT AUTHORITY ("Authority") was convened at 10:00 a.m. on Monday, September 19, 2005, in the Authority's New York Office at 485 Seventh Avenue, 10th floor, New York, New York, and by video conference in the Authority's Albany Office at 17 Columbia Circle, Albany, New York.

The following members of the Committee were present:

Robert B. Catell, Chair

Vincent A. Delorio, Esq., *ex officio*

George F. Akel (by video conference from Albany)

Jay L. Gottlieb

Thomas J. Marusak (by video conference from Albany)

Authority Member Parker D. Mathusa also attended in person. In addition, Peter R. Smith, President; Robert G. Callender, Vice President for Programs; Wendy M. Shave, Vice President for Administration and Secretary to the Board; Jeffrey J. Pitkin, Treasurer; Roger D. Avent, Esq., General Counsel; Jacquelyn L. Jerry, Esq., Associate Counsel and Secretary to the Audit and Finance Committee; Mark B. Mitchell, Director of Internal Audit; Bruce D. Van Dusen, Esq., and Thorne Clark, Esq., from Hawkins, Delafield & Wood; James Holodack, Steve McCaffrey, Esq., and Chris DiGilio from KeySpan Energy Delivery New York; Kaynaz Rokhsar and Elizabeth Esrov from Morgan Stanley & Co., Incorporated; and various staff of the Authority were present.

Since Mr. Catell, Chair of the Audit and Finance Committee, was unavoidably delayed, Mr.

DeLorio called the meeting to order. Mr. DeLorio noted the presence of a quorum and indicated that the first item on the agenda concerned the approval of the minutes of the eighty-ninth meeting of the Committee held on June 20, 2005.

Whereafter, upon motion duly made and seconded, and by unanimous voice vote of the Committee members then present, the minutes of the eighty-ninth meeting of the Committee, held on June 20, 2005, were approved.

Mr. DeLorio stated that next items on the agenda are proposed implementing resolutions on behalf of The Brooklyn Union Gas Company doing business as KeySpan Energy Delivery New York ("KeySpan"). Mr. DeLorio called on Jeffrey J. Pitkin, the Authority's Treasurer, to discuss the items. Mr. Pitkin explained that the Members are requested to approve two implementing resolutions authorizing the issuance of two series of bonds to refund bonds previously issued by the Authority on behalf of The Brooklyn Union Gas Company. The first refunding involves \$82 million in bonds issued in 1989. The 1989 bonds currently carry a 6.75% fixed interest rate with a maturity date of February 1, 2024, and are callable at 100.5% of par. The proposed refunding bonds would be fixed rate bonds. Based on current rates for fixed rate bonds, the refunding is estimated to provide about \$16.7 million in net present value interest rate savings, which will accrue to the benefit of KeySpan's ratepayers in accordance with Public Service Commission ("PSC") requirements.

The second refunding would refund \$55 million in bonds issued in 1990. The 1990 bonds currently carry a 5.6% fixed interest rate with a maturity date of June 1, 2025, and are callable at 101% of par. The proposed refunding bonds would be issued as multi-modal bonds, initially anticipated to be issued as auction rate bonds. Based on the 10-year average of interest rates for auction rate bonds, the refunding is estimated to provide about \$8.6 million in net present value interest rate savings, which will accrue to the benefit of KeySpan's ratepayers in accordance with PSC requirements.

Each series of bonds would be backed by an irrevocable promissory note issued by KeySpan, would be insured by Financial Guaranty Insurance Company, and would carry a AAA rating. Each

series of bonds would mature no later than the maturity date of the respective series of bonds it is refunding.

Issuance of the refunding bonds has been approved by the PSC, but will require approval by the Public Authorities Control Board.

KeySpan has requested that particular firms serve as underwriters with respect to each series of the refunding bonds and the firms are listed in the materials in the meeting packet. KeySpan believes, and Authority staff concurs, that all of the firms are qualified and experienced to serve as underwriters for the proposed refundings.

Whereafter, upon motion duly made and seconded, and by unanimous voice vote of the Committee members then present, the following resolution was adopted.

Resolution No. 305

RESOLVED, that the Audit and Finance Committee recommends that the Members of the Authority adopt a resolution in substantially the same form as the resolution submitted to the Committee (attached as Exhibit A), being an implementing resolution on behalf of The Brooklyn Union Gas Company doing business as KeySpan Energy Delivery New York, authorizing the issuance of bonds in an amount not to exceed \$82 million for the purpose of refunding bonds previously issued by the Authority in 1989 to finance facilities for the local furnishing of gas within the company's gas service territory in The City of New York.

Whereafter, upon motion duly made and seconded, and by unanimous voice vote of the Committee members then present, the following resolution was adopted.

Resolution No. 306

RESOLVED, that the Audit and Finance Committee recommends that the Members of the Authority adopt a resolution in substantially the same form as the resolution submitted to the Committee (attached as Exhibit B), being an implementing resolution on behalf of The Brooklyn Union Gas Company doing business as KeySpan Energy Delivery New York, authorizing the issuance of bonds in an amount not to exceed \$55 million for the purpose of refunding bonds previously issued by the

Authority in 1990 to finance facilities for the local furnishing of gas within the company's gas service territory in The City of New York.

Mr. DeLorio indicated that the next agenda item concerns a report on an audit being conducted by the Office of the State Comptroller ("OSC"). Mr. Pitkin reported that OSC staff remain on-site and that they are performing an audit of system benefits charge ("SBC") funded programs. They are nearing completion of their review of approximately 60 contract files relating to SBC-funded contracts. They have indicated that they expect to complete their on-site field work by the end of September 2005 and will be reporting on the results of their findings shortly thereafter.

OSC staff have discussed with Authority staff one area for improvement which might be included in OSC's final report. This area concerns the monitoring of indirect cost rates, such as overhead, which are being billed to the Authority by its contractors. Even though these rates are reviewed by the Authority's Technical Evaluation Panels for reasonableness and for comparative value, OSC will likely recommend that the Authority request from its contractors supporting documentation for indirect cost rates and that the Authority periodically audit or review such rates on a sample basis. Staff agrees that increasing monitoring over contractor indirect cost rates would be beneficial and are revising solicitation and contracting procedures accordingly. In addition, the Authority recently hired an individual, who is a certified public accountant, for a new Contract Auditor position. The Contract Auditor will perform periodic audits of contractor invoices, including indirect cost rates.

Mr. DeLorio then indicated that the next agenda item concerned a report from the Director of Internal Audit, Mark B. Mitchell. Mr. Mitchell reported that the Committee members are requested to approve the interim internal audit plan for the remainder of fiscal year 2005-06. Upon approval, Mr. Mitchell will implement the audit plan and will report on the results at future meetings of the Committee. An internal audit plan for the full 2006-07 fiscal year will be presented to the Committee at the April 2006 meeting.

The interim internal audit plan presented for approval is presented in the form of a business risk profile. The business risk profile was formulated from the results of an internal risk assessment

process and from information obtained through an employee survey. Information explaining the protocol for conducting the business risk analysis is included in the meeting packet. The internal risk assessment process did not include thorough testing or validation of every statement made during the interviews, however. For example, it did not include detailed review of specific processes or detailed testing of transactions. Instead, the internal assessment process was used as a means to identify areas that could benefit from more detailed review.

The business risk profile described in the meeting packet also highlights areas that appear to have strong controls. In the area of governance, the profile shows that the Authority's governance appears to be quite good. The Authority's governing board has a size that is within optimal range for effectiveness and the Members are actively engaged in performing their oversight responsibilities. In addition, there is regular, ongoing communications between the Chair and the President, as well as regularly scheduled meetings of all of the standing committees. As supported by the risk assessment interviews and the employee survey, oversight, monitoring, communication, and information cascade in abundance throughout the Authority.

The business risk profile also indicates that the Authority has in place many good preventive controls that are designed to avoid the creation of problems. Examples of these controls include, but are not limited to, strategic planning, program planning, program development, and procurement. But, no organization can rely solely upon preventive controls -- there must be controls designed to detect whether the preventive controls are working properly. The reviews indicated that the Authority has numerous controls designed to detect whether its preventive controls are working.

The risk assessment identified a few areas that could benefit from more detailed review, however. For example, the Authority's reliance on outreach projects consultants and implementation contractors for technical review, program delivery, and quality control was identified as a potentially higher risk area. Management is making improvements in this area, and others may be implemented as a result of further review. The other relatively higher risk area identified by the employee survey is whether there are a sufficient amount of resources available and whether programs are delivered

in accordance with the Authority's processes. The internal audit plan proposes to look at these areas in more detail.

The business risk profile also discusses some opportunities for improvement, even though they may not be considered among the Authority's higher risks. In several instances, management is either planning to or already has taken actions to address these opportunities. For example, as previously mentioned, a Contract Auditor has been hired to audit contracts and research, development, and demonstration recoupment.

Since the Authority's internal operating environment also influences the Authority's ability to manage its risks, the employee survey was designed to provide insight into how well the risk management philosophy is integrated into the Authority's culture. The survey indicates that things are quite good at the Authority and that the internal control climate is more than satisfactory.

Since Internal Audit is a new function for the organization, the interim internal audit plan will start with a review of the Projects Database -- the controls over entering and making changes to the Authority's contract reporting database system. Once this review is completed and a template for further reviews established, a review is planned of the new electronic invoice process and the effectiveness of the controls over it. After that, the interim internal audit plan calls for a review of the way that the Authority's project managers review and approve invoices for payment, followed by a review of the controls the Finance Unit uses in receiving and paying those invoices. Once these series of reviews are complete, the interim internal audit plan calls for updating the Authority's business risk assessment protocol. Mr. Mitchell concluded his presentation by stating that the results of the revised business risk assessment protocol will be used to develop an internal audit plan for the following fiscal year and will be presented to the Audit and Finance Committee in April 2006.

In response to a question from Mr. Gottlieb, Mr. Mitchell stated that staff was concerned about the amount of Authority oversight over external program administrators and outreach consultants involved with technical reviews of Authority projects. Mr. Pitkin explained that the concern was whether the "checker" was being checked, *i.e.*, whether the contractors are doing what they are

supposed to be doing. President Smith provided additional background information by explaining that it was initially determined with notice to the Members that the most efficient way to implement the technical Statewide programs was to enter into contracts with regional outside engineering and other such firms in the market place to work with potential customers and to review projects for technical compliance. Authority staff could then be focused on delivering the programs. Such firms were then selected on a competitive basis and their performance, including quality of delivery, is reviewed periodically.

Mr. Pitkin added that the rationale underlying the programs' design was to accomplish three purposes - - to promote the availability of programs and to provide access to these programs in a way that would encourage participation Statewide; to foster market transformation by initially coupling public and mid-stream private partnerships, with the long-term goal of having the mid-stream private sector develop the skills and knowledge necessary for recognizing energy commitment as an integral and important part of their business dealings; and to use a local presence to ensure compliance with program requirements.

In response to an inquiry by Mr. Marusak, President Smith indicated that, while the Authority had the in-house technical expertise to perform the work, it seemed more cost-effective to have outside contractors perform the technical audit reports and directly work with customers to promote energy efficiency projects, while devoting a smaller core of Authority staff to reviewing the audits and energy-related activities as part of general program administration. It was believed that this programmatic design would facilitate the Authority's ability to offer an expansive Statewide program and to encourage private sector firms to make energy use a more prominent and important part of their engineering and architectural analyses. For example, the highly successful Flexible Technical Assistance Program, uses 38 competitively-selected architectural/engineering firms to serve as catalysts for increasing energy awareness in planning and operations throughout all sectors.

In response to another inquiry from Mr. Marusak, Mr. Pitkin explained that the Authority is looking at ways to consolidate programs, by sector, thus allowing a customer to speak with one staff person who can assist them through each and every program that would be available to them.

President Smith added that the responsibility should fall to the Authority to determine where a customer best fits within the Authority's programs, rather than putting the onus on the customer. Staff is therefore looking at whether the Authority can better serve its customers, if specific staff are assigned to focus on a specific sector, have in-depth understanding of all Authority programs available that particular sector and are then made responsible for guiding customers through those programs that will meet their needs.

In response to a further inquiry from Mr. Marusak, Wendy Shave, the Authority's Vice President for Administration and Secretary to the Board, indicated that efforts are underway to fill the Manager of Human Resources position.

Mr. Delorio concluded the discussion by stating that risk assessment is an important tool in ensuring the effective use of Authority resources.

Mr. Catell arrived during this discussion, assumed his role as Chair of the Committee. He then asked for a resolution to approve the interim internal audit plan.

Whereafter, upon motion duly made and seconded, and by unanimous voice vote of the Committee members, the following resolution was adopted.

Resolution No. 307

RESOLVED, that the interim Internal Audit Plan (Exhibit C), as presented at this meeting, be, and it hereby is, approved.

Mr. Catell then called upon President Smith to update the Committee members on the implementation of model governance principles. President Smith explained that, at the last Committee meeting, he had reported on the proposed Public Authority Accountability Act of 2005 ("Act") and the creation of the New York State Commission on Public Authority Reform established by Executive Order No. 135. The proposed Act would change the Authority's enabling statute to re-designate the Chair as the primary liaison between the Members and staff and name the President as the Chief Executive Officer.

In August 2005, the Chair sent to each Authority Member a letter describing the terms of the proposed legislation and the actions that the Authority would have to take in order to meet the Act's requirements. Staff has been monitoring the progress of the proposed legislation, but it has not yet been enacted. Once the Act is in effect and its enabling statute amended, staff will ask the Members to approve the actions described in the Chair's letter.

Mr. Smith then asked Mr. Pitkin to report further on the Authority's implementation of the model principles of governance. Mr. Pitkin said that, at the June 2005 meeting of the Committee, the Committee members discussed a work plan for implementing an assessment and report on internal controls over financial reporting. This plan was developed by staff in response to the model governance principles issued by the predecessor to the New York State Commission on Public Authority Reform. Those principles included a recommendation that each public authority include in its annual financial statements a report on the effectiveness of its internal controls over financial reporting, including an attestation on such report by the independent auditors. The Act which provides legislative direction in this area, neither includes a requirement for the preparation of a separate report on financial reporting nor requires that this report be subject to attestation by the independent auditors. Therefore, staff proposes to refocus its efforts. This is because the perceived benefits from preparing the report for attestation by the independent auditors would not outweigh the either the administrative time that would be necessary to produce the documentation that would be required in order to obtain that attestation or the additional audit fees that would be incurred. The Act does, however, require each public authority to provide a report on the effectiveness of its internal control systems in general. The Authority is therefore intending to move forward, consistent with the internal work plan presented at the June meeting, with reviewing and documenting the effectiveness of its financial reporting controls. Staff understands that a number of other authorities are taking a similar approach.

As required under the internal work plan, staff has reviewed controls over two income statement areas -- salary expenses and royalty revenue. Staff found this process to be worthwhile, as it led to the identification of improvements in controls that have since been implemented. For example, in the area of royalty revenue, the Authority uses a database to monitor compliance with

recoupment provisions and payment obligations. While the Authority has processes in place to enter contracts into this system, there was insufficient assurance that the system accurately and completely identified all such recoupment contracts. As a result, the Authority is in the process of instituting a new internal control whereby the Director of Contract Management will be responsible for first identifying contracts containing a recoupment provision and then listing them in the recoupment database. The Director will also be responsible for ensuring that they are listed as recoupment contracts in the contracts payable system. Contracts Unit staff will then be required to reconcile these two databases, annually.

Staff will continue the documentation and assessment analysis for the other financial statement components and will report on the results at future meetings.

In response to an inquiry from Mr. Catell, Mr. Pitkin indicated that a schedule for completion of the review has not been established, but he will be advising the Committee members on staff's progress.

Mr. Catell said that the last item was other business and he asked if there were any other matters the Members wished to discuss. There being none, upon motion duly made and seconded, and by unanimous voice vote, the meeting was adjourned.

Respectfully submitted,


Jacquelyn L. Jerry
Secretary to the Committee