



ERCOT Finance & Audit Committee Meeting

ERCOT

7620 Metro Center Drive, Austin, Texas

Room 168

June 20, 2006; 8:00 a.m. - 10:00 a.m.**

| Agenda Item # | Description/Purpose/Action Required | Presenter | Time |
|---------------|---|--|-----------|
| | Call to Order | D Hayslip | 8:00 a.m. |
| 1. | Approval of Minutes* (Vote) (05/16/06) | D Hayslip | 8:00 a.m. |
| 2. | Review PwC 2005 financial audit recommendations | M Petterson | 8:05 a.m. |
| 3. | Procedures for handling reporting violations (whistle-blower) | C Vance | 8:20 a.m. |
| 4. | Review external auditor pre-approval status | M Petterson | 8:25 a.m. |
| 5. | Review and approve ERCOT annual report | D Roark/ M Petterson | 8:30 a.m. |
| 6. | Committee Briefs | All | |
| | • Risk Stop Light Changes | D Meek | 8:35 a.m. |
| 7. | Plan for PUCT involvement in 2007 Budget Preparation | S Byone/ Lane Lanford/ P Mueller | 8:45 a.m. |
| 8. | Nodal Funding Update | C Yager | 9:00 a.m. |
| 9. | Future Agenda Items/Other Topics | S Byone | 9:10 a.m. |
| 10. | Adjourn to Executive Session | | 9:15 a.m. |
| | • Compliance Update | D Meek | 9:15 a.m. |
| | • Approval of Revised 2006 Internal Audit Plan | B Wullenjohn | 9:20 a.m. |
| | • Update on Internal Audit Staffing | B Wullenjohn | |
| | • Significant Audit Findings | C Vance | |
| | • Ethics Point | C Vance | |
| | Adjourn | | 9:55 a.m. |

*** Background material enclosed or will be distributed prior to meeting. All times shown in the Agenda are approximate
The next FA Committee Meeting will be held June 20, at ERCOT, 7620 Metro Center Drive, Austin, Texas.*

Draft MINUTES OF THE ERCOT FINANCE & AUDIT COMMITTEE MEETING

Austin Met Center

7:30 A.M.

May 16, 2006

Pursuant to notice duly given, the meeting of the Electric Reliability Council of Texas, Inc. Finance & Audit Committee convened at approximately 7:30 A.M. on **May 16, 2006**. The Meeting was called to order by **Clifton Karnei** who ascertained that a quorum was present.

Meeting Attendance

Committee members:

| | | | |
|---------------------------------------|--------------------------------|----------------------------------|-------------|
| Clifton Karnei, <i>Chair</i> | Brazos Electric Cooperative | Cooperative | Present |
| Darrell Hayslip, <i>Vice Chair</i> | Calpine Corporation | Ind. Generator | Present |
| Robert Manning | H-E-B Grocery Co. | Consumer | Not Present |
| Miguel Espinosa | Independent Board Member | Independent Board Member | Present |
| R. Scott Gahn | Just Energy | Ind. Retail Electric Provider | Present |
| Tom Standish | Centerpoint Energy | Investor-Owned Utility | Present |

ERCOT staff and guests present:

| | |
|----------------------|---------------------------------|
| | |
| Brenton, Jim | ERCOT |
| Byone, Steve | ERCOT (CFO) |
| Davies, Morgan | Calpine (CWG Chair) |
| Doolin, Estrellita | ERCOT |
| Dreyfus, Mark | Austin Energy |
| Greer, Clayton | Constellation |
| Gresham, Kevin | Reliant Energy (PRS Chair) |
| Gruber, Rich | ERCOT |
| McElfresh, Brandon | ERCOT |
| Meek, Don | ERCOT |
| Mickey, Joel | ERCOT |
| Moseley, Cheryl | ERCOT |
| Mueller, Paula | PUC (Deputy Executive Director) |
| Petterson, Mike | ERCOT |
| Saathoff, Kent | ERCOT |
| Smitherman, Barry T. | PUC (Commissioner) |
| Troxtehl, David | ERCOT |
| Vance, Cathy | ERCOT |
| Vincent, Susan | ERCOT |
| Wullenjohn, William | ERCOT |
| Young, Mark | Deloitte & Touche |
| Yager, Cheryl | ERCOT |

Approval of Previous Minutes

Darrell Hayslip moved to approve the minutes for the previous meetings held April 18, 2006, April 26, 2006 and May 5, 2006; Tom Standish seconded the motion. The motion passed unanimously.

Credit Update

Morgan Davies presented an update to the Committee regarding actions taken by the market to improve the market credit profile, reviewed the current and expected levels of credit exposure, and requested Committee guidance regarding the preferred target level of credit exposure. Mr. Davies explained that plans were underway to implement (in the second Quarter of 2007) a long-term solution which would reduce the days required for the mass transition process from 9-11 business days to 3 business days. He also explained that an interim solution, to reduce the required time period to six days, was expected to be implemented in late May or June 2006.

Mr. Davies presented exit scenarios that demonstrated the reduction in credit exposure due to mass transitions after implementation of the interim and long-term solutions. After some discussion about the sample price used in the scenarios, Scott Gahn requested and Cheryl Yager agreed to provide to the Committee information on pricing trends and approximate figures demonstrating how ERCOT's actual 2004-2005 credit exposure numbers would be different if the interim and long-term solution were in place. Ms. Yager also agreed to show all digits of numbers in future credit reports and slides, instead of using thousands of dollars. Mr. Hayslip confirmed with Mr. Davies that all market segments were supportive of both the interim and long-term mass transition solutions.

After some discussion about the target level of credit exposure and the lack of consensus among market participants regarding how best to address residual credit exposure, Clifton Karnei requested that the Credit Work Group develop proposals for the Committee to review at its July meeting, from the various schools of thought in the market: (1) A proposal to collateralize less than the full exposure (lower barrier to entry, socialize losses to market), (2) A proposal requiring nearly complete collateralization (low risk but higher barriers to entry), and (3) A proposal for a middle (compromise) solution.

Quarterly Investment Results

Cheryl Yager reviewed the Summary of Investment Results for the first Quarter of 2006 and noted that she was looking at other investment funds and would report back to the Committee with more details.

Nodal Surcharge Filing Status

Steve Byone reported that staff had filed the request for a Nodal surcharge of \$0.0663 per MWh on May 5, 2006 and that an update with additional details would be filed two weeks prior to the hearing. Mr. Hayslip requested that the Committee be provided with fee filings, especially ones containing staffing information, for possible comment, before they were filed. Mr. Hayslip confirmed that the Committee did not want to delay any filings, but would like a brief opportunity to provide comments. Mr. Byone agreed to have such fee filings forwarded to the Committee before being filed.

2006 Fee Filing Update

Mike Petterson reported that the Final Order for the 2006 fee case, providing for a fee of \$0.4171 per MWh, had been issued by the Public Utility Commission of Texas on May 15, 2006 and was being distributed to the Committee via email. The fee approved in the Final Order is

less than the \$0.42 per MWh fee approved by the Board of Directors in September, 2005 because the PUCT concluded approximately \$858,000 of certain expenses, including reimbursement of employee relocation costs, intern expenses, leadership development training, and employee events, were not appropriate for ERCOT to incur and should not be recoverable through the ERCOT System Administration Fee.

Mr. Espinosa asked how ERCOT revenues were tracking in 2006, and Mr. Petterson confirmed that revenues were on budget through April.

2006 Forecast

Mike Petterson explained that, due to the PUC's instructions in the Final Order, staff was pursuing cost saving opportunities. It is expected that cost savings efforts will not only enable the organization to satisfy the provisions of the Final Order issued by the PUCT but would also allow payment of expenses relating to numerous unbudgeted initiatives identified after the 2006 budget and fee filing package were completed in late 2005.

2007 Budget Planning Assumptions Review

Mike Petterson presented an overview and general assumptions regarding the 2007 budget planning process. In response to one assumption that ERCOT's mission statement and 2006 goals be carried into 2007, the Committee suggested that the mission and goals should be revisited and possibly revised in recognition of recent events relating to communications and operational issues. After discussion by the Committee regarding budget planning, Mike Espinosa asked how the Committee could involve the PUC in the budget process, and Mr. Hayslip asked if a PUC representative could be assigned to be a continuous part of the budget planning process. Mr. Espinosa asked Commissioner Smitherman if ERCOT could get a designated person from the PUC to be the budget representative. Commissioner Smitherman stated that the budget process should be more collaborative, and it might not need to be a contested case, and suggested that each Commissioner could assign an aide to follow the process, along with PUC staff. Mr. Hayslip stated that he wanted to memorialize the Committee's desire to pursue this. **Mike Espinosa moved to request the PUC to identify one or more representatives to participate in the 2007 budget process; Darrell Hayslip seconded the motion. The motion passed unanimously.** Steve Byone stated that he would send the request letter to the PUC.

Committee Brief – Compliance Update

Don Meek reported that an effort was underway to have each ERCOT officer attest to full compliance to all laws, regulations, policies, protocols, contracts and other requirements. Steve Byone reported that a full compliance report for the Board would be available for the July Board meeting, as part of the commitment to share the information with the Committee twice yearly. Clifton Karnei asked if the report could be made available to the Committee in June, and then shared with the full Board in July. Mr. Byone explained that, due to competing priorities, the full compliance report would likely not be complete in time for the June meeting. Mr. Meek explained that the report was very extensive, including over 100 areas.

Committee Brief – Risk Stop Light Changes

Don Meek presented the updated Risk Management Event Profile Matrix ("Stop Light Report") and answered questions by Committee members. Mr. Meek explained that most changes on the Report were due to the April 17, 2006 EECF event and Communications and Human Resources concerns. Clifton Karnei complimented the Report and requested that changes in future reports be highlighted. Tom Standish suggested that high priority items from the Report

be tied to the budget; Steve Byone confirmed that they were tied to the 2006 re-forecast and that they would be considered in the 2007 budget planning process.

Committee Brief – Large Project Update

David Troxtell informed the Committee that only one project was scheduled for the full board approval: Enhancements to the Areva Study Tools (MOMS) – PR 50003.

Committee Brief – Audit Points

Steve Byone reported that all audit gaps previously identified by Deloitte & Touche had been completed and that training throughout the company was well underway.

Finance Goal Performance and Staffing Review

Steve Byone presented the Finance Division goals along with the corresponding color-coded status (green, yellow, red). Clifton Karnei suggested that the “ERM” goal be coded green, but Mr. Byone stated that he had further expectations.

Mr. Byone also presented a staffing report showing the number of full-time employees and contractors in place for each department in the Finance Division. He noted that the total number of contractors for the company was increasing due to the difficulty in filling positions with full-time employees. The Committee discussed the communication issues and risk factors involved in the company’s difficulty in attracting and maintaining sufficient qualified employees, the number of open positions, the vacancy rate, and the internal turnover rate. Mike Espinosa requested that the Committee continue to be updated monthly with the employee turnover figures and stated that the PUC needed to be made aware of the risk issues related to ERCOT’s HR issues.

Adjournment

At approximately 9:07 A.M., the meeting was adjourned and the Committee went into Executive Session. The next regularly scheduled meeting will be held on the morning of June 20, 2006.

Susan Vincent, Secretary

Review PwC 2005 Financial Audit Recommendations – Mike Petterson

May 15, 2006

Members of the Audit Committee
Electric Reliability Council of Texas, Inc.
7620 Metro Center Drive
Austin, TX 78744

Dear Audit Committee Members:

In planning and performing our audit of the financial statements of Electric Reliability Council of Texas (the "Company" or "ERCOT") as of and for the year ended December 31, 2005, in accordance with auditing standards generally accepted in the United States of America, we considered its internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of internal control over financial reporting. Accordingly, we express no such opinion.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily disclose all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses as defined in the proposed amendment to AU 325, *Communication of Internal Control Related Matters Noted In An Audit*, of the *AICPA Professional Standards* and shown below:

Control deficiency – exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

Significant deficiency - a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected.

Material weakness - a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

As we agreed in the Audit Committee meeting on February 21, 2006, we are providing you with a report of any material weaknesses or significant deficiencies and a description of operational or business observations relating to other deficiencies. The following sections of this report summarize our identification of deficiencies and related recommendations, and are presented using the categories of deficiencies identified above.

Significant Deficiency

Control Deficiency: Controls associated the analysis and review of accounts payable and accrued liabilities at period end were not functioning with sufficient effectiveness.

Observation: Our testing of accounts payable and accrued liabilities identified a number of accruals in 2005 for goods and services and some invoice payments relating to 2005 which were not recorded as liabilities when the service was performed/goods were received.

Implication: Expenses and project assets (and their related liability) could be misstated in financial statements used for management purposes and reported to the Board.

Recommendation: Procedures surrounding the analysis and recording of accrued liabilities at each reporting date should be enhanced to provide for improved accuracy. Additional procedures should include:

- A more comprehensive approach to reviewing and approving account analysis and other closing processes
- More thorough monthly assessment of accrual and liability accounts through reviews of subsequent disbursements and open invoices;
- Expanded review of contract liabilities for all significant open purchase orders with service organizations; since physical delivery is not evidenced in these types of contracts, the risk associated with services being performed but not recognized by ERCOT is higher.
- Enhanced fixed asset addition review procedures at each reporting period-end to determine costs are captured in the accrual for consulting and contract services that have been incurred but not invoiced.
- Enhance controls to require that vendor invoices are delivered timely to Accounts Payable personnel.

These and other structured monthly review/reconciliation closing procedures should exist to determine that accounts payable and accrued liabilities (e.g. legal accruals, outside service expenses, etc.) are properly recorded.

Management Response: Management is committed to enhancing procedures surrounding the analysis and recording of accrued liabilities at each reporting date to provide for improved accuracy and completeness by the close of the June 2006 accounting period. In devising the enhanced procedures, management will carefully consider implementing each of the recommendations offered by PricewaterhouseCoopers.

Recommendations Arising from Other Identified Deficiencies

1.) Management should adopt a monitoring process to enhance compliance with procedures for the preparation, review and approval of journal entries.

Observation: We identified manual journal entries which were posted to the general ledger without proper review and approval. For example, an entry relating to the elimination of fixed asset balances did not have evidence of required dual signatures of employees other than the preparer as required by policy. In testing journal entries, we identified several instances where journal entries that exceeded \$500,000 were lacking appropriate evidence of review.

Implication: Unauthorized / improperly approved journal entries could be recorded potentially resulting in financial statement misstatement.

Detail Recommendation: We recommend the Company follow its established policy for review and approval of journal entries which requires that two authorized employees, independent of the preparer, indicate their review and approval of journal entries greater than \$500,000. We also recommend that ERCOT's accounting policy be updated to accurately identify those employees with appropriate authority to review and approve journal entries. Further, to ensure compliance with these procedures, the Company should adopt a monitoring process to review monthly journal entries to determine if appropriate approvals have been obtained.

Management Response: The recommendations made by PricewaterhouseCoopers are very similar to those raised by ERCOT's Internal Audit staff during their audit of ERCOT's journal entries accounting conducted in late 2005 and early 2006. Following the report issued Internal Audit staff and in connection with ERCOT's Internal Control Management Program, the Company has adopted revised procedures, including lowering the threshold for journal entries requiring two authorized signatures from \$500,000 to \$100,000, relating to the review and approval of journal entries that incorporate the specific recommendations made Internal Audit staff and PricewaterhouseCoopers.

2.) Record fair value of derivative instruments on a timely basis

Observation: We noted during our audit of ERCOT's 2005 financial statements that the Company entered into a swap agreement during August 2005. The issue of swap agreement accounting was revisited during planning for the 2005 financial audit and again at the commencement of the 2005 audit. While we noted the Company was tracking value of the swap on a monthly basis, the value was not recorded in the company's general ledger before our audit commenced. The fair value of the swap should be recorded as an asset/liability and corresponding interest income/expense at the balance sheet date.

Implication: Improper accounting for interest rate swaps

Detail Recommendation: The fair value of derivative instruments should be recorded in conjunction with period-end closing procedures; consider performing each quarter.

Management Response: Effective April 2006, ERCOT is recording the change in the value of the Company's derivative instrument as part of its monthly close process. As has been done since the initiation of the derivative agreement, the Company will continue to receive and review weekly interest rate information relating to the swap and monthly swap valuation statements from an independent derivative valuation service provider.

3.) Enhance controls surrounding the preparation, review and retention of period-end account reconciliations

Observation: We noted instances wherein documentation supporting reconciliations were not available, where reconciliations were not completed in a timely manner, and where managerial reviews were not evidenced.

Implication: Account balances could be misstated.

Recommendation: Management should adopt more structured procedures relating to the preparation, review and retention of month-end account reconciliations. Such procedures should include clear identification of review and approval responsibilities to ensure that there is effective monitoring of this process. Review and approval should be evidenced via signature and date.

Management Response: ERCOT, in connection with its Internal Control Management Program, has adopted more structured procedures relating to the review and retention of month-end account reconciliations that incorporate the specific recommendations made by PricewaterhouseCoopers. The new procedures were adopted by the organization and effective in the second quarter of 2006.

* * * * *

This letter is intended solely for the information and use of the audit committee, board of directors, management, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties.

If you would like any further information or would like to discuss any of the issues raised, please contact Sean Barry at 916-930-8502.

Very truly yours,


PricewaterhouseCoopers LLP

cc: Steve Byone, Michael Petterson, Tom Schrader, Internal Audit

- Employees may report their concerns via a number of sources, including:
 - **Manager or Director**
 - **Human Resources**
 - **Legal**
 - **Internal Audit**
 - **EthicsPoint** (anonymous)
 - **PUCT**
 - **Board Members**
- Employees receive training to ensure they are aware of these options
- Reiterated during annual Ethics Reaffirmation process





































Non-audit services provided by the independent auditor:

- **F&A committee charter requires approval of non-audit services provided by the independent auditor**
- **PricewaterhouseCoopers provides the following non-audit services:**
 - Subscription to Comperio, an accounting, auditing, and reporting software tool with annual cost of \$1,500. The subscription was pre-approved by the F&A committee on November 15, 2005.

Review and approval ERCOT annual report-

Dottie Roark & Mike Petterson

ELECTRIC RELIABILITY COUNCIL OF TEXAS, INC.
RISK MANAGEMENT EVENT PROFILE MATRIX (as of June 2nd, 2006)

|  Strategic Position |  Operational Excellence |  Market Facilitation |  Grid Reliability |  Reporting |  Compliance  |
|---|--|---|--|---|---|
|  Strategy Development <i>Objective setting adequately incorporates informed stakeholder input, market realities and management expertise</i> |  Performance Monitoring <i>Clearly defined performance metrics linked to mission and goals; actively monitored, status communicated and corrective action taken</i> |  Customer Choice <i>Market design promotes efficient choice by customers of energy providers with effective mechanisms to change incumbent market participants as desired.</i> |  Grid Operations <i>Information required to operate the grid is efficiently gathered and appropriate tools are prudently configured to efficiently operate the system</i> |  Review Practices <i>Prudent measures are taken to insure that company disclosures are properly vetted and not misleading</i> |  Legal & Legislative <i>Operations are conducted in compliance with all laws and regulations and current and proposed legislation is understood and communicated</i> |
| ERCOT staff is generally not sufficiently aware of ERCOT's short or long-range strategic plan. Turnover in Senior Management has resulted in uncertainty regarding ERCOT's strategic vision Additionally, issues surrounding the proposed ERO/RE and nature of a 'Quasi-state' entity environment increases risk. | Performance monitoring tools lack desired early warning indicators and may fail to highlight potential underperforming activities. Additional efforts have been undertaken to refine the dashboard reports to provide more meaningful information on goal performance. | IT components supporting Customer Choice are currently not at the desired levels to meet SLA's. Successful replacement of SeeBeyond Application with TIBCO and Test environment build out will have a major impact on Customer Choice operations. | Current tools utilized by the System Operator (including the State Estimator and the accuracy/availability of SCADA data) and the lack of an Operator Training Simulator exposes ERCOT to greater reliability risks. | Internal review standards to ensure accuracy and completeness of information prior to release are below desired levels. Board of Director's Review of management activities on an ongoing basis assists in ensuring proper review and disclosure practices. | Failure to properly comply with laws, regulations, and protocols may result in fines, penalties, reliability degradation or other impacts. Senate hearings relating to the Apr. '06 EECF indicate that additional efforts are required to ensure proper understanding and communication of legislative and PUC directives. |
|  Mission and Goals <i>Corporate objectives and performance standards are understood and followed</i> |  Business Practices <i>Business planning, processes and management standards are effective and efficient</i> |  Nodal Implementation  |  Planning <i>Long-range planning methods enable efficient responses to necessary system changes to maintain reliability standards</i> |  Disclosure <i>Reporting and other disclosures to intended parties is timely, accurate and effective</i> |  Internal Control Compliance  |
| Current management initiatives related to goal setting and 'Line of Sight' have increased awareness of goals, and objectives related to high-level corporate objectives and priorities for individual divisions, departments, and employees. | Business continuity and disaster recovery plans, record retention procedures, and safety practices are currently below desired expectations. Additional development activities required to implement and test these procedures. | Significant risks exist with respect to project budgeting, human resource staffing, project scope and management, and tracking completion of the project in an acceptable timeframe. The magnitude and scope of the initiative provides significant levels of risk to the organization which have not been fully addressed at this time | Lack of timely and accurate information necessary to build reasonable system models and forecasts, an insufficient ability to conduct long-range (6-10 years out) planning, demands on planning resulting from a transition to Nodal. | A Disclosure Committee is in the process of being institutionalized to discuss and report on issues related to external reporting and compliance. | Failure to comply with internal controls may lead to imprudent or unauthorized use of corporate assets and/or inaccurate reporting. Audit findings are actively monitored by management as well as Internal Audit. While, an internal control compliance effort was largely completed in May 2006, staffing turn-over has resulted in new individuals filling positions who have not received adequate ICMP training |
|  Reputation <i>Positive perceptions by stakeholders typically lead to less cost and greater flexibility resulting in enhanced enterprise value</i> |  Human Resources  |  Counterparty Credit  |  Bulk System Resources |  Communication  |  Industry Standards <i>Business practices provide stakeholders with required assurances of quality</i> |
| Increased scrutiny resulting from the Fee Case filing, high visibility of initial Nodal implementation and impacts resulting from the Apr. '06 EECF and Dec '05 Retail Transaction system failure events combine to negatively impact ERCOT reputation. Recent settlements relating to the 2004 scandal reflect favorably on ERCOT Inc. | PUCT inquiries regarding compensation programs, a mandated salary freeze and employee related cost cutting directives increase the risk of higher turnover and prolonged recruitment efforts. Hiring necessary to support the NODAL ramp-up further strains the situation. Previous mitigation actions including variable pay, relocation, tuition reimbursement and employee training are also in question. | Processes for removing defaulting participants from the market increases the potential for credit losses. A medium to large market participant default could materially impact the ERCOT market, grid reliability, and ERCOT's reputation. Recent PRR's related to shortening the timeframe related to drops to POLR have reduced exposure by an estimated 37% | Uncertainty surrounding generation projects, installed and operational capacity, and the high dependency on natural gas in Texas' generation fleet may impact reliability. | Issues surrounding communications of April 17th EECF event and notification of key stakeholders, governmental agencies, and the general public have heightened a significant need for improved resources and strategies in internal and external communications. Extensive work has been conducted related to external communications and crisis management. | Failure to adhere to ERCOT adopted industry standards, and/or industry standards with which ERCOT is expected to adopt, may increase risks. Changes in NERC / FERC standards and policies require ERCOT action to ensure ongoing compliance. SAS 70 Audit Issues remain to be addressed. |
|  Fiscal Management <i>ISO design requires competent, prudent and cost effective provision of services</i> |  Technology Infrastructure <i>Information systems and data are effectively managed and are reliable</i> |  Administration, Settlement & Billing <i>Market rules are fairly applied to all participants and accounting is timely and accurately reflects electricity production and delivery</i> |  Operational Responsibility <i>Market participants conduct their operations in a manner which facilitates consistent grid reliability</i> |  Adequacy and Integrity <i>Robust processes exist to support management assertions embodied within financial reports</i> |  Regulatory Filings <i>Evidence, testimony and other supporting materials are compelling and successful</i> |
| Current fiscal practices are effective in managing and controlling costs. Management has a focus on cost control having developed a key corporate goal to monitor on-going cost savings. | System development, testing, implementation, and data management environments are not at desired levels. The technology roadmap is not clearly defined and contributes to overall technology inefficiencies. Retail Transaction systems issues provide evidence of existing infrastructure concerns. | ERCOT's settlement/dispute processes has a small number of ADR's outstanding, however these are being addressed in a timely fashion. The recent SAS 70 audit has found no significant issues in the 13 Settlement & Billing control areas. No significant issues relating to administration of existing protocols have been identified. | Ineffective ERCOT enforcement ability relating to reliability standards may lead to gradual erosion of reliability. Response of generators to Apr. '06 EECF event requires greater scrutiny in analyzing market participant operations. | Financial and Operations management information is being redesigned to enable management to effectively monitor and manage all aspects of the business. No significant items identified at this time. A fully functioning Compliance and Disclosure risk sub committee will further support this area. | Filings are completed timely and accurately. Ongoing management of competing priorities is necessary to avoid impacting the accuracy and timeliness of filings. |

Legend:  Elevated Risk Level  Reduced Risk Level  Special Attention Required (New Risk Categories / Descriptions Indicated in Green)

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Rationale for Category Risk Assessment Changes

| | | |
|-----------------------------|-----------|---|
| Counterparty Credit | Upgrade | Recent PPR's have reduced the timeframe for drops to POLR and reduced credit exposure by an estimated 37% |
| Communication | Upgrade | Extensive work has been conducted in developing emergency communications and crisis management plans |
| Internal Control Compliance | Downgrade | Internal staff turnover has resulted in a number of staff members in new positions not fully trained on ICMP procedures |

ERCOT Market Credit Status

| | as of 04/30/06 | | | | | as of 05/31/2006 | | | | |
|--|----------------|--|--------------|--|---|------------------|--|--------------|--|---|
| | # of QSEs* | Estimated Aggregate Liability (\$) | % of EAL | Total Unsec Credit Limit / Security Posted | | # of QSEs* | Estimated Aggregate Liability (\$) | % of EAL | Total Unsec Credit Limit / Security Posted | |
| <u>QSEs that meet ERCOT Creditworthiness Standards</u> | | | | | | | | | | |
| Ratings over BBB- | 8 | 28,436,346 | 12% | 236,269,112 | U | 7 | 19,723,333 | 6% | 221,449,377 | U |
| <u>QSEs that do not meet ERCOT Creditworthiness Standards</u> | | | | | | | | | | |
| Ratings below BBB- or not rated | | | | | | | | | | |
| Cash & Letters of Credit | 45 | 126,658,022 | 48% | 286,585,050 | S | 37 | 129,020,519 | 42% | 255,898,664 | S |
| Guarantee Agreements | 11 | 108,710,859 | 40% | 318,750,000 | S | 11 | 161,987,474 | 52% | 320,500,000 | S |
| Total Exposure | 64 | 263,805,227 | 100% | | | 55 | 310,731,326 | 100% | | |
| Other QSEs in the ERCOT Market (ERCOT owes) | | | | | | | | | | |
| <u>QSEs that meet ERCOT Creditworthiness Standards</u> | | | | | | | | | | |
| Ratings over BBB- | 8 | (3,585,754) | -9% | 161,744,343 | U | 9 | (5,663,794) | -8% | 176,564,077 | U |
| <u>QSEs that do not meet ERCOT Creditworthiness Standards</u> | | | | | | | | | | |
| Ratings below BBB- or not rated | | | | | | | | | | |
| Cash & Letters of Credit | 33 | (16,513,709) | -39% | 48,830,544 | S | 41 | (27,363,111) | -40% | 79,593,425 | S |
| Guarantee Agreements | 11 | (22,020,644) | -52% | 120,200,000 | S | 11 | (34,817,076) | -52% | 120,200,000 | S |
| Total | 52 | (42,120,107) | -100% | | | 61 | (67,843,981) | -100% | | |
| Total | 116 | | | | | 116 | | | | |

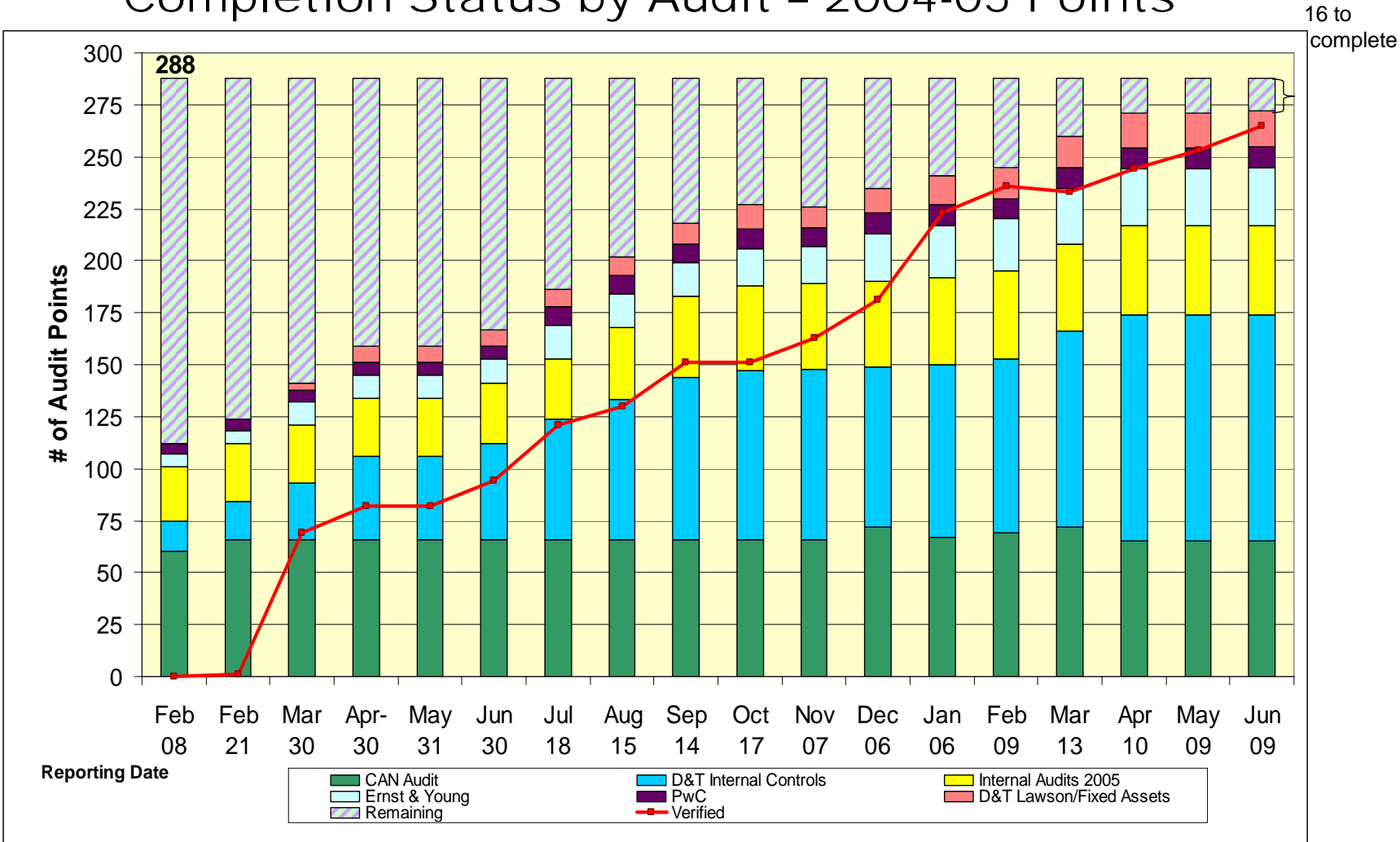
U: Unsecured since these QSEs meet the creditworthiness standards

S: Secured i.e. required to post collateral since these QSEs do not meet the creditworthiness standards

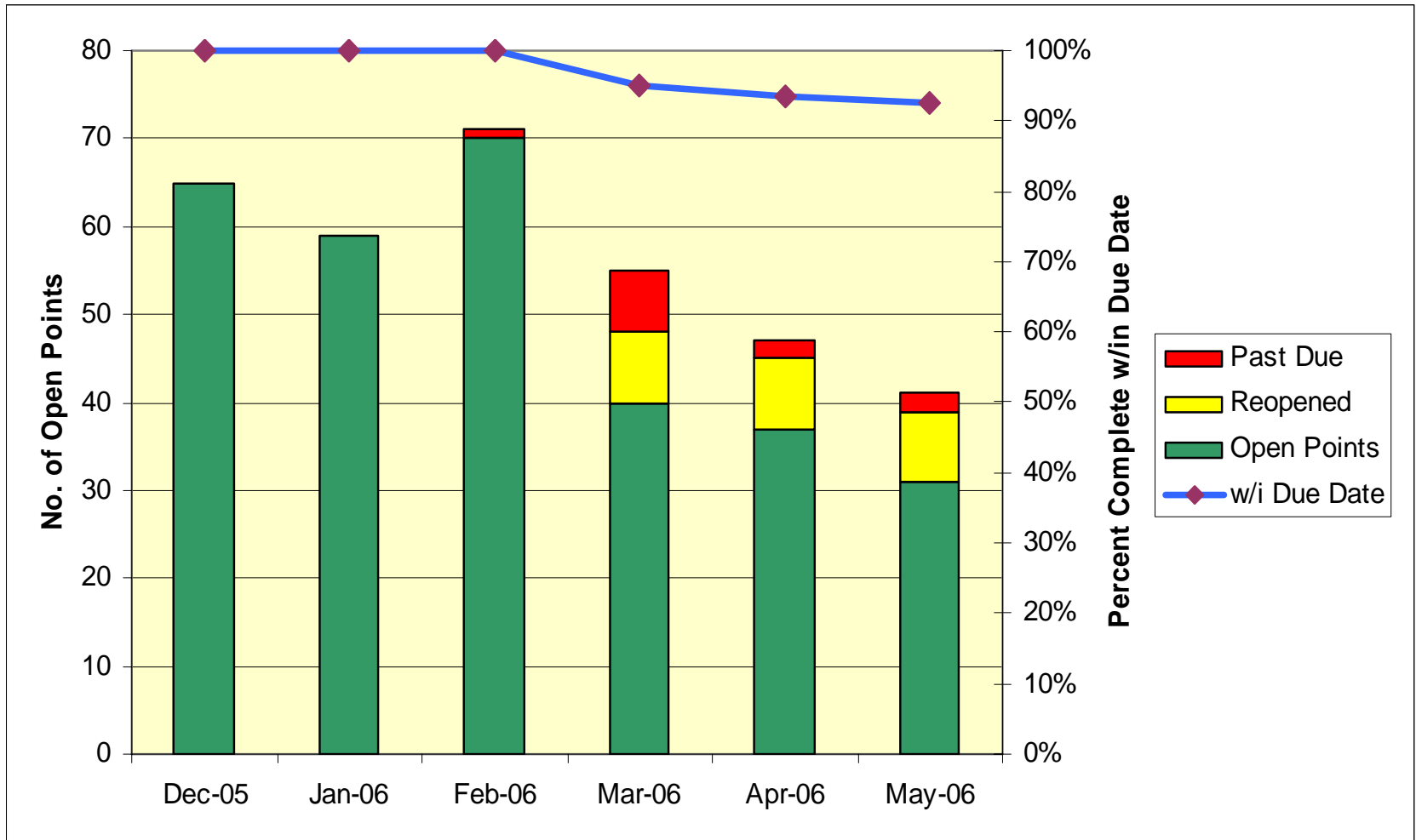


- Documentation for processes and initial training related to processes and controls is complete
- Completed updates of controls in control repository based on gap remediation and review with process owners
- Completing control self assessments on updated controls
- Provided controls from repository and documentation for each business process to D&T for review of control framework
- D&T will start transactional testing after July 4th

Completion Status by Audit – 2004-05 Points



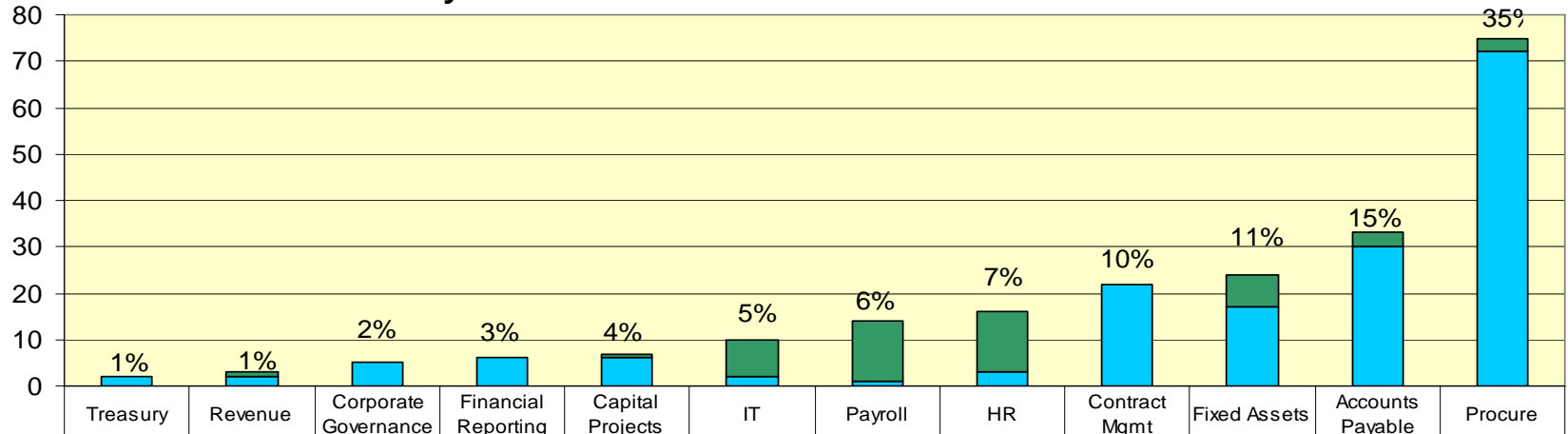
Status of Open Audit Points - 2006



% = % of Total

Status of 217 D&T Actionable Internal Control Gaps by Business Process as of 06/09/06

of Actionable Gaps

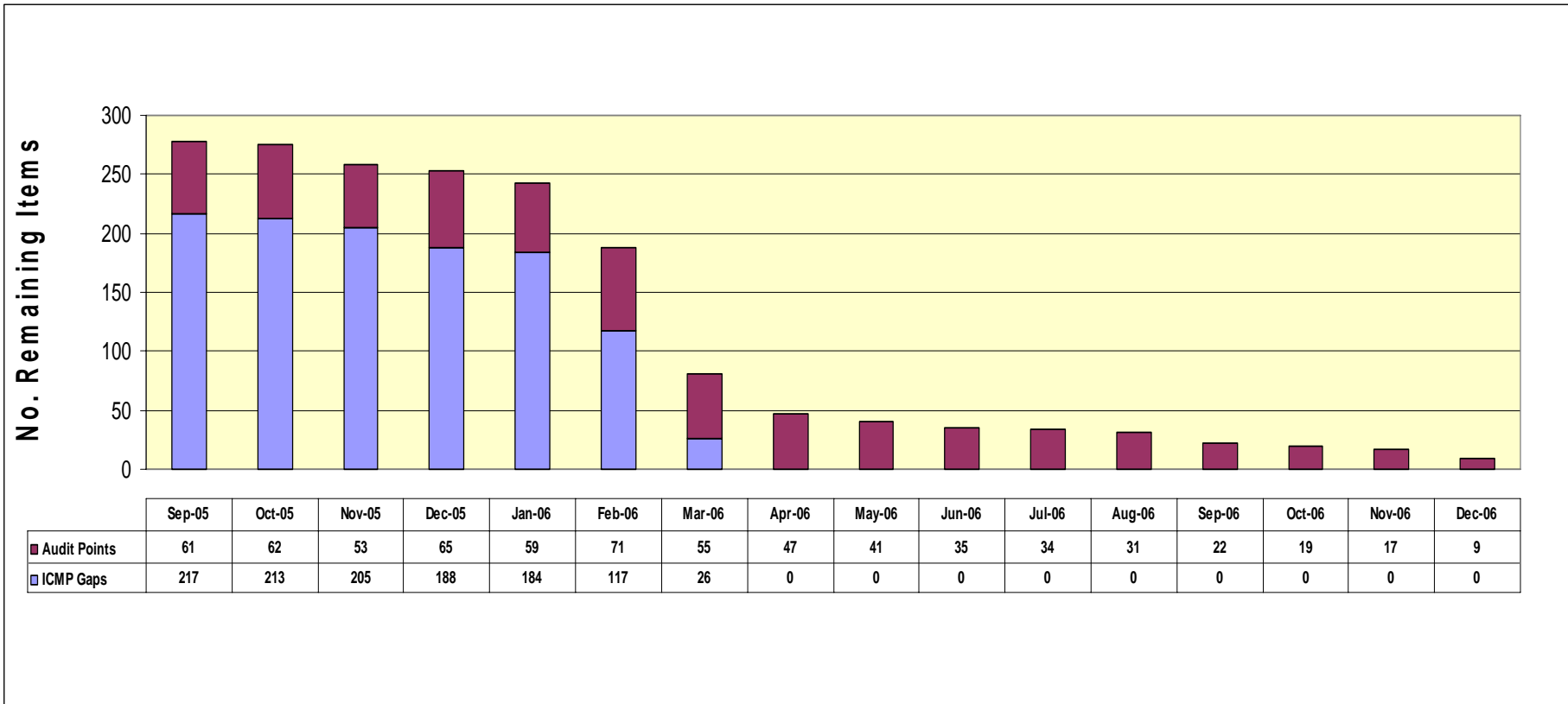


■ Planning - Key ■ Planning - Non Key ■ Execution - Key ■ Execution - Non Key ■ Complete - Key ■ Complete - Non Key

CHANGES FROM PRIOR REPORT on 5/09/06 - Increase/(Decrease):

| | Treasury | Revenue | Corporate Govern- ance | Financial Reporting | Capital Projects | IT | Payroll | HR | Contract Mgmt | Fixed Assets | Accounts Payable | Procure- ment | Total |
|---------------------|----------|---------|---------------------------|---------------------|------------------|----|---------|----|---------------|--------------|------------------|------------------|-------|
| Complete - Non Key | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Complete - Key | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Execution - Non Key | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Execution - Key | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Planning - Non Key | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Planning - Key | - | - | - | - | - | - | - | - | - | - | - | - | - |

Projected Audit Point & ICMP Gap Progress



Audits Completed (last three months)

Internal Audits

- Market Operations
- General Ledger Adjusting Journal Entries
- Congestion Management/TCR
- Lawson HR System
- MV90 System

External Audits

- Sales Tax
- 2005 Financial (PwC)

Open Audits

Internal Audits

- Payroll
- Credit (QSE)
- Outage Scheduling & Coordination
- Fraud Prevention (ongoing)

External Audits

- 2006 SAS70 (PwC)
- Internal Controls (D&T)

Planned Audits (next 3 months)

Internal Audits

- Ethics Compliance
- Consultants, Contractors & Compliance
- Investments

External Audits

- Texas Nodal Program Review (managed by IAD)
- 401k / MPP (PwC)

Planned Items (next 3 months)

External

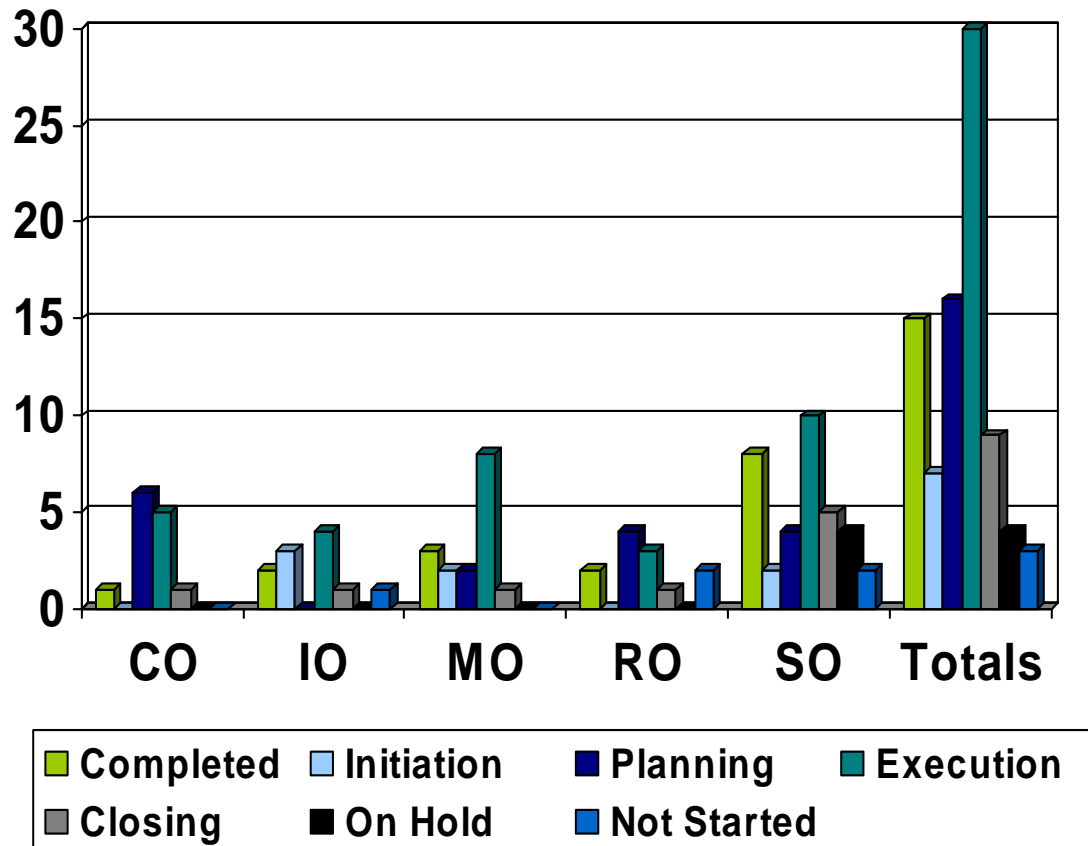
- Various reviews of ERCOT's network and system security posture.

2006 YTD Project Portfolio

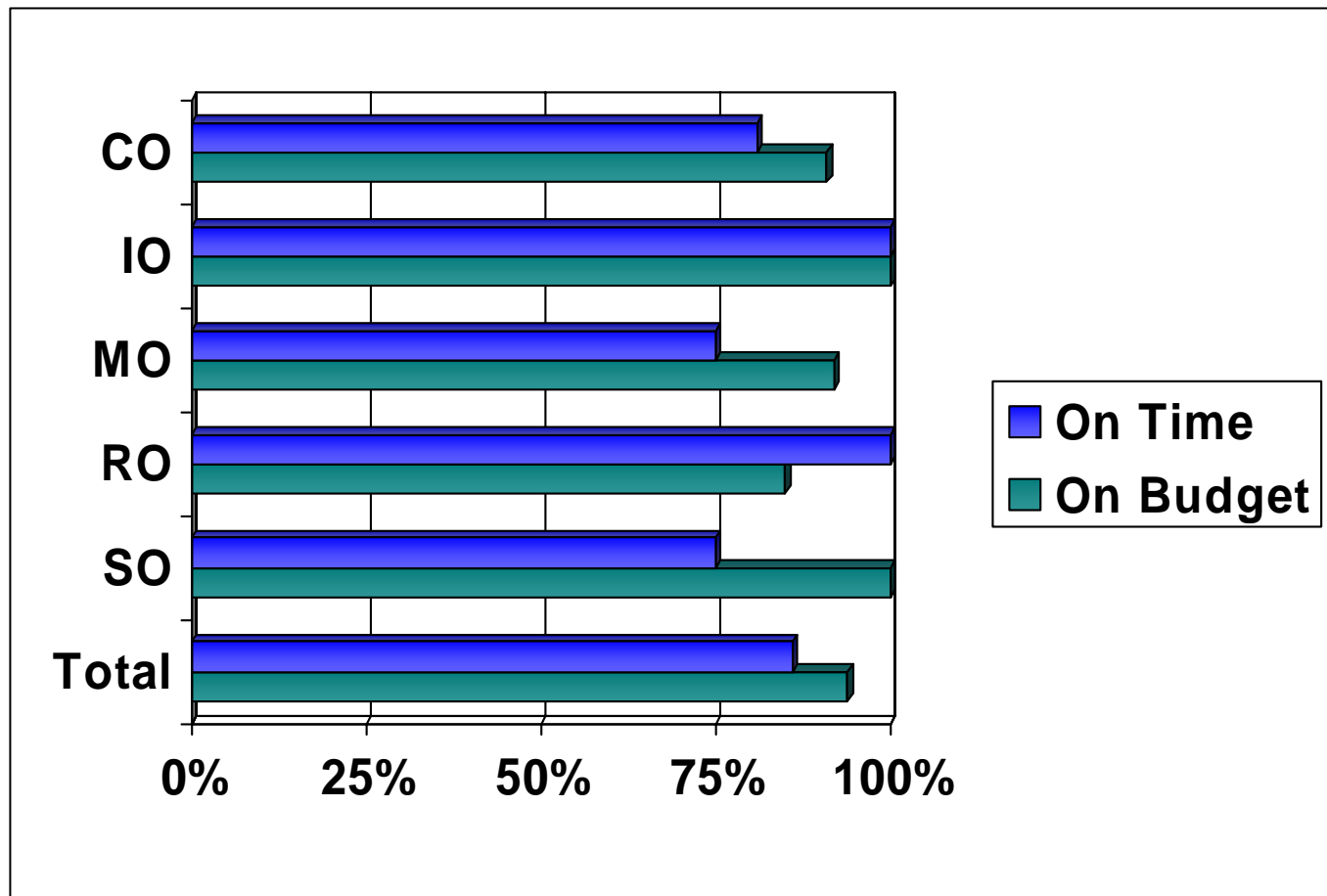
Project Totals

- **Completed Projects**
 - 3 completed in May
 - 15 completed YTD
- **Active Projects**
 - 7 in *Initiation*
 - 16 in *Planning*
 - 30 in *Execution*
 - 9 in *Closing*
- **Inactive Projects**
 - 4 projects *On Hold*
 - 5 projects *Not Started*















Project Activity by Division



2006 YTD Project Performance Active and Projected Portfolio



Major ERCOT Projects Summary

| Project | Total Budget | Actual 05/31/06 | Metrics | |
|---|-------------------------------------|-----------------|---|---|
| Duration/Information (Sponsor) | Phase/Scheduled Completion | | Schedule | Budget |
| Service Oriented Architecture (2004-2006) | \$6.1M | \$5.9M |  |  |
| <i>3 separate projects over 12 mos. (R. Giuliani)</i> | <i>Execution Phase/4th Qtr 2006</i> | | | |
| Enterprise Data Warehouse (2003-2006) | \$3.5M | \$2.7M |  |  |
| <i>9 separate projects over 36+ mos. (R. Hinsley)</i> | <i>Execution Phase/3rd Qtr 2006</i> | | | |
| Operator Training Simulator (2005-2006) | \$3.8M | \$528K |  |  |
| <i>Training Simulator System for Operators (S. Jones)</i> | <i>Execution Phase/2nd Qtr 2007</i> | | | |
| Enhancements to FasTrak Tools (2005-2006) | \$2.5M | \$1.6M |  |  |
| <i>Tool for Tracking Market Issues (R. Giuliani)</i> | <i>Execution Phase/3rd Qtr 2006</i> | | | |
| Enhancements to SCR727 (2005-2006) | \$1.9M | \$432K |  |  |
| <i>Entered into Execution (R. Giuliani)</i> | <i>Execution Phase/3rd Qtr 2006</i> | | | |
| Austin QA Build out (2005-2006) | \$1M | \$799K |  |  |
| <i>Entered into Testing (R. Hinsley)</i> | <i>Execution Phase/3rd Qtr 2006</i> | | | |
| Enhancements to AREVA Study Tools (2006) | \$1.2M | \$220K |  |  |
| <i>Entered Execution (S. Jones)</i> | <i>Execution Phase/1st Qtr 2007</i> | | | |

Projects Completed in May

- PR-50151 Additional SMP Front End
 - **Scope:** SMP Front End has reached capacity. No new QSEs, QSE DRs or TDSPs can be added until SMP Front End is expanded.
 - **Deliverables:** Add an additional SMP front end system to ERCOT EMS system.
 - **Timeline:** Oct 2005 – May 2006
- PR-50026 SIR Enhancements
 - **Scope:** This project included a bundle of System Investigation Requests for “New” functionality needed to improve the operational functions of the ERCOT Retail systems.
 - **Deliverables:** Project delivered 39 SIRS across 5 systems.
 - **Timeline:** Aug 2005 – May 2006

Projects Completed in May (cont.)

- PR-50132 Network Intrusion/Detection System
 - **Scope:** Implement Network Intrusion Detection and Intrusion Protection Systems into the ERCOT network at the perimeter and internal network layers.
 - **Deliverables:** More efficiently monitor and identify potential and actual threat based traffic on the network and, after due consideration of impact, begin to block the traffic from the outside that constitutes a threat to the security of ERCOT's Information Systems.
 - **Timeline:** Jun 2005 – May 2006

<Open Discussion>

Surcharge

- **Filed information package with PUC** **June 2**
- **Settlement discussions around a 4.5 cent interim surcharge**
 - Lower interim surcharge means that a slightly higher surcharge will be necessary to fund a “flat fee” option in the full filing (e.g. approx 6.9 cents rather than 6.6 cents, based on \$125 million estimated cost)
- **Approval of an interim surcharge (“flat fee” option) will not meet all funding requirements for Nodal**
 - Debt funding mechanism is needed
- **Temporary funding of ongoing Nodal costs is covered through currently established ERCOT debt facility**
 - Existing ERCOT debt facility was not “sized” to accommodate spending on the scale of Nodal

Debt

- **High level borrowing needs - 2006**

- 2006 capital (60% of \$ 25,000 m) \$ 15,000 m
- 2006 Nodal (\$ 30,000 m - \$ 9,000 m from Sur) \$ 21,000 m

Estimated borrowings at YE \$ 36,000 m

- Liquidity requirement at YE-incl Nodal
(approx \$ 25 – 30,000 m) \$ 30,000 m

Total \$ 66,000 m

- **Current revolver capacity \$ 50,000 m**
- **Expected liquidity shortfall by YE \$ 16,000 m**

- **Probably need to expand borrowing capacity by Oct 31**
- **Will present proposal for mid-term financing
at July F&A meeting**

Future Agenda Items

- CWG Credit Proposals
- Nodal Financing & Liquidity Update
- Internal Control Audit Update
- SAS 70 Update/2005 Remediation
- 2007 Budget Preview
- Risk Response Planning
- Internal Audit Update

Other Topics

- Future Special Fee Request – Entergy Study

F & A Yearly Schedule

Quarter 1

- ✓ •Elect officers and confirm financial qualifications
- ✓ •Review Finance Audit Committee charter
- ✓ •Approve the Guidelines for Engagements of External auditors for Other Services (pre-approval policy)
- ✓ •Required written communication and discussion of auditor independence
- ✓ •Review scope of annual financial audit
- ✓ •Report by CWG Chair on ERCOT credit policy

Quarter 2

- ✓ •Report results of annual independent audit to the Board
 - Report of external auditor pre-approval status/limits
 - Review the procedures for handling reporting violations
- ✓ •Review conflict of interest and ethics policies
 - Review results of annual audit (including required communications)
 - Review and approve ERCOT Annual Report
- ✓ •Review operating plan and budget assumptions

Quarter 3

- Appoint the independent auditors for upcoming year
- Approval of independent auditor fees for upcoming year
- Assessment of compliance, the internal control environment and systems of internal controls
- Review and approval of annual operating budget
- Report by CWG Chair on ERCOT credit policy
- Review updated year-end forecast

Quarter 4

- Approve audit committee meeting planner for the upcoming year, confirm mutual expectations with management and the auditors
- Review and approval of Financial, Investment & Credit policies
- Approve scope of internal auditing plan for upcoming year
- Assessment of the adequacy and effectiveness of the Internal Audit staff
- Perform Finance & Audit committee Self Assessment
- Vote on CWG Chair
- Review requirements for membership in CWG
- Review and approve CWG charter
- Review updated year-end forecast

Recurring Items

- Review minutes of previous meeting
- Report monthly matters to the Board (chair)
- Review EthicsPoint activity
- Review significant audit findings and status relative to annual audit plan

✓ Items completed for 2006