MINUTES OF THE NINETY-FIRST MEETING OF THE
AUDIT AND FINANCE COMMITTEE
HELD ON JANUARY 23, 2006

Pursuant to notice dated January 11, 2006, the ninety-first (91st) meeting of the Audit and Finance Committee of the NEW YORK STATE ENERGY RESEARCH AND DEVELOPMENT AUTHORITY ("Authority") was convened at 10:30 a.m. on Monday, January 23, 2006, in the Authority's 10th floor conference room at 485 Seventh Avenue, New York, New York, and was available by video conference in the Authority's board room at 17 Columbia Circle, Albany, New York, and in the Authority's conference room at 617 Main Street, Suite 105, Buffalo, New York.

The following members of the Committee were present:

Robert B. Catell, Chair
Vincent A. DeIorio, Esq., ex officio
Jay L. Gottlieb

Members Akel and Marusak did not attend.

Also present were Authority Members Parker Mathusa and Dr. Elizabeth Thorndike; Peter R. Smith, President; Robert G. Callender, Vice President for Programs; Wendy M. Shave, Vice President for Administration and Secretary; Jeffrey J. Pitkin, Treasurer; Roger D. Avent, Esq., General Counsel; Jacquelyn L. Jerry, Esq., Associate Counsel and Secretary to the Audit and Finance Committee; and various other staff of the Authority.

Mr. Catell called the meeting to order and noted the presence of a quorum. He indicated that the first item on the agenda concerned the approval of the minutes of the ninetieth (90th) meeting of the Committee held on September 19, 2005.

Whereafter, upon motion duly made and seconded, and by unanimous voice vote, the minutes of the ninetieth (90th) meeting of the Committee, held on September 19, 2005, were approved.

Mr. Catell said that the next item on the agenda concerned an audit conducted by the Office of the State Comptroller ("OSC"). At Mr. Catell's request, Jeffrey J. Pitkin, the Authority's Treasurer, explained that OSC has completed its audit of the system benefits charge ("SBC") program and that the Authority received a draft of the final report on Friday, January 20, 2006. As part of the audit, OSC reviewed the Department of Public Service's ("DPS") oversight of the Authority's SBC program, reviewed the independent evaluation of the SBC program, and selected and reviewed approximately 70 SBC-funded contracts. A closing conference meeting attended by OSC, the Authority, and DPS staff was held on November 23, 2005. OSC staff indicated that overall, DPS's oversight of the program and the independent evaluation of the program were effective and that the Authority was effectively administering the SBC program.

In addition, OSC staff made two recommendations for improvement with respect to the Authority's contracting process. The first recommendation, which was discussed at the Authority's September 2005 meeting, calls for increased monitoring of contractor overhead rates. This recommendation has been implemented by increasing monitoring of such rates, both prior to contract award and after contracts are executed.

The second recommendation calls for reminding Authority staff of the importance of verifying contract provisions and documentation prior to making payments. This verification should include program staff's review of the underlying contract terms and deliverables and the Finance Department's review of compliance with the contract's provisions, prior to authorizing payment. For one of the contracts selected, OSC found that program staff had adjusted a request for a program participant incentive payment payable under the current year's program by adding funds for an incentive that accrued under the prior year's program. This adjustment failed to take into account that the incentive for the current year was different than the incentive payable under the prior year. In combining the incentives, the aggregate amount payable was improperly calculated using the higher incentive rate offered in the current fiscal year. As a result, the Authority overpaid the program participant by about $21,000 on its approximately $752,000 payment. This miscalculation by program staff was not detected by the Finance Department staff, prior to making payment. OSC

agreed that this appeared to be an isolated occurrence, but suggested that the Authority remind staff of the need to document and verify payments, which has been done. The Authority has also recovered the overpayment, as recommended by the OSC audit.

Mr. Pitkin concluded the presentation by stating that a copy of the final report from OSC and the Authority's response to the report will be provided to the Members, once they are available.

Mr. Catell said that he viewed the audit as favorable to the Authority, since only two relatively minor problems were identified. Mr. Pitkin added that Authority staff welcomed the review and demonstrated their willingness to accept and implement the recommended actions quickly. The Chair concluded the discussion by stating that he also thought that the audit reflected favorably upon Authority operations.

Mr. Catell said that the next item on the agenda concerned principles of governance and he called upon Peter R. Smith, the Authority's President, to discuss the matter. President Smith explained that the Public Authority Accountability Act of 2005 ("Act") was passed by the Legislature in June 2005. In August 2005, Chair DeIorio sent the Members a letter summarizing the Act's provisions. The Act has just been signed into law by Governor Pataki. As was approved by the Members, the Act includes the language proposed by the Authority to designate the President as the Chief Executive Officer of the Authority. In addition, the Act requires the Authority to establish a governance committee. The purposes of the governance committee would be to keep the Authority informed on best governance practices, to review corporate governance trends, to update the Authority's corporate governance principles, and to advise appointing authorities on the skills and experiences required of potential Members. These and other provisions of the Act will require the Authority to make changes to its By-laws, policies, and operating manuals. A complete set of changes will be provided for consideration at the April meeting.

With respect to the Members' responsibilities, the Act requires all Members to attend "state approved training" which is to address the legal, fiduciary, financial, and ethical responsibilities of being a Member. The City University of New York's School of Professional Studies ("CUNY")

sponsored several two-day training sessions in late 2005 and at least one of the Authority's Members attended a session. Since the CUNY initial sessions involved a two-day time commitment, staff began investigating the potential for having an Authority-specific training session conducted by an independent consultant and tailored to the Authority's specific needs. Authority management suggest that it would be beneficial to have a session where the Members could participate as a group, where collective discussion could occur, where the topics could be tailored to the Authority's mission and programs, and where this specialized focus could reduce the amount of time that the Members would have to commit to meet the statutory requirement. Staff are hoping to strike a balance between the Members' already busy schedules with their need to comply with the Act. Mr. Catell said that he fully supported this approach and asked staff to consider combining the training with a scheduled meeting of the Members.

President Smith then called upon Mr. Pitkin to continue the report on model governance principles. Mr. Pitkin reported on proposed regulations recently issued by OSC. In December 2005, Comptroller Hevesi announced that he would issue regulations for certain budgeting, management, and reporting practices of the State's public authorities using Article X, Section 5 of the State Constitution as the source of his regulatory authority. The proposed regulations were issued in December 2005 and comments on the draft regulations will be accepted through Monday, January 23, 2006. Staff have reviewed the draft regulations and found that, if enacted in their current form, they would have an impact on the Authority's current practices. In particular, the proposed regulations would require changes in the Authority's budget by requiring preparation of both accrual and cash basis budgets, requiring inclusion of multi-year financial projections, requiring supporting information on significant assumptions related to budget preparation, and requiring certification from the President on its accuracy. They would require that the budget be made available to the public on the Authority's website, be posted in other forums, and be filed with OSC. They would also require that additional contractor information be included in the Annual Procurement Contracts Report.

The Authority has submitted comments on the draft regulations, primarily seeking additional guidance on implementation strategies and seeking clarification on some of its provisions. An update

will be provided once the regulations are final.

In response to an inquiry from Mr. Gottlieb, Mr. Pitkin indicated that staff did not believe that compliance with the proposed regulations would constitute an onerous burden. President Smith added that the proposed regulations are intended to provide more transparency in public authorities' operations. Mr. Pitkin added that the Members are not apt to notice a significant increase in the amount of information they receive, if the proposed regulations become final, because most of the information required is already included in various reports that are submitted to the Members for informational purposes or for approval.

Mr. Catell then indicated that the next item on the agenda was a report on the Authority's internal controls. Mr. Catell first called upon President Smith. Mr. Smith explained that, in 1989, a male job applicant was unsuccessful in obtaining the job he had applied for, losing to a female applicant. He thereafter filed a claim with the New York State Division of Human Rights ("DHR"), alleging that the Authority discriminated against him on the basis of gender. While the Authority responded to the complaint in 1990, DHR did not schedule an initial hearing until 2001. This was consistent with DHR's then approximately 10 year back-load of cases. A rehearing on additional matters was held in 2004.

Throughout the process, the Authority has consistently maintained that there was no discrimination on the basis of gender and that the Authority selected the better candidate based upon the candidate's resume, references, and background.

Last month, the DHR Administrative Law Judge who heard the matter issued a Recommended Decision. The Recommended Decision found that the Authority did discriminate on the basis of gender and recommended an award of damages of approximately $80,000, including interest. The Authority will be filing objections to the finding and updating the Members on the progress of these efforts.

In response to an inquiry from Chair DeIorio, Roger D. Avent, the Authority's General

Counsel, explained that the monetary award is based upon the would-be salary and benefits for the period that the unsuccessful job applicant was unemployed, plus interest. Staff will update the Members on the progress of the appeal.

President Smith then called upon Mr. Pitkin. Mr. Pitkin said that, in his capacity as Internal Control Officer, he wanted to update the Members on the activities that were undertaken over the last 12 months. The responsibilities of the Internal Control Officer are, in part, to assist in implementing and monitoring a system of internal controls and in implementing staff education and training programs that promote internal control awareness and understanding. During the year, the Internal Controls Manual, which summarizes the Authority key internal control policies, was reviewed, revised, and approved by the Members, consistent with the model governance principles set forth by the Secretary to the Governor and the Public Authority Governance Advisory Committee. Those revisions, as well as the other requirements in the manual, are being followed.

During the last 12 months, the Authority also implemented certain recommendations made by OSC as a result of its 2005 internal control audit. Some examples of these revisions are having the Members approve certain contracts at each regularly scheduled meeting instead of just annually, changing the cash receipts process to record and stamp receipts more frequently, and conducting third-party billing and invoicing processes more frequently. Both OSC's suggestions and the Authority's response to those suggestions were discussed with the Members prior to implementation.

Regarding training and awareness, all new employees are provided the various Authority policy manuals, including the Code of Conduct approved by the Members. In addition, training and workshops for appropriate staff were held on solicitation and contract development and contract invoice approval procedures; sexual harassment prevention training; business writing; strategic mapping; and team building exercises. In addition, an Authority-wide presentation on internal controls was given by the Director of Internal Audit and all staff were given the opportunity to attend various professional development seminars on a variety of topics conducted by internal staff or invited presenters. All of these training efforts help reinforce the Authority's system of internal controls.

As reported in previous meetings, the Authority also instituted a fraud and abuse hotline service operated by an independent public accounting firm. This hotline provides a confidential means for employees to report suspected instances of fraud or abuse. In addition, Authority management reminds staff on a quarterly basis of the availability of this service and reminds them of the requirement contained in the Code of Conduct to report instances of non-compliance. To date, no reports have been filed with the service.

In the next 12-month period, the review and monitoring of internal controls will be continued, with improvements made when appropriate, and as previously discussed, the requirements of the Public Authority Accountability Act of 1005 will be implemented. In addition, staff will continue to be provided with access to relevant training.

Mr. Pitkin continued by explaining that, as previously reported to the Committee, a system of internal controls cannot provide absolute assurance, but can provide reasonable assurance concerning the accomplishment of objectives and the prevention or detection of risks. From this perspective, updates on some previously reported issues and one new issue were discussed.

At the January 2005 meeting, staff reported on two irregularities they were investigating with respect to two different contractors under two metering solicitations. Based upon an internal investigation by one energy service company, the company discovered that it was not meeting a solicitation requirement of obtaining one-half cost sharing from its customers. Using the correct cost-sharing requirement, the Authority found that there was an overpayment of $23,561. The contractor concurred with this conclusion and entered into an agreement with the Authority to repay the funds in eight quarterly installments. The contractor is up-to-date on its payments.

At the January 2005 meeting, staff also reported that the Authority was looking at another energy service company's participation with respect to two metering solicitations. At the conclusion of its review, Authority staff found that this second company had not met the cost-sharing requirement either and, under another solicitation, was billing for incentives in excess of it's actual costs. Staff then compared the amounts paid under each solicitation using the corrected cost-sharing

amounts under the one solicitation and the contractor's actual costs under the other solicitation and adjusted the incentive amounts accordingly. Once the company finishes monitoring the meters for the required two-year, post-installation period for several projects, it is expected that the Authority will owe the contractor additional incentives.

In addition, three clients of the energy service company which were participants in the Authority's program were found to have received advanced payments in the total amount of about $10,000 that were in excess of the contractor's reimbursable costs. The Authority has received about $8,000 in repayments from two of the three clients and it is working with the contractor and the remaining client to obtain the third and last repayment.

As mentioned before, as part of OSC's 2005 internal control audit, OSC suggested that the Authority increase the timeliness of its review of overdue account receivables and Authority staff agreed with this recommendation. As a result, staff are reviewing accounts receivable every week. Mr. Pitkin is then reviewing outstanding billings in detail on a monthly basis and efforts to collect overdue amounts have been increased. After the Authority made a number of unsuccessful attempts to obtain payment on 21 past due invoices, the Authority referred them to the State Attorney General for collection. Using this process, the Authority has collected on 16 of the past due invoices totaling about $124,000, so far. (These referrals represent about 5% of the billings processed during this time period.) In addition to increasing collection efforts, the process for ensuring that program billings are completed on a more timely basis has been improved.

With respect to new matters, the Authority recently discovered some billing irregularities on an on-going research and development program contract. In late 2004, the Authority funded a project for developing and demonstrating kinetic hydro-turbine technology. During 2005, some irregularities with respect to the contractor's billings were found and the Associate Contract Auditor was sent to audit the contract. Using the audit results, staff found, and the contractor agreed, that the Authority was overbilled by $54,625 due to an error concerning labor overhead costs. The contractor promptly reimbursed the Authority this amount.

As a result of the audit, a disagreement between staff and the contractor has also arisen on whether there is appropriate documentation submitted to justify $132,000 billed to and paid by the Authority, including $50,000 that was documented, but had not paid to subcontractors. The Authority has sent a letter to the contractor demanding repayment of the $132,000, but negotiations among the Authority, the contractor, and the contractor's counsel are underway to resolve the disagreement in a mutually acceptable manner. Staff will continue to provide the Members with an update on this matter.

In response to an inquiry from Mr. Catell, Mr. Pitkin explained that the Authority initially paid the contractor approximately $400,000 under the contract and $54,625 was returned. However, a dispute remains regarding $132,000. In response to an inquiry from Mr. Gottlieb, President Smith reported that the Authority has no documentation proving that this was a result of fraudulent practices.

President Smith continued by explaining that this project is important to the State, since the turbine technology could potentially provide great benefits, if sited in the East River. That the Authority is working with a contractor engaged in a cutting edge technology, but which is in the early stages of developing good business practices, is not a unique occurrence. Mr. Pitkin explained that the Finance Department regularly works with relatively new companies to ensure that the companies submit appropriate documentation with their invoices. The amount and type of assistance provided varies on a case-by-case basis.

Mr. Calender added that staff will routinely provide assistance to new businesses in developing documentation and appropriate business records. Mr. Gottlieb suggested that the Authority look into providing business services on a more focused basis.

Mr. Mathusa commented that, considering the 3000 to 4000 contracting actions processed by the Authority on an annual basis, the relatively few numbers of problems identified is an indication that a lot of good projects are moving forward. In response to further suggestions by Mr. Mathusa and Mr. Catell, Mr. Pitkin explained that the newly hired Associate Contract Auditor will

be conducting random audits of paid invoices. The Director of Internal Audit, Mark Mitchell, would also provide coverage in this area. Mr. Mitchell added that a portion of the audit plan calls for more in-depth review of the Authority's auditing process and that the timing of this review will be determined occur over the next few months.

Mr. Catell then called upon Mark Mitchell, Director of Internal Audit. Mr. Mitchell reported that an audit of electronic invoice processing had been completed and no significant issues were identified. He found that the new process has resulted in a reduction in the number of days it takes to approve invoices. It has also made it easier for the Finance Department to track invoice status and location and to assure that the Authority maintains compliance with its Prompt Payment Policy Statement. In addition, Mr. Mitchell reported that he is currently conducting an audit of the Authority's Projects Database System.

Mr. Mitchell then explained that he intended to regularly report to the Committee on the existence and status of any significant findings and on the subsequent actions taken or to be taken to resolve the issue. No significant findings have yet been identified.

Lastly, Mr. Mitchell reported that he is participating in implementation of the work plan for reviewing and documenting an assessment of the effectiveness of financial reporting controls.

Mr. Catell indicated that the last agenda item concerned other business. There being no further business, upon motion duly made and seconded, and by unanimous voice vote, the meeting was adjourned.

Respectfully submitted,

Jacquelyn L. Jerry

Jacquelyn L. Jerry
Secretary to the Committee