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ALBANY, NEW YORK 12236

STATE OF NEW YORK
OFFICE OF THE STATE COMPTROLLER

March 2, 2001

Mr. Robert King
Chancellor
State University of New York
Albany, NY 12246

Re: Nissequogue Cogen Partners
Report 99-R-2

Dear Mr. King:

Pursuant to the State Comptroller's authority as set forth in Article V, Section 1 of the State Constitution and Article II, Section 8 of the State Finance Law, we audited the books and records of the Nissequogue Cogen Partners (NCP) for the period of January 1, 1997 through June 30, 1999. Our audit related to reimbursements claimed by NCP under Contract C-000727 awarded by the State University of New York at Stony Brook (SUNY-SB).

The objectives of our financial-related audit were to determine whether billings claimed by NCP were allowable, adequately documented, and incurred for services funded under the contractual agreement we were auditing. We also reviewed the decision to extend the contract from 2015 to 2023. To accomplish these objectives, we reviewed the contractual agreement, the billing calculations, internal controls over charges to the contract, and the level of NCP's compliance with contractual terms. We also evaluated the system by which SUNY-SB staff reviewed the bills submitted. In addition, we reviewed the documentation supporting the decision to extend the contract.

We conducted our audit in accordance with generally accepted government auditing standards. Such standards require that we plan and perform our audit to adequately assess those operations of NCP that are included within our audit scope. Further, these standards require that we review and report on NCP's internal control structure and its compliance with those laws, rules, and regulations that are relevant to NCP's operations included in our audit scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in the accounting records and applying such other auditing procedures as we consider necessary in the circumstances. An audit also includes assessing estimates, judgments, and decisions made by management. We believe that our audit provides a reasonable basis for our findings, conclusions, and recommendations.

In planning and performing our audit procedures, we considered NCP's internal control structure. Our consideration was limited to a preliminary review of this structure that would enable us to understand the control environment and the way in which transactions flowed through the systems supporting NCP's claims. Because we did not intend to rely on the internal control structure in performing our work, our assessment did not extend beyond the preliminary review phase. Instead, we appropriately extended our substantive audit tests.

In conducting our audit, we performed tests of NCP's compliance with certain terms of the contract. Our objective in performing these tests was to obtain reasonable assurance about the allowability of amounts NCP received from SUNY-SB, not to provide an opinion on NCP's overall compliance with such provisions.

The results of our tests indicate that, with respect to the items tested, NCP complied in all material respects with the provisions referred to in the preceding paragraph, except as noted in Section B of this report. With respect to the items not tested, nothing came to our attention that caused us to believe that NCP had not complied, in all material respects, with those provisions.

A. Background and Contract Terms

NCP, originally formed in May 1990, is a general partnership created for the purpose of designing, constructing, equipping, renovating, operating and maintaining the cogeneration facility located on the campus of SUNY-SB. The facility generates electricity and steam for the university, and has been in operation since April 1995.

NCP, located at the Stony Brook campus, was originally formed by two partners, Stony Brook Cogeneration, Inc. (SBCI) and CEA Stony Brook, Inc. SBCI, then owned by Gas Energy, Inc., is now an affiliate of the Calpine Corporation; CEA Stony Brook is now owned by Statoil Energy Stony Brook, Inc. (SESB), a subsidiary of Statoil Energy, Inc. According to the audited financial statements for the years ended September 30, 1996 and 1997, and December 31, 1998, NCP reported average annual operating revenues of $32 million. In the year ended December 31, 1998, NCP reported a net loss of $2.9 million. NCP has 20 employees, all of whom are now employed by Calpine.

The terms under which energy is sold to SUNY-SB are regulated by a contract (C-000727) between the two parties. The contract period is for 28 years, from April 1, 1995 through March 31, 2023, with a maximum value of approximately $1 billion. Initially, the contract was to end in 2015; however, in 1998, the contract period was extended for eight years until 2023.

Cogeneration means producing two forms of energy from one process. The facility utilizes a combustion turbine generator, which produces electrical energy which is transmitted to SUNY-SB's electrical grid. The process also generates heat, which is recovered and converted to steam, which is then sent to SUNY-SB's heating plants for heating and cooling needs. The primary fuel for the facility is natural gas.

NCP submits monthly billings to SUNY-SB for the energy they provide, with separate calculations for electrical and thermal energy (steam). The charges for steam are calculated according to a complex formula specified in the contract, which incorporates a number of factors based on estimates and economic indexes. The formula also includes a combination of variable and non variable costs, as well as a 20 percent discount of energy charges.

B. Results of Audit

1. Review of Bills

We examined the monthly NCP bills from January 1997 through June 1999, in order to determine whether they were calculated accurately by NCP and in accordance with the terms of the contractual formula, and whether there were errors not detected by SUNY-SB's review of the bills. Most of the variances we found did not involve significant dollar amounts, and they included both overpayments and underpayments. However, we found two areas of concern, which represent a total refund of $203,217.

a. Boiler Efficiency Factor

According to the contract, one of the factors in the steam cost formula is based on the efficiency level of SUNY-SB's boiler, which was stated as 75 percent. The efficiency rate is then factored into the formula as a coefficient equal to 1/(Efficiency Rate). That coefficient is listed in the contract as 1.351. However, the coefficient for an efficiency rate of 75 percent should be 1.333. A coefficient of 1.351 would have been appropriate for an efficiency rate of 74 percent, not 75 percent. Since the bills used the higher coefficient, the steam billings were overstated by $190,382 during the two and one-half years ended June 1999.

SUNY-SB officials agree that the coefficient values are contradictory. We believe that the efficiency rate defines the coefficient. While we are not seeking to void the agreement, we recommend that SUNY-SB officials resolve an ongoing and undisputed error which is increasing SUNY-SB's utility costs. (NCP officials asserted that the 74 percent rate is correct. SUNY-SB will consult with the Office of University Counsel to determine the appropriate actions to resolve this matter.)

b. Spot Gas Price Index

One of the indexes which comprise the steam billing formula is the Spot Gas Price Index. This is a composite index of monthly market prices for gas that includes six different price quotes grouped into four components. Because of the multiplier effect in the formula, relatively small variances in this calculation may materially affect the steam portion of the NCP billings. In January 1998, the bill was calculated using an estimated Spot Gas Price Index. Since NCP did not maintain the source documents used to calculate the index, we could not determine the precise effect on the bills. We estimated, based on data available for February 1998, that the January

1998 bill may have been overstated by as much as $15,000. This underscores the necessity of obtaining and retaining these source documents. (SUNY-SB responded that, subsequent to our audit, NCP obtained the correct data and acknowledged an overbililng of $12,835.)

2. Internal Controls Over Billing and Monitoring

Because the dollar amounts involved are large, and the contractual billing formula is complex, SUNY-SB's monitoring efforts are crucial to ensure that payments to NCP are correct. In the course of our review of the bills, we observed a number of conditions that could be remedied, thereby improving the detection and correction of billing errors.

a. General Controls

The general conditions we observed during the audit relating to internal controls include the following:

- NCP has no written procedures for bill preparation, nor has it documented the design of its computerized billing system.

- SUNY-SB does not have written procedures for processing the bills submitted by NCP.

- The Controller is the only NCP person involved in preparing the billings. The review is controlled, processed and authorized by one SUNY-SB official.

- SUNY-SB did not have its own automated electric metering system to measure output at the point of transmission by NCP. As a result, SUNY-SB relied upon NCP's meter readings. (SUNY-SB officials responded that they have since installed automated meters.)

- Similarly, SUNY-SB did not have its own meters to measure the steam provided by NCP. They relied on NCP to provide accurate reports of steam production. A problem associated with this condition is discussed below. (SUNY-SB responded that they have since installed a metering system for steam.)

b. Specific Controls

We also observed certain conditions pertaining to specific aspects of the billings, as follows:

- As previously mentioned, for one of the factors, the Spot Gas Price Index, the source documentation was absent for January 1998. Considering the potential impact of

incorrect indexes on the bills, it is essential that supporting documentation for all pertinent billing factors is obtained and included in the billing records.

- We observed situations where there were variances due to human error. For example, the rate for an electricity demand factor known as VAR was reduced in 1998, but bills from June 1998 through January 1999 continued to apply the old, higher rate. Also, changes in the Employment Cost Index from July 1997 to January 1998, which affected billing calculations, were not reflected in the billings. For example, SUNY-SB adjusted the Employment Cost Index incorrectly in April, May and June 1997, and again in February and March 1998.

- In reference to adjustments for steam credits, which occur when SUNY-SB produces steam from its own plant, we observed that the adjustments were made at irregular intervals. While the SUNY-SB plant is normally on standby and does not provide steam every month, credits should be made promptly in those months when the plant is used.

- There is an apparent discrepancy between NCP's reported steam output and SUNY-SB's combustion control reports. The SUNY-SB control reports are based on daily telephone contacts with NCP. Since both reports originate with NCP, there is no reason why the output shown on the bills should be inconsistent with the output reported daily to SUNY-SB. The monetary impact was not material in the bills we reviewed, but SUNY-SB should still look into this discrepancy.

3. Review of Contract Extension

We reviewed the documentation surrounding SUNY-SB's approval of the contract extension. This consisted of 1998 correspondence between SUNY-SB and NCP, the SUNY Administration and the Office of the State Comptroller. In essence, the correspondence indicates that NCP was concerned over the impact on cash flows of price reductions associated with the Long Island Power Authority's (LIPA) buyout of the Long Island Lighting Company (LILCO). NCP sought to raise cash by issuing 25-year bonds whose terms would end in 2023. NCP needed to assure bondholders of a revenue stream throughout that term, which was eight years longer than the original contract period. They, therefore, proposed a contract extension through 2023. In return, SUNY-SB obtained a reduction of $300,000 per year in the non variable costs charged to the steam portion of the billings. According to SUNY-SB officials, this would result in a savings of $9.6 million over the 25 years remaining on the contract period (assuming an annual indexing rate of 2 percent). Furthermore, SUNY-SB officials emphasized that the Office of the State Comptroller approved the contract extension on the basis of the documentation then at hand.

In an April 1, 1998 letter to SUNY's administration, SUNY-SB declared that, "Stony Brook stands to reduce its thermal energy costs substantially as a result of the agreement." Clearly,

however, these savings were overstated; for just as the steam billings are subject to a 20 percent discount, so is the reduction of non variable costs. In reality, the potential savings total $7.7 million. Even if the annual savings had actually been $300,000, that amounts to only about one percent of energy billings of almost $30 million per year.

We requested from SUNY-SB officials any additional files supporting the extension decision. To date, they have not produced any other documentation. There is no evidence that any other initiatives were pursued or alternative proposals advanced, other than the $300,000 discount. As SUNY-SB officials explained, the concept of a fixed benefit every year appealed to them. Although NCP had originally proposed a discount of $100,000, which they negotiated up to $300,000, they did not provide any additional documentation to support these negotiations. We believe by not fully exploring the options available to them, SUNY-SB officials may have forfeited the opportunity to obtain more favorable contract terms.

(SUNY-SB responded that past contacts with the Comptroller's Office including a visit by an Audit Manager did not raise the concerns cited in the audit. In order not to unduly delay the contract approval process, both contracts and contract extensions are approved on the basis of a pre-audit review. Post audit, which is a more detailed examination, serves to compliment the Comptroller's contract-approval process. The purpose of the visit by the Audit Manager to Stony Brook was not to express an opinion on the adequacy of the basis of the extension decision. His purpose was to determine, using our "risk assessment" model, whether this contract should be included for post audit.)

As described above, cogeneration means producing two forms of energy from one process. By definition, the NCP facility should produce steam at a cost per unit cheaper than if electricity and steam were produced in separate plants. Two of the major cost components of the plant are gas, the fuel that powers the turbine generator, and the so-called non variable costs, i.e., plant salaries and maintenance. These are costs primarily associated with electricity generation. Recovering excess heat and converting it to steam would incur relatively little of these costs, in terms of the marginal cost per unit of steam produced. Yet, on the bills, both of these cost factors are charged to every unit of steam.

While the electricity bills are calculated based on 80 percent of LILCO/LIPA rates, we cannot ignore the fact that the NY State Public Service Commission also incorporates plant overhead and fuel costs when setting utility rates. This means that SUNY-SB pays for these cost components (indirectly) in the electric bills, and then again directly in the steam bills. We could not determine the extent to which these charges overlap; nor could we determine if they are fully offset by the 20 percent discount. Without having studied these factors, SUNY-SB does not know either. While SUNY-SB officials view the contractual structure as an indivisible coupling of the thermal and electrical portions of the agreement, the billing formulas are clearly distinct and separable, as are the individual components of these respective formulas.

The steam billing formula is structured so that SUNY-SB pays "avoided" costs. That is, cost determination begins with what SUNY-SB paid in the past, in 1989, prior to cogeneration. The 1989 costs are then linked to economic indexes to arrive at the billings. This seems disadvantageous to SUNY-SB, since it ignores savings in the real cost of producing electricity and steam. Under the present formula, however, NCP enjoys the benefits of cost reduction (especially through technology), and SUNY-SB stands pat. SUNY-SB should be benefitting from the cost reductions of cogeneration, as well as the economies of scale resulting from increasing demand.

SUNY-SB officials maintain that when the contract was originally negotiated, they were advised by various experts that the avoided cost approach was appropriate. SUNY-SB should be cognizant of those aspects of the agreement that work to their disadvantage should an opportunity arise for renegotiation.

Another disadvantage we identified is the boiler efficiency component. The steam billing formula factors in the 75 percent efficiency rate of SUNY-SB's own (and largely non producing) boiler, measured at some time prior to the contract. This is doubly disadvantageous to SUNY-SB. On one hand, SUNY-SB is locked into a historical performance rate that does not allow for improvement or for current performance. On the other hand, the plant of the producer (NCP) whose boiler actually generates the energy, had an efficiency rate of 85 percent. The use of the lower efficiency rate cost SUNY-SB $1.8 million in additional billings in the 2.5 year billing period we reviewed. We believe this neither makes good economic sense nor serves SUNY-SB's interest.

In our opinion, there are other aspects of the billing formula that could be amended to SUNY-SB's benefit, should an opportunity for renegotiation arise. We suggest any combination of the following possibilities:

- Increase the discount for non variable costs significantly beyond the current level of $300,000 per year (less the 20 percent discount). We believe NCP can afford to grant a larger reduction.

- Renegotiate the 20 percent discount. An increase in the discount for the entire bill, or even of only the steam portion, is potentially much more advantageous than the non variable cost discount, and could be phased in over time.

- Utility companies typically offer customers volume discounts. There is no reason why NCP could not do the same. SUNY-SB is also entitled to benefit from NCP's economies of scale.

  (SUNY-SB officials responded that as a consumer, SUNY-SB does benefit from economies of scale, inasmuch as overall unit cost decreases. However, this decrease only reflects NCP's fixed costs being spread over an increasing number of units of consumption; the unit variable rates charged to SUNY-SB still remain the same. We

believe SUNY-SB should share in these increased revenues by obtaining a reduction in the variable rate as well.)

- As discussed above, the efficiency factor has a significant impact on steam pricing, and could be associated with the boiler of either the consumer or the producer. Efficiency could also be a measure of either historical or current actual boiler performance. We favor a measure of the producer's actual boiler performance, perhaps reevaluated at mutually agreeable intervals (for example, every five years) over the life of the contract.

  (SUNY-SB disagrees with our review of the contract extension. They emphasize that the extension preserved the 20 percent discount feature, as well as the cost reductions, relative to LIPA rates, that were built into the original agreement. The only new concession won from NCP was a net cost reduction of less than one percent of annual billings. As detailed above, we believe there are several options that SUNY-SB can pursue to effect cost savings. Our report is intended to encourage SUNY-SB to analyze its options thoroughly in order to position itself to take advantage of any subsequent renegotiation opportunities.)

Recommendations

1. *Obtain a refund of $203,217 from NCP.*

2. *Work with NCP to resolve the error resulting from the use of a contradictory coefficient value.*

3. *Ensure that NCP develops documentation for its billing system, and implements internal controls so that accuracy of billings is not dependent on one key NCP official.*

4. *Obtain a complete set of source documents for all factors in the contract formula to ensure that bills are reviewed accurately.*

5. *Utilize SUNY-SB's Internal Auditors to perform spot reviews of billings to detect possible errors.*

6. *Perform adjustments to bills promptly and ensure that they are reviewed.*

7. *Develop automated metering systems both for electricity and steam to verify reported NCP output.*

8. *Perform an evaluation aimed at improving the contract terms to benefit economically from increased sales, cost reductions to the producer and the efficiencies of new technologies.*

Draft copies of this report were provided to State University of New York and SUNY-SB officials for their review and comment. Their comments have been considered in preparing this final report and are included as Appendix A. Excerpts from their response and our related comments are included parenthetically, as appropriate, in the body of the report.

Major contributors to this report were Charles Hammarberg, Aaron Fruchter, Michael Miller, Gennaro Petillo, Mostafa Kamal and Carole LeMieux.

Within 90 days after final release of this report, as required by Section 170 of the Executive Law, the Chancellor of the State University of New York shall report to the Governor, the State Comptroller, and the leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and where recommendations were not implemented, the reasons therefor.

We wish to thank the management and staff of the State University at Stony Brook and the Nissequogue Cogen Partners for the courtesies and cooperation extended to our auditors during this audit.

Very truly yours,

William P. Challice
Audit Director

cc: Charles Conaway
Dr. Shirley Strum Kenny
Dr. Richard Mann
Robert Monteith
John Murphy
Douglas Panico
Deirdre Taylor

THE STATE UNIVERSITY *of* NEW YORK

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November 6, 2000

Mr. William Challice
Audit Director
Office of the State Comptroller
Division of Management Audit & State
Financial Services
123 Williams Street, 21st Floor
New York, New York 10038

Dear Mr. Challice:

In accordance with Section 170 of the Executive Law, we are enclosing the comments of State University of New York at Stony Brook and SUNY System Administration regarding the draft audit report on the contract between Nissequogue Cogen Partners and State University of New York at Stony Brook (99-R-2).

Sincerely,

Enclosure

State University of New York
at Stony Brook
Nissequogue Cogen Partners
99-R-2

State University of New York at Stony Brook Comments

1. Review of Bills

Background (Page 2) – The contractor advises that the project's administrative headquarters have not been located in New Jersey since April of 1995 (Date of Commercial Operations). They also note that since this audit was conducted Calpine Corporation now employs all employees of NCP.

Spot Gas Price Index (Page 3) – The contractor advises that they have since obtained correct indices for January 1998 and recalculated the invoice. They acknowledge an over billing of $12,835. Stony Brook personnel will validate the contractor's calculation and recover any amounts due.

2. Internal Controls Over Billing and Monitoring

Segregation of Duties (Page 4) – As stated in our original response to the preliminary findings, the report implies that Stony Brook has no segregation of duties with respect to the verification and processing of the contractor's invoices. In fact, the establishment of the contract, the verification of consumption, the authorization for payment and the processing of the payment were and are all performed by different campus offices and personnel.

Contractor Segregation of Duties (Page 4) – The contractor advises that three individuals – the plant manager, the controller and the operations supervisor prepare data used for invoicing and that reports are cross referenced to insure the accuracy of the information.

Electric Metering (Page 4) – We note that we have always had meters installed to measure plant output. At the time of the auditors' arrival on campus there were meters at the contractor's point of transmission and, in fact, we could measure output. These existing meters have since been automated to allow for verification of consumption by rate period.

Steam Metering (Page 4) – We note that, prior to the auditors' arrival on campus, we had begun implementing a plan to install steam meters. These meters have since been installed and automated.

3. Review of Contract Extension

See Note

We are disappointed with the tone of this section of the report and disagree with the auditor's characterization of Stony Brook's attitude with respect to this contract. The entire agreement occurred precisely because Stony Brook did not "stand pat". In the 1980's the University

Note: To reflect some concerns raised by SUNY-SB in its response, and to better convey our intent, we have recast this section of the report. While we recognize that SUNY-SB has attained some benefits with cogeneration, we believe there are additional benefits that can be achieved.

recognized the fiscal and operational pressures it was facing as a result of skyrocketing energy costs that were the highest in the nation and an aging and unreliable physical plant that required extensive rehabilitation and looked to the private sector for an innovative solution. The efforts of campus personnel since then have been focused on ensuring that the long and short run interests of the campus are served by this contractual arrangement. The contract extension does this by preserving and extending the valuable discount percentages in the original agreement and by substantially reducing steam costs over the remaining term. The auditors' report does not recognize our efforts to significantly reduce costs while gaining the added benefit of enhanced electrical and steam utility reliability and seeks only to be critical of the progress that we have made to date. An example of this is the double standard of materiality that has been applied. The one-percent annual savings achieved by campus personnel is trivialized while the matter of the contradictory boiler efficiency coefficient (which amounted to .3 percent of billings over the audit period) is emphasized in the report.

In October of 1997, during the ongoing discussions that led to the extension of the contract term, the contractor offered a reduction of $100,000 to the fixed portion of the steam price in exchange for the eight-year extension. Campus personnel negotiated a 200% increase in this offer, resulting in the agreed to $300,000 (1989 dollars) reduction in the fixed portion of the steam price. In addition, the campus received an eight-year extension of the 20% discount on electric and thermal energy and the site fee contained in the original contract and preserved the discounts for the remainder of the original contract term. We also note that if the contractual Fixed Expense Index is applied to the auditors' calculation the resulting savings approximate the original $9.6 million figure.

a. NCP's Benefit from the Contract Extension

In our opinion, the auditors' conclusion in this section is unfounded and the use of irrelevant numbers could lead the reader to improper or erroneous conclusions regarding the benefits to the parties. The large amounts quoted do not measure such benefits. We also note that the bond prospectus used by the auditors is dated December 2, 1998, subsequent to the approval of the contract. We believe that the savings resulting from the extension are both meaningful and significant.

During the course of the audit, Stony Brook personnel informed the auditors that one of the items considered in the decision to extend the contract was the ability to continue the 20 percent discounts on electrical and thermal energy, since we were quite aware of their substantial dollar value. Based upon this, the University extended its agreement with the contractor for an additional eight years and accomplished the following (in 1999 dollars):

- Obtained a $317,968 annual reduction (after the 20% discount) of the fixed cost of thermal energy over the remaining term of the agreement. This generates savings of $7.9 million.

- Extended the valuable discounts on electrical and thermal energy for an additional eight years. We value the discount on electrical energy to be at least $38 million and the discount on the variable cost of thermal energy at $26 million over the eight-year extension term.

- Extended the site fee revenue for an additional eight years. We value the additional site fee revenue at $3.8 million over the eight-year extension term.

The extension also addressed threats to the viability of the project, thereby reducing uncertainty and preserving the substantial discounts in the agreement for the 17 years remaining in the original term. The discounts on electrical and thermal energy over the remainder of the original term are estimated at $65-70 million and $35-40 million based on their current annual values of approximately $3.8 million and $2 million respectively including increased consumption (1999 dollars).

In return, the contractor was able to redistribute its existing debt service payments over a longer term. We note a substantial portion of the debt service payable by the contractor in the final eight years of the bond term is actually a redistribution of debt service that would have been paid in earlier years had the agreement not been extended, rather than "additional" debt service as asserted by the auditors.

In April 1998 Stony Brook did, in fact, provide documentation to the State Comptroller's Office supporting the extension of the contract. In June 1998 the Comptroller's Bureau of Management Audit sent a representative (an Audit Manager) to Stony Brook to meet with campus personnel to discuss, in detail, the rationale for the decision to extend the contract and to review documents relating to the proposed contract extension. At no time during this campus visit did the Comptroller's representative give campus personnel any reason to believe that the basis for the extension decision was not adequate. In August 1998, subsequent to this review the Comptroller's Office approved the contract extension. At no time during this process was the campus made aware of any deficiencies in the documentation provided to the Comptroller's Office or the methodology used.

b. SUNY-SB Has Not Enjoyed the Benefits of Cogeneration

In this section, the Comptroller's staff appears to question the appropriateness of the "avoided cost" approach to the original contract. We note that the bid documentation and the original contract were developed by a project team which included personnel from SUNY System Administration and the State University Construction Fund (Fund) as well as legal consultants with expertise in the utility industry who were retained by SUNY. The project team maintained ongoing communication, including periodic briefings and meetings with the State Comptroller's Office concerning the approach to and status of the contract beginning at least 2 1/2 years before the original contract was approved in order to ensure that the Comptroller's Office would have sufficient information on the project to make an informed and appropriate decision concerning its approval. Ultimately, the Comptroller approved the contract. If the Comptroller's Office believed that a different approach to this contract would have been more beneficial to the University, this should have been communicated to the University at the outset. We note that the avoided cost arrangement allowed the University to benefit from additional electric rate reductions associated with the LIPA takeover. The combined effect of the LIPA reduction and the 20% contractual discount produces electric rates that are 35% below previous LILCO rates. Stony Brook will also participate in any future rate reductions that may occur. A contract not structured in this manner would not necessarily have allowed for this.

The auditors treat this contract as if it were a cost reimbursement contract between the State and a not-for-profit organization. This treatment does not recognize that the University and the contractor share the benefits of cogeneration. This made the construction and operation of the plant beneficial and attractive to both the University and to the contractor. Without such mutual benefit the project would not have occurred and the University would not have benefited from the discount contained in the contract.

c. Alternative Approaches

Page 7, Last Paragraph

The "modification" referred to by the auditors was an agreed to change in the base year of an economic statistic published by the federal government. The change was agreed to because the federal agency discontinued maintaining the index with the prior base year. The change of base year has no effect on the calculation of the consideration due under the agreement, and therefore does not increase the State's liability under the contract. We disagree with the auditors' assertion that this suggests any "measure of flexibility".

Page 8, Bullet 2

Stony Brook does benefit from economies of scale. The cost for steam does, in fact, decrease at progressive levels of consumption. This is because the fixed cost of steam is divided up over an increasing number of units of consumption. Also, prior to this contract, Stony Brook paid a LILCO/LIPA tariff that reflected its status as a large volume user of electricity. Since this tariff is used to compute electrical costs under the contract, Stony Brook continues to benefit from this status.

Recommendations

(OSC)	1.	Obtain a refund of $190,382 from NCP.
(OSC)	2.	Work with NCP to resolve the error resulting from the use of a contradictory coefficient value.
(SUNYSB)	1,2.	The contractor advises that they disagree with the auditors' assertions regarding the boiler efficiency factor. Stony Brook will consult with the Office of University Counsel to determine the appropriate actions to resolve the matter of the contradictory coefficient value.
(SUNY)	1,2.	We concur with Stony Brook's response.
(OSC)	3.	Ensure that NCP develops documentation for its billing system, and implements internal controls so that accuracy of billings is not dependent in one key NCP official.

(SUNYSB)	3.	The development of billing system documentation and implementation of internal controls to ensure the accuracy of billings is the responsibility of NCP management. Stony Brook encourages NCP management to make the recommended improvements to their internal controls.
(OSC)	4.	Obtain a complete set of source documents for all factors to ensure that bills are reviewed accurately.
(SUNYSB)	4.	We agree and will continue to maintain a complete set of source documents to support the payments. We note that the only item that we were unable to provide was the January 1998 Spot Gas Price Index.
(OSC)	5.	Utilize SUNY-SB's internal auditors to perform spot reviews to detect possible errors.
(SUNYSB)	5.	We agree. To supplement the detailed review and verification of bills already performed by Stony Brook's utilities personnel and budget staff, our internal audit staff has included periodic audits of the contractor's invoices in their audit plan and has recently completed an audit of one such invoice.
(OSC)	6.	Perform adjustments to bills promptly and ensure that they are reviewed.
(SUNYSB)	6.	We will work with the contractor to ensure the timeliness of adjustments.
(OSC)	7.	Develop automated metering systems for both electricity and steam to verify reported NCP output.
(SUNYSB)	7.	We agree. Prior to the auditors' arrival on campus, Stony Brook had installed electric meters on the 69 kV side of our transformer to improve monitoring of overall consumption and was in the process of automating them to allow for verification of consumption by rate period. Automation of these meters has since been completed. Also, prior to the auditors' arrival on campus, Stony Brook had begun implementing a plan to install meters to verify steam consumption. The meters have since been installed and automated.
(OSC)	8.	Perform an evaluation aimed at improving the contract terms to benefit economically from increased sales, cost reductions to the producer and the efficiencies of new technologies.
(SUNYSB)	8.	Stony Brook will consider the auditors' comments and recommendations in renegotiations of contractual terms that may occur in the future.
(SUNY)	3-8.	We agree with the recommendations and Stony Brook's responses.