

Memorandum

To: ISO Board of Governors

From: Nancy Saracino, Vice President, General Counsel and Corporate Secretary

Date: May 14, 2010

Re: **Decision on Audit Committee Charter and Administration of ADR Process**

This memorandum requires Board action.

EXECUTIVE SUMMARY

The ADR/Audit Committee operates under a charter issued by the full ISO Board of Governors. The current charter assigns the Committee a number of responsibilities, which fall in three general areas:

- administration of the alternative dispute resolution process (ADR) under the tariff;
- oversight of financial accounting and the independent auditors; and
- oversight of the compliance program.

This memorandum recommends revisions to the Committee's charter, including formal reassignment of responsibility for administering the ADR process to Management. This change, which would be consistent with recent amendments to the bylaws, would enable the Committee to focus exclusively on its remaining responsibilities, which are more typical for an audit committee. It would also be consistent with the practices of other ISOs and RTOs. In addition to a revision of the charter, this change will require an amendment to the tariff, which is also discussed in this memorandum.

With respect to the Committee's remaining responsibilities, Management recommends revisions to the charter to be consistent with current corporate best practices and to clarify roles and responsibilities.

Moved, that the ISO Board of Governors approves the proposed revisions to the charter of the ADR/Audit Committee, as attached in the memorandum dated May 14, 2010; and

Moved, that the ISO Board of Governors approves the proposal regarding changes to the administration of the alternative dispute resolution process, as detailed in the memorandum dated May 14, 2010; and

Moved, that the ISO Board of Governors authorizes Management to make all necessary and appropriate filings with the Federal Energy Regulatory Commission to implement the proposed tariff change.

DISCUSSION AND ANALYSIS

Administration of the Alternative Dispute Resolution Process

The tariff specifies a process for resolving disputes raised by market participants, including procedures for negotiation, mediation, and arbitration, as well as appeals of arbitration awards to FERC or a court. Responsibility for administering and coordinating this process is assigned to a committee of the Board.

Until recently, the bylaws provided for a special committee to administer the ADR process. Over the years, the ADR Committee's responsibilities have been gradually reduced. Shortly after the ISO's start up, the ADR Committee delegated its responsibilities with regard to the conduct of arbitrations to the American Arbitration Association (AAA). For the last several years, because its minimal workload did not justify a separate committee, the ADR Committee has been merged with the Audit Committee and has been referred to as the "ADR/Audit Committee. Finally, in October 2007, to ensure that any responsibilities could be fulfilled between Board meetings, the Committee delegated its ADR administrative functions to the General Counsel.

At its most recent meeting, the Board approved amendments to the bylaws that eliminated the ADR Committee. Notwithstanding this amendment, the Committee retains these responsibilities under its charter and the tariff, pending changes to these documents.

The Committee's responsibilities for administering the ADR program include:

- Publishing summary information regarding ADR activities (claims, decisions, appeals, etc.) on the ISO website or using other methods;
- Maintaining a list of qualified potential mediators;
- Maintaining a list of qualified potential arbitrators and access to appropriate established third-party ADR service providers; and
- Compiling standard procedures for arbitration of disputes based on section 13 and the American Arbitration Association Commercial Arbitration Rules, to the extent not inconsistent with section 13.

The proposed tariff amendment reassigns these responsibilities to an "ADR Coordinator," defined as an employee selected by the Chief Executive Officer. The amendment would also include minor changes to update tariff language and ensure procedural fairness when the ISO is a party to proceedings. These include:

- Updating language about publication of ADR claims and decisions to replace references to an ISO "newsletter or electronic bulletin board" with a reference to the ISO website, and a mandatory market notice to announce new claims;
- Formally recognizing the role of AAA in administering any arbitration proceedings and supplying the names of potential arbitrators; and

- Designating AAA to identify potential mediators if parties elect to mediate but cannot agree on a mediator from the list maintained by the ISO.

As a practical matter, the amendment should not change how the ISO's dispute resolution process is conducted. The amendment would make the ISO tariff consistent with the tariffs of other independent system operators and regional transmission organizations. Of these, only the Midwest ISO involves its governing board directly in the administration of dispute resolution (through a committee). Both PJM and the New York ISO assign coordinating responsibility to a staff position, PJM having eliminated its governing board committee last year.

The proposed amendment has been reviewed by stakeholders, who have no objection. A white paper was posted for review, along with revised tariff language. Management received only one written comment, from the California Municipal Utilities Association, suggesting a change to the tariff provision about selection of mediators. A conference call was held on April 23, 2010. During that call, the ISO introduced a further revision to the tariff language to address the comment submitted by CMUA.

With the elimination of its ADR responsibilities, the Committee would be known as the "Audit Committee."

Other Audit Committee Responsibilities

Working with an outside expert on compliance and corporate governance, Management has developed proposed revisions to remaining charter provisions. Regarding the Committee's oversight of accounting, financial statements and the independent auditors, these revisions would add detail consistent with current best practices. For example, the proposed revisions would include:

- Issues that the Committee should consider when reviewing the ISO's engagement letter with the auditors, such as the proposed fees and other relationships between the ISO and the auditing firm;
- Specific topics that the Committee should explore when reviewing the ISO's accounting practices and annual financial statements, such as the auditors' access to information, alternative treatments of financial information, and legal matters that could affect the financial statements;
- Clarifying the role of the Audit Committee with respect to the internal audit functions at the ISO; and
- Adding a requirement that audit committee members must be financially literate, or commit to becoming so.

In addition to these changes, Management would add a statement to clarify the Committee's role with respect to financial statements as oversight only; it is not responsible for preparing or certifying financial statements.

Similar types of revisions are recommended regarding the Committee's responsibility to oversee the compliance program. The revised charter would identify particular issues to consider when reviewing the internal audit program. It would also require the Committee to review policies and procedures for treating allegations of suspected misconduct. The proposed revisions would state more clearly that, while it will review the compliance program, the Committee is not responsible for directing the program.

Finally, at a general level, Management is recommending revisions that would:

- State clearly that the Committee will have full access to the books and personnel of the company;
- Consolidate the various requirements regarding Committee reporting to the Board into a single provision, which will require reporting to the Board on all of the Committee's responsibilities "as appropriate";
- Clarify the purpose of the charter and its relationship with other governing documents; and
- Update the style of the document including, most prominently, moving away from the framework of a formal resolution toward more plain English.

Both redline and clean copies of the proposed amendments are attached, along with a clean copy of the current charter.

CONCLUSION

Management recommends the Board approve the proposed modifications to the Audit Committee charter and delegate the administration of the alternative dispute process to Management, as detailed above.