

ERCOT Board of Directors Retreat

**February 22, 2006
Lakeway Inn & Resort
Lakeway, Texas**

Board of Directors Attendees:

Mark Armentrout	Bob Manning	Tom Standish	Brad Cox
Mike Espinosa	Carolyn Gallagher	Andrew Dalton	Paul Hudson
Clifton Karnei	Bob Kahn	Scott Gahn	

Segment Alternate Attendees:

Mike McCall	Bob Helton	Jean Ryall
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Guests:

Nancy McIntire	Carolyn Shellman	Sam Jones	Steve Byone
Ron Hinsely	Ray Giuliani	Mark Dreyfus	Michael Gent
Andrew Gallo	Read Comstock		

Chairman Armentrout began the session by welcoming everyone and providing some background information.

Board Survey Results

Mr. Schrader began by presenting the results of the Board survey. Fourteen people responded to the survey. A large majority of respondents felt positive about many aspects of ERCOT's operations, with almost all questions averaging a rating of three or higher. Twelve of fourteen respondents usually responded with a three or above.

Questions rated less than three included:

- (i) strategic vision for 3-5 years;
- (ii) focus on long-term vs. short-term;
- (iii) CEO performance review and succession planning; and
- (iv) liability insurance.

Questions with more than one-third low ratings were:

- (i) key indicators for tracking progress toward strategic goals; and
- (ii) staffing is appropriate to handle responsibilities.

With respect to this last issue, there were two groups – one group concerned about not enough staffing and one group concerned about over-staffing.

Other topics with four low responses included:

- (i) roles of Board, CEO and staff are clear;

- (ii) committee assignments offer opportunity for development; and
- (iii) need to consider all PRRs.

Chairman Armentrout stated that he believes each Board member has an obligation to help to improve the areas about which s/he had a concern. Mr. Espinosa stated that two of the items involve strategic vision and long-term planning and, in his opinion, the Board meetings have a tendency to look backward at what has happened instead of looking forward. He would like to see the Board do more forward-looking work. Mr. Standish agreed.

Mr. Karnei stated that ERCOT has very simple roles – facilitate the market, keep the systems running and respond to the PUCT directives. Those roles do not require much strategic planning. Ms. Gallagher stated that, in her opinion, the strategic vision should focus on how ERCOT will perform those tasks well and where ERCOT will be in three-to-five years. Mr. Gahn stated that he has noticed reluctance within ERCOT to advocate a direction for the organization. There seems to be a question regarding whether ERCOT has the ability to forge its own direction or if it will only respond to the PUCT and stakeholders.

Chairman Hudson stated that ERCOT seems to employ an “incrementalist” approach – *i.e.* it makes a series of decisions without seeing how they fit into a direction for the company as a whole. He acknowledged a tension between the PUCT’s responsibilities and ERCOT’s responsibilities.

Mr. Dreyfus stated that he thinks the Board and stakeholders should have more interaction. In years past, TAC handled more of the day-to-day operational issues and the Board focused on strategic planning. Those roles have changed over time. He thinks the organization should reconsider which items the Board should get involved in versus allowing TAC to handle them.

Chairman Hudson stated that the Board seems to have different opinions regarding ERCOT’s role. He asked whether that fact may impact the ERCOT staff’s perception, as well.

Mr. Cox stated that ERCOT is a regulated monopoly and, therefore, strategic planning may mean different things to different Board members.

Mr. Schrader then distributed two documents containing: (i) topics for further Board attention; and (ii) action items from the 2006 Board Survey. He asked Board members to rank the items on each page from one to five. The results are attached to this document as Attachment A.

Compliance and Controls

Mr. Byone presented ERCOT’s compliance and control program. Mr. Karnei made comments from the perspective of the F&A Committee. Chairman Armentrout stated that, in his opinion, the Board should review the prior year’s audits each January and approve the company’s audit plan. Several comments were made regarding the format of the compliance dashboard.

Board and TAC Working Relationship

Chairman Armentrout introduced Sam Jones to discuss the working relationship between the Board and TAC. Mr. Jones began by reviewing the TAC subcommittee work plans. The move to the Nodal market design will require the efficient use of resources. Reducing the number of Board and TAC meetings during the Nodal development period would free up ERCOT resources for use on Nodal market design and implementation.

Mr. Comstock stated that the TAC is trying to present to the Board the topics and discussions taking place at the TAC and subcommittee level. Much of what TAC sends to the Board is required by the Protocols.

Chairman Armentrout asked whether all PRRs approved unanimously – with all segments present and the budget approved – could be sent to the Board for consent action. Mr. Helton stated that he believes this is a good idea. Mr. Kahn stated that governmental authorities often handle matters in a consent agenda and individual items are considered only by exception. A discussion ensued regarding the use of this process.

Mr. Gahn stated that the Board should not have to consider PRRs which fall below the “cut line” because it wastes the Board’s time.

Chairman Hudson stated that ERCOT might have to consider a date certain (perhaps June or July 2007) as a deadline for considering further zonal Protocol changes so that the focus can be on the Nodal market design and implementation.

Ms. Gallagher stated that the Board should not have to consider items that will not be implemented. She recommended holding items approved at TAC (but below the cut line) and “monitoring” them. If the item then goes above the cut line for some reason, it would be submitted to the Board for approval. Mr. Schrader mentioned that there are project management issues associated with that approach.

Mr. Jones then raised the issue of how to handle changes in market design after Nodal implementation so as to avoid a rush of costly, time-consuming design changes driven by particular Market Participants.

Mr. Jones then raised the issue of “scope creep” on the part of the TPTF. For example, TPTF is now asking ERCOT to hire staff and acquire facilities. Mr. Jones is asking for the Board to set policy direction for staff and stakeholder resources. Mr. Helton agreed that the TPTF must stay within the boundaries set forth in the transition plan document.

What is the Strategy for the Board of Directors

Chairman Armentrout began with a background discussion regarding what he learned when he first joined the Board and how the Board’s role has evolved since that time. Mr. Manning stated that he sees ERCOT’s role as meeting the requirements set forth in SB 7.

Chairman Hudson asked about the development of the dashboard items as they arose from the SB 7 requirements. Mr. Schrader stated that each dashboard item relates back to one of the SB 7 core requirements.

Chairman Hudson asked if anyone in the room had an opinion regarding where ERCOT will be in three to five years (budget, head count, *etc.*). Mr. Hinsley stated that, if the plan for ERCOT is to be smaller with a smaller budget, Market Participants and consumers must understand that ERCOT will have to offer fewer services.

Mr. Karnei stated that, in 2010, he sees ERCOT with the same amount of people, much more debt and struggling to fix the issues associated with implementing the Nodal market. Mr. Standish stated that he believes the Nodal market design will cost much more than people think and will require much more work than people think.

Chairman Armentrout asked what people *want* ERCOT to be in 2010. Comments included:

- better systems
- functioning Nodal market
 - on time/budget/scope
 - well managed impact
- trusted relationships with all constituents
- healthy and productive relationship with ERO
- reliability – perfect compliance
- attractive investment environment
- a well functioning, effective market monitor
- transmission planning/construction continuing to do a great job with necessary robustness
- generation adequacy continually verified
- high employee morale – a place where people want to work and feel challenged

Mr. Schrader made a reference to some information previously handed out regarding the planning environment, issues and possible ERCOT initiatives.

Chairman Armentrout subsequently drafted a vision statement which is attached to this document as Attachment B. He asked that Board members review this document and provide him comments.

What is the Nature of the Relationship between the Board and the PUCT

Mr. Espinosa led the discussion. He began by stating that the requirement that Board members cannot talk to more than one Commissioner at a time creates some logistical challenges. He also stated that the Board and PUCT must address different perspectives regarding the ERCOT budget and budget creation process.

Chairman Hudson stated that the Board should ensure that ERCOT staff applies sufficient rigor in creating its budget each year. He wants the Board to be active and vigilant.

Ms. Gallagher stated that the rigor in the ERCOT budget process takes place primarily in the committee level and the PUCT does not see this process. Therefore, the Commissioners may not appreciate how hard the budget is scrubbed. Mr. Manning agreed with Ms. Gallagher's comments and stated further that, in his work preparing the budget, he has never seen an organization that uses more rigor than ERCOT in the process of creating a budget. He believes ERCOT's management puts all costs under a microscope before including them in the budget.

Chairman Armentrout recapped by saying that the Board has exercised great oversight over the budget process, but that process is not made sufficiently clear for the PUCT.

How can we improve the Board Meetings

Mr. Manning led this discussion. He began by quoting from the Board Policies and Procedures that seem to give the Board general direction ("the Board shall establish the overall direction and affirm the annual goals and objectives established by ERCOT staff." and "the Board shall retain a CEO with the capabilities to execute Board policies"). Additionally, the Board must be responsive to the PUCT's desires and must fulfill certain requirements in the Protocols. Some stakeholders want the Board to focus more on policy issues; others want the Board to focus on operational issues. Mr. Manning reported that it costs ERCOT approximately \$100,000.00 to have each Board meeting.

Mr. Cox asked how that number was determined. For example, he suggested that reports by ERCOT officers could occur quarterly if much of that cost relates to reports. Mr. Espinosa asked whether ERCOT gets that amount of value out of each Board meeting.

Mr. Manning stated that he reviewed the agenda for yesterday's meeting to see how the items on the agenda related to the four core functions in SB 7. He stated that, in his opinion, only one-third of the agenda time related to the core ERCOT functions.

Mr. Standish stated that the Board has not evolved much from its original function and he would have expected more of an evolution. He believes the Board should delegate more items to TAC and ERCOT staff. Mr. Kahn agreed with these comments. He believes the Board should see metrics quarterly and should hear only about things that went wrong or that specifically need Board attention.

Chairman Hudson suggested that ERCOT staff review the agenda for the Board meetings for 2005 and determine how much of the agendas relate to the core SB 7 functions.

Mr. Cox stated that, last year, the question of whether to have fewer Board meetings arose and many people stated they like having monthly meetings. However, he thinks fewer items could come before the Board at each meeting, which might lessen the burden on ERCOT staff.

Mr. Karnei questioned whether the Board members could fulfill their obligations as directors if the meetings were less frequent. Each item the Board addresses is a “tip of the iceberg.” Ms. Gallagher suggested that, for other boards to which she belongs, the committees do the “detail” work and the Board handles major policy/strategic issues. This raised a question regarding whether the Board has the proper committees.

Chairman Armentrout stated that, if the committees became more involved and thorough, it might lead to the need for fewer full meetings.

Mr. Gent stated that, in his experience on other Boards, the use of a “consent agenda” can be very helpful. Additionally, only items requiring action would be included on the agenda, which would have distinct categories for different responsibilities. Committee work is also very important and should be open to the public.

Mr. Standish stated that the organization must have policies, procedures and controls in place and trust them. Doing so will remove many obligations from the Board.

Mr. Cox stated that, in his opinion, the main issue is how much the Board is willing to delegate to the stakeholder process, up through the TAC.

Chairman Armentrout stated that, in his opinion, the ERCOT staff reports at each Board meeting could be reduced or eliminated. The general consensus of the group agreed with this comment. The onus would then be on the individual Board members to read the materials sent in the monthly Board packet.

What is our Future Relationship at the Federal Level

Mr. Schrader began this discussion by reviewing the requirements of the new federal legislation. Mr. Jones stated that, in his opinion, ERCOT will not see many region-specific regulations. He envisions a great deal of interaction between ERCOT and the new Regional Reliability Organization.

In the near future, ERCOT will have to have to consider separation requirements and the governance model for the new organization. Additionally, we will have to match ERCOT’s compliance functions to the FERC/NERC rules. Finally, a proposal for the Board will have to be developed.

Chairman Armentrout raised concerns about having ERCOT report to the PUCT while the RRO reports to the NERC and FERC. Mr. Schrader stated that ERCOT will probably need to set up an affiliate company with its own by-laws, *etc.* Mr. Jones stated that he believes ERCOT is close to having these issues resolved, but needs to focus on details.

Mr. Gent stated that NERC was concerned about ensuring that an independent organization monitors compliance in the ERCOT Region. Mr. Jones stated that, in approximately 2000, ERCOT chose to voluntarily comply with NERC requirements. Therefore, this new legislation will not create a huge change in ERCOT’s compliance practices.

How Should we Think about Forward Markets and Nodal

Mr. Helton led the discussion. He stated that, currently, ERCOT does not have a forward market, but will have one in the Nodal market design. He asked whether ERCOT should open certain forward markets as part of a transition into the Nodal market design.

Chairman Armentrout asked for the factors weighing in favor of forward markets. Mr. Helton provided some examples (economic dispatch, proper financial incentives, *etc.*).

Mr. Schrader stated that this issue has been analyzed in the recent past and, in light of the cost and time to implement (and drain on ERCOT resources away from the Nodal market implementation), it was decided to not pursue early implementation of a forward market.

Ultimately, the question evolved to whether this is an effort worth pursuing or whether ERCOT should wait until the Nodal market begins. The general consensus seemed to be to wait until Nodal market redesign takes place.

What Changes should we consider in Governance and Committee Structure

Ms. Gallagher led this discussion. One question focused on whether the committees currently have too much work to do. Another question is whether the Board should form additional committees.

Mr. Karnei stated that the F&A Committee is looking at many finance-related issues and, in addition, must handle audit issues. He is concerned that there is not enough time to give as much attention as he would like to all the issues before the committee. He questioned whether “finance” and “audit” should be separate committees.

Generally, the members agreed that it would be beneficial to have committees delve into topics in more detail and then provide brief reports to the full Board.

One suggestion was to have committee meetings take place in the morning and have the Board meeting in the afternoon. Ms. Gallagher suggested that the committees should limit the issues with which they will deal each month.

Ms. Gallagher asked if the committees should handle additional matters. Chairman Armentrout suggested that each committee build a calendar of events that occur regularly each year. Mr. Gent asked if the committees do self-evaluations. Mr. Karnei replied in the affirmative. Mr. Dalton asked if any committee should study the issue of conflicts of interest. Mr. Armentrout asked whether the Board should establish an “operations” committee. Ms. Gallagher mentioned that capital spending seems to be a concern of the Board and asked if a separate committee might consider those issues and the associated cost/benefit analyses. Mr. Cox agreed with that idea. Mr. Karnei suggested a “budget” committee.

Should we continue with the current fee allocation Method

Mr. Kahn began by providing some history on the subject. The most recent history was that the PUCT would consider the issue. The PUCT has not made a decision and will not make a decision in connection with the Nodal Protocols. However, once the PUCT approves the Nodal Protocols, it will consider how to pay for the Nodal market redesign. They may consider fee allocation in connection with that process.

Mr. Cox stated that having a stable, predictable stream of revenue to ERCOT is an important consideration.

Mr. Karnei stated that the F&A committee will develop a proposal for how to fund the Nodal market redesign. One consideration is whether the fee should be charged ahead of the market open in order to avoid paying for the Nodal market with debt financing.

Mr. Karnei also stated that ERCOT's fee looks very favorable when compared to the fees of other ISOs, which is especially impressive in light of the fact that ERCOT handles retail transactions when the other ISOs do not.

Mr. Helton questioned whether the fee is held artificially low by not implementing all the capital projects that the stakeholders have requested.

Mr. Armentrout asked whether TAC should have the option to allow the proponent of a PRR to fund the cost of implementing the PRR. Mr. Dreyfus questioned whether that can be done in relation to the current project prioritization process.

Is our current approach to credit Adequate

Mr. Karnei led this discussion. He stated that, of the 109 QSEs in the ERCOT Region, fifteen have an investment grade credit rating; *i.e.* 86% of QSE had a credit rating less than credit grade (and they represent 77% of the Load).

Over the last several years, ERCOT has had to uplift \$23 million resulting from QSE defaults, an amount approximately ten times the dollars associated with the 2004 contracting irregularities which received so much attention.

At market open, the decision was made to have low barriers to enter the market. Mr. Karnei suggested that the barrier may have been set too low.

A discussion took place regarding the monitoring of QSE credit and market activity, collateral deadlines, contract deadlines and other matters.

Chairman Armentrout recommended that the F&A committee consider how to handle the issues associated with credit risk.

Wrap Up

Chairman Armentrout thanked everyone for their participation and candor.

Action Items

- Review the Protocols to see which items current require Board action/involvement and whether that requirement should change
- Ensure that all Board members get the minutes from all the sub-committees.
- Determine ownership and committee structure for compliance issues
- TAC review the progress of each subcommittee on its work plan
- TAC to consider a change in the PRR process which would allow for approval of a PRR by TAC but not sending it to the Board unless the project is above the “cut line” and approval by TAC would allow an item to go on the project list and become part of the annual ranking
- ERCOT Staff should review the agenda for each month’s Board meeting last year and determine how many of the activities relate to the four key SB 7 functions
- Each Board member should send to CES a list of matters on the agenda that the Board member believes are not required for the Board to meet its obligations
- Each Board member should send to CES a suggestion on how to create an agenda template (i.e. what to include on the agenda)
- Mr. Kahn and CES will work on development of a consent agenda
- TAC to consider whether to allow individual Market Participants to fund PRRs that might otherwise fall under the “cut line”
- F&A Committee will consider how to handle the issue of credit exposure in the ERCOT Region

Attachment A

Board Retreat

February 22, 2006

Summary of Ranking of Actionable Items

The ranking of topics for Board attention with relative weight given:

- 10 Nodal
- 8 Strategic Planning
- 6 Energy Policy Act
- 5 Risk Management
- 4 Credit Policies
- 3 Compliance/Internal Control
- 3 Relationship with PUCT/Legislature

The ranking of action items from survey with relative weight given:

- 10 Planning Process
- 7 Determine Policy Issues
- 5 Restructure PRR Process
- 3 Risk Management Work Plan
- 2 Credit Risk Work Plan
- 2 Review Staffing Needs
- 2 Meet Bi-monthly
- 1 Compliance/internal control verification
- 1 Remove items from board agenda

Attachment B

The following is a draft vision statement intended: (i) as input to the ERCOT Management Team's vision development; and (ii) to summarize as best as possible the intentions of the Board of Directors comments on this subject in February 2006.

The ERCOT vision is for consumers in this electric market to enjoy a choice of electricity suppliers with excellence in reliability, transmission planning, and generation planning. ERCOT's vision of the electric market is for open access that is attractive for new investment and which relies on trusted information exchange. ERCOT will maintain and expand effective and trusted relationships with the state Public Utility Commission, the federal Electric Reliability Organization, the Texas Legislature, and all other related constituencies. ERCOT will create a workplace that is exciting and rewarding for all its employees.