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DIVISION OF STATE SERVICES

NEW YORK POWER AUTHORITY

INTERNAL CONTROLS OVER PROCUREMENT

2005-S-28

AUDIT OBJECTIVES

One objective of our audit was to determine whether the New York Power Authority (NYPA) established an adequate system of internal controls over its procurements to provide reasonable assurance that costs are authorized and appropriate. Another objective was to determine whether our prior audit recommendations related to the Poletti power plant had been implemented. A final objective was to determine whether the Poletti plant has been completed and at what cost.

AUDIT RESULTS - SUMMARY

We found that NYPA has implemented adequate internal controls over its procurement operations. Specifically, we found that NYPA has developed extensive written policies and procedures and has incorporated the necessary controls to ensure that procurement-related expenditures are authorized and appropriate. [Pages 3-5]

We followed up on the recommendations related to the Poletti plant from our previous audit (Report 2001-S-64, issued May 12, 2004). We found that the cost of the Poletti plant had increased by another $90 million, bringing the total budgeted cost to $740 million – almost twice that originally estimated by NYPA when the project was first approved in 1999. This latest increase is due to a settlement NYPA reached with its primary contractor for additional work that had not been included in the initial contract. As of the start of 2006, the new Poletti plant is now operating. NYPA officials continue to expect that, even after the significant increases in cost, the plant will help provide governmental customers with prices lower than the retail market. [Pages 6-8]

Most of our prior audit recommendations addressed actions NYPA needs to take to evaluate alternatives and better estimate costs when deciding on similar projects in the future. Because no such projects have occurred, we could not yet evaluate the adequacy of NYPA's actions in these areas. We did however find that NYPA has implemented our recommendation directed toward developing a fuel strategy plan for the Poletti plant. [Page 7-8]

Our report contains two recommendations to further improve controls. Officials agreed with our recommendations and indicated they have already implemented them.

This report, dated July 31, 2006, is available on our website at: http://www.osc.state.ny.us. Add or update your mailing list address by contacting us at: (518) 474-3271 or
Office of the State Comptroller
Division of State Services
State Audit Bureau
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BACKGROUND

Created in 1931, NYPA is the largest state-owned utility in the United States. NYPA provides about one-quarter of the electricity used in the State by operating 17 power generating facilities located throughout the State and more than 1,400 circuit miles of transmission lines. NYPA provides electricity to power various State and local government operations, including trains, subways, office buildings and public housing. In addition, NYPA provides electricity to job-producing industries and to other public and private electric utilities throughout the State. NYPA also administers programs promoting economic development, energy efficiency, and the development of new electro-technologies.

NYPA's Board of Trustees consists of five members, all of whom are appointed by the Governor. At the time of our audit, NYPA had 1,675 employees that worked out of two administrative offices (in White Plains and Albany), as well as the various power generating facilities. According to its 2004 annual report, NYPA had 2,141 contracts open or completed during that year with a value of nearly $2.5 billion. In 2004, NYPA reported operating revenues of $2.2 billion and expenses totaling $2.1 billion.

AUDIT FINDINGS AND RECOMMENDATIONS

Procurement

We analyzed and tested NYPA's expenditure data for the period January 1, 2003 through March 31, 2005 to determine whether controls were adequate and provided assurance that employees adhere to internal policies and procedures. We reviewed and analyzed NYPA's procurement policies and procedures relating to procurement credit cards, travel expenses, large-dollar transactions, and utilization of minority and women-owned business enterprises for procurement transactions. These categories of expenditures totaled about $833 million for the period.

Generally, NYPA has adequate internal controls that are working as intended to ensure that employees adhere to internal policies and procedures. We found certain instances where policies and procedures were not followed and where improvement opportunities are possible. However, for the most part, we concluded these matters were isolated.

Credit Cards

For expenditures valued less than $5,000, NYPA utilizes a credit card system. Credit cards along with convenience checks are assigned to NYPA employees who are authorized to purchase goods or services. According to NYPA's policies and procedures, goods or services that may not be procured with credit cards include: utility payments, purchases over $4,999, checks payable to cash, and services that extend beyond one year, such as telecommunication expenses. For the period January 1, 2003 through March 31, 2005, credit card purchases totaled nearly $12.1 million. Based on the transaction description recorded in NYPA's accounting system, we judgmentally selected and reviewed 195 credit card transactions totaling $260,000 from the following locations:

- White Plains Office - (93);
- Niagara Plant - (44);
- Blenheim-Gilboa Plant - (38);
- St. Lawrence Plant - (10); and
- Albany Office - (10).

All transactions we sampled were for legitimate goods or services, and while, in general, we found employees who are assigned credit cards are adhering to NYPA's policies and procedures, we did identify six instances where NYPA employees did not comply, as follows:

- One transaction included a check payable to cash for $95;
- One transaction exceeded the $4,999 threshold;
- The aggregate value of three separate transactions for the same item on the same day exceeded the $4,999 threshold; and
- One transaction was for telecommunication services.

We expanded our initial review of transactions to identify all instances where NYPA employees paid for telecommunication charges with credit cards. Using auditing software, our data analysis found 61 additional instances at the Blenheim-Gilboa plant and 7 at the Poletti plant. The seven instances at the Poletti plant occurred after NYPA had issued an internal audit report regarding this matter.

In response to our findings, NYPA officials acknowledged that credit cards should not have been used in these instances and corrective action would be pursued. Officials further indicated that the 61 additional instances for telecommunication charges at the Blenheim-Gilboa plant were previously identified by their staff and corrective action was taken. The seven instances identified at the Poletti plant were the result of the vendor not following NYPA's request to cease automatic billing on the credit card. We verified NYPA's explanation for the telecommunication charges at these facilities and were satisfied that corrective action had been taken.

NYPA's policies and procedures also require that, on an annual basis, cardholders identify and report transactions that exceed $25,000 per vendor. Such transactions must be evaluated to determine the potential for competitive bidding or for use of a blanket purchase order. Additionally, cardholders in the same department must make a best effort to ensure that the combined total dollars of all transactions authorized by the cardholders to the same vendor do not exceed $25,000. We tested credit card transactions that exceeded the $25,000 annual limit and found that NYPA staff were complying with NYPA's policies and procedures. We also determined that NYPA staff were using credit cards economically and efficiently.

Travel Expenditures

NYPA's policies and procedures require that NYPA's Corporate Travel Desk make all travel arrangements for NYPA staff. The Corporate Travel Desk is required to obtain the lowest-cost travel arrangement for its employees. For lodging, the maximum rate should not exceed the applicable Federal reimbursement rate.

For the period January 1, 2003 through June 23, 2005, travel expenses totaled $5.6 million. We judgmentally selected 87 travel reimbursements totaling $270,579 to assess compliance with NYPA's policies and procedures. The 87 reimbursements consisted of 58 payments to staff-level employees, 15 payments to executives and 14 payments to Trustees. We selected our sample based on highest amounts paid and the individual's frequency of travel. Our review consisted of verifying that the maximum rates for meals and lodging were not exceeded and that the

reimbursement had been properly approved and authorized.

Generally, we found NYPA's travel policies and procedures are adhered to. However, we did find 11 instances where the Federal lodging rate was exceeded. In some of those cases, the Corporate Travel Desk was not able to provide documentation to support why the rate was exceeded, and instead had to go back to the employee to obtain the reason. The Corporate Travel Desk was subsequently able to provide reasonable explanations for the variances and agreed to adequately document future instances when the Federal rate is exceeded.

Large-Dollar Transactions

For the period January 1, 2003 through March 31, 2005, NYPA's accounting system processed 12,561 transactions each totaling $5,000 or more, for a total of over $816 million. We judgmentally selected 37 of these "large-dollar" transactions totaling $67,971,436 and reviewed them for compliance with NYPA's procurement policies and procedures. For each transaction, we examined vendor selection activities to determine if the transactions were properly bid, approved and awarded. In each case, we found that NYPA employees adhered to required policies and procedures.

Minority and Women-Owned Business Enterprises (M/WBEs) Transactions

NYPA's Supplier Diversity Division is responsible for monitoring the use of M/WBEs for procurement. Annually, NYPA submits a plan, to the New York State Department of Economic Development (DED) that identifies its annual goals for using M/WBEs. Each quarter, NYPA is required to submit a report to DED identifying the payments made to the M/WBEs. In addition, for every contract awarded where the use of M/WBEs is required, the contractor must submit an M/WBE Utilization Plan. NYPA monitors whether the contractor is fulfilling the M/WBE requirements and verifies the contractor is making the appropriate payments to the M/WBE.

Using the same 37 large-dollar transactions from our previous sample, we identified 20 contracts which specified M/WBEs would be used to complete a portion of the contract. We found that all 20 contracts had evidence that a M/WBE Utilization Plan was submitted and approved by the contractor and that NYPA had monitored whether payments were actually made to the M/WBE by the contractor. To verify that the controls in place were working as intended, we selected an additional sample of five businesses reported on NYPA's quarterly report to DED as M/WBEs to determine if the reported information was accurate. We were able to trace all payments to the five M/WBEs.

We concluded that NYPA has identified the supporting of and contracting with M/WBEs as a priority. NYPA's commitment to M/WBEs is also exemplified through its active involvement in the community, as well as its sponsorship of an annual M/WBE conference held in White Plains.

Recommendations

1. Reinforce NYPA's policies and procedures on the use of credit cards for employees not adhering to these requirements.

2. Require the Corporate Travel Desk to maintain appropriate documentation when it is necessary to exceed the Federal lodging rate.

Poletti Plant

In a previous audit (Report 2001-S-64, issued May 12, 2004), we evaluated the processes used by NYPA in deciding to provide additional power in the New York City area by building and operating a new power generating plant, known as the Poletti plant, located in Queens. We found that, before proceeding with its plans to build and operate the new plant, NYPA did not evaluate a number of alternatives commonly considered by utilities contemplating large construction projects. While additional power plants are badly needed in the New York City area, one or more of the alternatives not considered by NYPA may have been more financially beneficial to NYPA, and may also have been more financially beneficial to NYPA's government customers. In addition, in the new competitive markets created by the restructuring of New York State's power industry, one of the alternatives not considered by NYPA may also have been more financially beneficial, in the long run, to all power users in the New York City area.

Our prior audit also determined that improvements were needed in NYPA's cost estimation process, as NYPA's estimate for the new plant rose from $375 million in 1999, when NYPA's Board of Directors approved financing for the project, to $650 million in 2002, when construction actually began. Our report expressed concern that NYPA's Board of Directors cannot make informed decisions about construction projects if cost estimates are not reasonably accurate, and we determined that many of the costs not identified until late in the construction planning process could have been identified earlier.

As part of our current audit, we followed up on the prior recommendations relating to the Poletti plant, and we reviewed the status of the Poletti construction project. We found that although the Poletti plant went into operation at the start of 2006, the cost to complete the project had further escalated by another $90 million to $740 million – slightly less than two times the amount NYPA originally expected to spend on the plant.

NYPA has implemented our recommendation in regards to the fuel strategy plan for the Poletti plant. Our other recommendations relating to the Poletti plant addressed actions NYPA should take in managing similar projects in the future. However, since no such projects have occurred, NYPA has not yet had the opportunity to take action in these areas.

Status of the Poletti Plant

As detailed in our prior audit report, when NYPA first considered building the new Poletti plant in 1999 at an estimated cost of $375 million, its research indicated the strategy would be more cost effective than purchasing additional energy. However, by 2000, the estimated cost of construction began to increase. Also, due to regulatory/licensing requirements, NYPA had to change from using cooling towers to a dry cooling system. These two main issues, along with other minor issues, led to a revised estimate of $475 million to build the plant. This estimate was presented to NYPA's Board of Trustees in December 2001. In April 2002, NYPA received bids for the general work contract to build the power plant equipment. The bid accepted by NYPA was $143 million more than expected. This, along with other cost increases, led to another increase in the estimated budget. In a May 2002 report, NYPA indicated the revised estimate for the project budget was to increase to $650 million. NYPA's analysis still indicated that it would be more cost efficient to build a power plant than purchase energy. In

September 2002, the Board of Trustees gave approval to begin construction on the Poletti plant based on the $650 million budget.

After the project had begun, NYPA encountered various issues and delays with the primary contractor. The contractor had various reasons for the delays such as the weather, encumbrance of the site by another contractor, and labor productivity issues. NYPA officials agreed with some issues, such as labor productivity and weather, but disagreed with others like encumbrance of the site by another contractor. NYPA officials also indicated that the contractor did not mobilize in a timely manner and that the supervision of the project was inadequate. These delays caused the contractor to miss many milestone dates and ultimately pushed back the expected date the facility would be running at full capacity. Originally, the power plant was to be running at full capacity by the spring of 2005.

According to a NYPA report prepared for the Board of Trustees, during the summer of 2004 it became evident that the contractor had fallen behind its work schedule and that it would not meet the contractual September 1, 2004 substantial completion date. The contractor had also submitted claims for $110 million beyond the $650 million contract amount.

NYPA ultimately negotiated a settlement with the contractor of all current claims and secured a commitment from the contractor to complete the work within a schedule (including milestones) acceptable to NYPA. This settlement directly resulted in the increase of the project from $650 million to $740 million. The additional $90 million was allocated as follows:

Settlement with Contractor	$59 million
Extra work by Contractor after March 31, 2005	7 million
Labor to Support Startup of Plant	5 million
Construction Cleanup Contract	4 million
Construction Contingency	5 million
Extended Costs for Support Services by Third Parties	10 million
Total	$90 million

The new Poletti plant became operational at the start of 2006. NYPA officials indicate that the $90 million added to the contract since the last audit has increased NYPA's fixed costs by about $2.50 per megawatt-hour, and that NYPA's operational margin for the project (the difference between revenues from the sale of power and the cost of fuel required to generate it) is expected to be about $30 per megawatt hour. NYPA expects that it will be able to provide its governmental customers with prices that are 30 to 40 percent lower than the retail market.

Follow-up of Prior Recommendation on Fuel Strategies

In our prior report, we recommended that NYPA finalize the fuel-supply strategy for the Poletti plant in Queens without further delay. We found that NYPA has taken action to implement this recommendation.

NYPA officials indicated that, in conjunction with its consultant, the Pace Global Energy Group, they have finalized a fuel supply strategy for the Poletti plant. The fuel strategy will be a portfolio approach in which NYPA will purchase fuel from multiple

sources, using firm contracts to provide for reliability and operational efficiency. In addition, NYPA officials indicated they will use spot market purchases and brokered pipeline capacity to meet total natural gas requirements as part of a balanced portfolio approach.

AUDIT SCOPE AND METHODOLOGY

We conducted our performance audit in accordance with generally accepted government auditing standards. We audited NYPA's procurement practices for the period January 1, 2003 through March 31, 2005. To accomplish our objectives, we reviewed NYPA's procurement policies and procedures relating to credit cards, travel, and large-dollar purchases, including M/WBE transactions. Additionally, we conducted interviews with NYPA officials to obtain an understanding of how their policies and procedures have been implemented throughout NYPA and what controls are in place to ensure that employees are adhering to these policies and procedures. We obtained and analyzed NYPA's expenditure and travel data to identify spending patterns and trends. Based upon our data analysis, we judgmentally selected five locations (White Plains, Blenheim-Gilboa, Niagara, St. Lawrence, and Albany) to visit and review supporting documentation for a sample of transactions relating to NYPA's expenditures. We selected our sample based upon our assessment of risk and the potential for unauthorized or inappropriate transactions based upon the description, the number of occurrences per vendor, and the amount of the expenditure.

In addition to being the State Auditor, the Comptroller performs certain other constitutionally and statutorily mandated duties as the chief fiscal officer of New York State, several of which are performed by the Division of State Services. These include operating the State's accounting system; preparing the State's financial statements; and approving State contracts, refunds, and other payments. In addition, the Comptroller appoints members to certain boards, commissions and public authorities, some of whom have minority voting rights. These duties may be considered management functions for purposes of evaluating organizational independence under generally accepted government auditing standards. In our opinion, these management functions do not affect our ability to conduct independent audits of program performance.

AUTHORITY

The audit was performed pursuant to the State Comptroller's authority as set forth in Article X, Section V of the State Constitution. Additionally, Chapter 469 of the Laws of 1989 requires the State Comptroller to conduct a program, financial, and operations audit of NYPA at least once every five years.

REPORTING REQUIREMENTS

Draft copies of this report were provided to NYPA officials for their review and comment. Their comments were considered in preparing this report, and are included as Appendix A.

Within 90 days of the final release of this report, as required by Section 170 of the Executive Law, the Chairman of the New York Power Authority 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.

CONTRIBUTORS TO THE REPORT

Major contributors to this report include Frank Houston, John Buyce, Christine Rush, Kevin Kissane, Richard Podagrosi, Matt Phillips, and Paul Bachman.

APPENDIX A - AUDITEE RESPONSE

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NEW YORK POWER AUTHORITY 75 1931-2006

NewYorkPower Authority

Joseph J. Seymour
Chairman

March 16, 2006

Mr. Frank J. Houston
Audit Director
Office of the State Comptroller
Division of State Services
State Audit Bureau
123 William Street – 21st Floor
New York, NY 10038

Dear Mr. Houston:

Please deem this letter as the New York Power Authority's response to the draft final audit report (2005-S-28) entitled: New York Power Authority – Internal Controls over Procurement (the "2006 Draft Final Report").

The Authority is pleased that the Office of the State Comptroller (OSC) has found that it has implemented adequate internal controls over its procurement operations; that the Authority has developed extensive written policies and procedures; and has incorporated the necessary controls to ensure that procurement-related expenditures are authorized and appropriate.

Regarding the Authority's responses, please note that:

1. The Authority agrees with the two procurement recommendations set forth in the 2006 Draft Final Report and has already implemented both.

2. Regarding the OSC's follow-up in this audit of the Authority's 500-MW Project, the Authority has previously responded to the management audit report (2001-S-64, issued May 12, 2004) which identified the OSC's observations.

The Authority appreciates the balanced reporting approach adopted by the OSC and the OSC's recognition of the cooperation and courtesies extended by the Authority to its auditors during the audit.

If you have any questions please do not hesitate to contact me at 518-433-6710.

Very truly yours,

Joseph J. Seymour
Chairman of the Board of Trustees

JJS/tac