



ERCOT Finance & Audit Committee Meeting

ERCOT

7620 Metro Center Drive, Austin, Texas

Room 168

August 15, 2006; 8:00 a.m. - 10:00 a.m.**

Agenda Item #	Description/Purpose/Action Required	Presenter	Time
	Call to Order	C Karnei	8:00 a.m.
1.	Approval of Minutes* (Vote) (07/18/06)	C Karnei	8:00 a.m.
2.	Review reforecast of 2006 revenues and expenses	M Petterson	8:05 a.m.
3.	Review revised 2007 budget schedule	M Petterson	8:15 a.m.
4.	Surcharge Briefing	S Byone	8:20 a.m.
5.	Discussion of materiality level	M Petterson	8:25 a.m.
6.	Project priority list/funding level review	D Troxtell K Gresham	8:30 a.m.
7.	Audit Status Briefing (internal controls/SAS 70)	S Byone	8:50 a.m.
8.	Audit and Compliance, Incidence Response Preparedness and ERM Update (preview of full Board presentation)	D Meek	9:00
9.	Credit (preview of full Board presentation)	M Davies	9:05 a.m.
10.	Committee Briefs (major changes/Q&A)	All	9:10 a.m.
11.	Future Agenda Items/Other Topics	S Byone	9:15 a.m.
12.	Adjourn to Executive Session		9:20 a.m.
	• Financial auditor selection	M Petterson	9:20 a.m.
	• SAS 70 auditor selection for 2007	B Wullenjohn	9:25 a.m.
	• Internal Audit Department Goals for 2006	B Wullenjohn	9:35 a.m.
	• Significant Audit Findings	B Wullenjohn	9:40 a.m.
	• Ethics Point	C Vance	9:50 a.m.
	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 September 19, at ERCOT, 7620 Metro Center Drive, Austin, Texas.*

Draft MINUTES OF THE ERCOT FINANCE & AUDIT COMMITTEE MEETING

Austin Met Center
8:00 A.M.
July 18, 2006

Pursuant to notice duly given, the meeting of the Electric Reliability Council of Texas, Inc. Finance & Audit Committee convened at approximately 8:00 A.M. on **July 18, 2006**. The Meeting was called to order by **Clifton Karnei** who ascertained that a quorum was present.

Meeting Attendance

Committee members:

Clifton Karnei, Chair	Brazos Electric Cooperative	Cooperative	Present
Miguel Espinosa, Vice Chair	Independent Board Member	Independent Board Member	Present
Robert Manning	H-E-B Grocery Co.	Consumer	Present
R. Scott Gahn	Just Energy	Ind. Retail Electric Provider	Present
Tom Standish	Centerpoint Energy	Investor-Owned Utility	Present
William Taylor	Calpine Corporation	Ind. Generator	Present

ERCOT staff and guests present:

Barry, Sean	PricewaterhouseCoopers (PwC)
Berinsky, Carl	ERCOT
Byone, Steve	ERCOT (CFO)
Davies, Morgan	Calpine
Delenela, Ann	ERCOT
Doolin, Estrellita	ERCOT
Dreyfus, Mark	Austin Energy
Fournier, Margarita	Competitive Assets
Gresham, Kevin	Reliant Energy
Hancock, Misti	ERCOT
Helton, Bob	American National Power
Jones, Randy	Calpine
Jones, Liz	TXU
Lozano, Rafael	PSEG Texgen I
Meek, Don	ERCOT
Petterson, Mike	ERCOT
Ruebsahm, Jammie	Deloitte & Touche (D&T)
Troxtehl, David	ERCOT
Vance, Cathy	ERCOT
Vaughn, Les	ERCOT
Vincent, Susan	ERCOT
Wagner, Marguerite	Reliant Energy
Webking, Catherine	TEAM
Wullenjohn, William	ERCOT
Yager, Cheryl	ERCOT

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Approval of Previous Minutes

Tom Standish moved to approve the minutes for the previous meeting held on June 20, 2006; Miguel Espinosa seconded the motion. The motion passed unanimously.

Election of Vice-Chair

The Committee discussed its need, with Darrell Hayslip's departure, to elect a new Committee Vice Chair. **Mr. Scott Gahn moved to elect Miguel Espinosa as Vice-Chair of the Committee; Bob Manning seconded the motion. The motion passed unanimously.**

SAS 70 Audit Plan

Sean Barry with PwC provided an overview of the 2006 SAS 70 audit and including the background and purpose of the audit. He explained that the scope would include eighteen (18) control objectives—13 business processes and 5 information systems. Mr. Barry explained that the four areas of emphasis of the SAS 70 are (1) exceptions noted in prior year's SAS 70 Report; (2) higher risk areas for most ISOs/ RTOs; (3) changes to Protocols since the last audit; and (4) changes in key personnel and responsibilities.

Mr. Espinosa asked if there had been any issues with the pre-testing. Mr. Barry responded that ERCOT's results were probably average and that most ISOs with which PwC was involved last year had exceptions similar to ERCOT's.

Credit Work Group Proposals

Morgan Davies reported on CWG's efforts to develop options for dealing with residual credit exposure including methods to reduce credit exposure with and without increasing collateral. Mr. Davies explained that opinions within the CWG varied as to how much residual credit exposure could or should be accepted in the market. Based on the Committee's request, the CWG also discussed various middle ground or compromise solutions concerning additional actions to take to mitigate credit exposure and correspondingly, how much credit exposure to accept in the market. Mr. Davies reported that, while not achieving 100% consensus, the CWG did reach a significant level of agreement concerning a compromise solution that would require additional changes to the Protocols. Mark Dreyfus and Kevin Gresham noted that neither TAC nor PRS had yet reviewed the proposed solution. Both indicated that PRS and TAC would provide input.

Mike Espinosa moved to instruct the CWG to file a PRR to implement the compromise credit position by reducing the time to post collateral from two business days to one business day. Bob Manning seconded the motion. The motion passed unanimously.

Mr. Karnei noted the progress that had already been made in reducing credit risk.

The Committee also discussed critical feedback that Committee members had received from market participants regarding the CWG. Clifton Karnei asked the CWG to review its governance to determine if any changes should be made and report back the Committee with recommendations.

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2007 Budget Preview

Mike Petterson provided an update on the 2007 budget process and recommended that, in order to provide time to obtain the revised Texas Nodal Market Implementation Program (TNMIP) and budget (expected in September) and the Delegation Agreement for the Regional Entity among other items, the budget schedule be revised to allow the first budget draft to be presented to the Committee in October and to the full Board in November. Clifton Karnei suggested that staff visit with PUC staff to make sure the revision would be acceptable. Bob Manning cautioned staff about the risks with delaying finalizing the budget too long, but the Committee confirmed acceptance of this proposal, so long as the PUC indicated approval.

Nodal Financing/ Liquidity Planning

Cheryl Yager explained that the temporary funding of ongoing TNMIP costs was being covered through the existing ERCOT debt facility that was not large enough to accommodate spending on the scale of the Nodal project. She noted that because ERCOT would need additional borrowing capacity by October to maintain liquidity requirements, she had begun to review financing alternatives and have conversations with potential lenders. Ms. Yager will present to the Committee in September an analysis of specific proposals.

Internal Control Audit Update

Steve Byone explained that D&T had made some preliminary comments on the ERCOT framework and believed there might be an opportunity to reduce the number of key controls. Accordingly, the timing will be extended to allow for more time to improve the design phase. The final report is expected in September; however, the possibility of a change in schedule following an upcoming status meeting with D&T was discussed.

SAS 70 Update/ 2005 Remediation Status

Ann Delenela reported that the remediation of Control Objection #17 (Logical Security Controls) and #18 (Physical Security Controls) was being coordinated by Information Systems Security. Sean Barry noted that the PwC had been unable to pre-audit the recertification process because the auditors had been unable to promptly get the information they needed. Mr. Barry confirmed that his team had received the needed access after going to senior management. Mike Espinosa and Mr. Karnei instructed Mr. Barry to contact the Committee for assistance if he experienced any delay or other issues with access to information in the future. Committee members stressed the need for ERCOT staff to cooperate with the PwC auditors and their expectation that the auditors be provided access to all information requested in connection with their fieldwork.

Committee Briefs

Credit Update

Cheryl Yager explained that the difference in Total Unsecured Credit Limit/ Security Posted between the May and June reports was due to a change in reporting criteria, not a substantive decrease. The Committee indicated that the new reporting format was acceptable. Ms. Yager also informed the Committee that a recent voluntary exit by a QSE would likely result in a credit exposure of \$150,000 to \$200,000.

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Quarterly Investment Results

Cheryl Yager presented a Summary of Investment Results for second quarter of 2006 and informed the Committee that a previous decision to change a fund had been reversed due to improvement of the fund's investment performance relative to ERCOT's approved benchmark.

Project Management Office

David Troxtell reported that PR-60075_1 regarding Identity & Access Management would be presented to the Board for approval and that PR-600004_1 regarding EIS Conformed Data Warehouse Foundations would not be presented to the Board as previously planned because the scope had changed and budget reduced.

Future Agenda Items

Steve Byone reviewed the following as agenda items for August:

1. Approval of 2007 Operating Budget
2. Selection of Independent Auditor for 2006 and approval of fees

Adjournment

At approximately 9:32 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 August 15, 2006.

Susan Vincent, Secretary

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Review Reforecast of 2006 Revenues and Expenses

M. Petterson

	2006 Original Budget	2006 Expenditure Forecast	Variance
Base Operations	133.37	(132.20)	1.17 (a)
Market Monitoring	3.00	(1.60)	1.40
Incremental Debt	1.45	(1.45)	-
Subtotal	137.82	(135.25)	2.57
Wholesale Market Redesign	-	(30.00)	(30.00)
Total	137.82	(165.25)	(27.43)

Note:

Reconciliation of Base Operations Variance:

Labor & Benefits	2.55	Higher than anticipated vacancy savings
Property Taxes	0.34	Property valuation adjustment
Interest Expense	0.33	Reduced term note interest
Other	0.36	Reduced employee expenses and supplies
	<u>3.58</u>	
Outside Services	(2.09)	Unbudgeted initiatives
HW/SW License & Maintenance	(0.32)	Increased cost for enterprise agreement
	<u>(2.41)</u>	
Total	<u>1.17</u>	

Review Revised 2007 Budget Schedule

M. Petterson

Date	Action
Monday, Apr. 17	Executive Committee - Preliminary Conceptual Direction Discussion
Tuesday, Apr. 18	Board of Directors - Conceptual Direction Discussion
Tuesday, May 16	Public Meeting - Strategic Planning & Budgeting (in conjunction w/Board Meeting)
Thursday, Jun. 22 - Wednesday, Jun. 28	Budget Review - CFO and Directors (individual meetings will be scheduled)
Monday, July 10	Executive Committee - 2007 Budget Final Review
Friday, July 14 - Tuesday, Aug. 15	PUCT Focused Reviews
Tuesday, July 18	Finance & Audit Committee Agenda - Preliminary Budget Presentation
Wednesday, July 19 - Friday, Dec. 29	Development and implementation of ERCOT's Revised Compensation Strategy
Tuesday, Aug. 1	Draft Delegation Agreement to NERC as ERO, to become Regional Entity (RE) for the ERCOT Region
Tuesday, Aug. 15	Finance & Audit Committee Agenda - Review of TAC-approved 2007 Project Priority List
Tuesday, Sept. 19	Finance & Audit Committee Agenda - 2007 Budget Status Report
Tuesday, Sept. 19	Board Agenda - Updated Texas Nodal Market Implementation Program resource requirements, timeline, and budget
Tuesday, Sept. 26	Public Meeting - Preliminary 2007 Budget Presentation
Sunday, Oct. 1	Final Delegation Agreement to NERC as ERO, to become Regional Entity (RE) for the ERCOT Region
Thursday, Oct. 5	Finance & Audit Committee Special Meeting - 2007 Budget Review (if necessary)
Tuesday, Oct. 17	Board Agenda - Finance & Audit Committee 2007 Budget Recommendation
Tuesday, Nov. 14	Board Agenda - 2007 Budget Approval
Friday, Dec. 15	PUCT Fee Filing

<open discussion>

- **Direction and clarity on the concept of “materiality” with regard to ERCOT’s financial statements will help ERCOT in several key ways:**
 - More efficient design of internal controls
 - Identification of transactions requiring control
 - Level of controls
 - Type of controls
 - More efficient execution of audits by independent auditors and ERCOT’s Internal Audit team
 - Confidence in internal controls
 - Potential for smaller sample sizes and scope of testing

- **Control deficiency** – design or operation of controls do not allow ERCOT personnel, in the normal course of performing their assigned functions to prevent or detect misstatements on a timely basis
- **Significant control deficiency** – single control deficiency (or combination of control deficiencies) results in more than a remote likelihood (probable and reasonably possible) that a misstatement in ERCOT’s financial statements that is more than inconsequential will not be prevented or detected
- **Material weakness** - single significant control deficiency (or combination of significant control deficiencies) results in more than a remote likelihood (probable and reasonable possible) that a material misstatement in ERCOT’s financial statements will not be prevented or detected

- **Issues and Concepts**

- Material misstatements
- Inconsequential misstatements
- Users of ERCOT financial statements
- Quantitative factors
- Qualitative factors

Interoffice Memorandum

To: Finance and Audit Committee
From: M. Petterson
Date: August 8, 2006
Re: ERCOT Financial Materiality Assessment

OBJECTIVE

Summarize and provide rationale, support, and background for management's conclusions regarding the type and size of transactions of transactions considered material to ERCOT's financial statements taken as a whole.

CONCLUSION

Considering pertinent qualitative and quantitative issues, ERCOT management believes that transactions representing 1% of total assets (approximately \$3.4 million) or 1% of total operating expenses (approximately \$1.3 million), if inaccurately recorded, may create substantial likelihood that the judgment of a reasonable person relying on ERCOT's financial reports would have been changed or influenced by the different accounting of the transactions.

Assessment of the materiality of a transaction in question will likely be completed by management on a case-by-case basis. Transactions that approach or exceed the thresholds for materiality detailed in the paragraph above and which require unusual management interpretation or estimation will be communicated to senior management and members of the Finance and Audit Committee of the Board as appropriate.

In addition to quantitative factors, the assessment would likely include such qualitative factors as the following:

- Does the transaction have a significant impact on the ERCOT System Administration Fee?
- Does the transaction mask a financial trend?
- Does the transaction change an income into a loss or vice versa?
- Does the transaction affect regulatory compliance?
- Does the transaction have the effect of increasing management compensation?
- Does the transaction affect compliance to loan covenants?
- Does the transaction involve concealment of unlawful transactions?
- Does the transaction have impact on the volatility of ERCOT's securities?
- Has management intentionally misstated items in the financial statements to "manage" reported earnings?
- Does the transaction significantly alter the total mix of financial information made available?

RATIONALE, SUPPORT, AND BACKGROUND

ERCOT is a non-profit entity subject to regulatory oversight by the Public Utility commission of Texas. ERCOT is a breakeven entity and its fees are established to recover its costs of operations or revenue requirements which can be summarized into three categories:

1. Operating and maintenance expenses,
2. Debt service obligations (principal and interest), and
3. A portion of capital project expenditures (approximately 40 percent for planning purposes).

ERCOT is designed, structured, and organized to generate little if any net income or net unrestricted assets (equity). Financial ratios based on net income or net unrestricted asset figures are a secondary consideration to users of the company's financial statements.

Significant users of ERCOT's financial statements have been considered in the evaluation of materiality relative to ERCOT's operations and financial results. A brief statement on each of the significant category of financial statement users is presented in the passages below.

Lenders - ERCOT's lenders have been most interested in the company's relationship with the PUCT and its demonstrated ability to obtain a System Administration Fee income sufficient to repay debt service obligations.

In the second quarter of 2004, ERCOT negotiated a new two-year \$50 million revolving credit facility and new five-year \$50 million term loan agreement. The deals were completed with audited 2003 financial statement that included a net loss of \$15.9 million for the year and a negative \$5.1 million net unrestricted asset balance at the end of 2003. Pro forma financial statements used to support the new borrowings showed continued operating losses and negative net unrestricted assets in future years as well.

The debt covenants included in lending agreements reveal the interests of the lenders. Most notably, there are no debt covenants relating to net unrestricted net assets and only one covenant addressing debt coverage (Covenant 6.21 of the Term Notes Payable agreement).

Rating agencies - ERCOT was assigned an issuer rating of A1 by Moody's Investor Services, Inc. in first quarter 2002, which was reaffirmed in April 2004. According to Moody's, the credit rating reflects, among other things:

1. the well-established and accepted role ERCOT maintains in the electric industry in Texas and the essential services ERCOT provides in establishment and enforcement of protocols for operation and reliability of the transmission system in the ERCOT Region;
2. ERCOT's risk profile, limited by the assumption of commodity risk and counter party risk by entities other than ERCOT;
3. the Company's costs, which are primarily administrative expenses such as computer operations and staffing, being fully recoverable by a fixed administrative fee assessed to qualified scheduling entities (QSE)s;

4. the size, stability and liquidity of ERCOT's electric power market, which together minimize price and reliability risk as the Texas electric market deregulates; and
5. the weighted average credit quality of ERCOT's QSEs and the credit standards for new QSEs.

On this basis, ERCOT has received a very strong issuer credit rating despite a relatively short operational history marked by operating losses and negative unrestricted net assets (equity). Moody's reaffirmation of ERCOT's issuer rating was completed with audited 2003 financial statement that included a net loss of \$15.9 million for the year and a negative \$5.1 million net unrestricted asset balance at the end of 2003.

Public Utility Commission of Texas and market participants – The PUCT and market participant interests are primarily focused on ERCOT's operational role in safely and reliably managing the ERCOT grid, and accurately and timely settling the market. However, they are also keenly interested in ERCOT's financial performance as it translates into the ERCOT System Administration Fee. Market participants from all of segments of the ERCOT market have intervened and/or actively participated in each of ERCOT's annual budget and fee filing cases. The interests of the market participants and PUCT staff, based on comments at public meetings and hearings and formally filed requests for information, are centered on the levels of proposed operating expenses, capital expenditures, new debt borrowing, and the resulting impact on the ERCOT System Administration Fee. The PUCT and market participants have expressed interest in having a stable, low fee that enables ERCOT to acquire the resources to perform its duties effectively and efficiently. The 2004 budget approved by market participants, the ERCOT Board of Directors and the PUCT, included an operating net loss of \$4.3 million and projection of a negative \$18.3 million net unrestricted net asset balance at December 31, 2004. ERCOT budgets for 2005 and 2006 have been approved while including financial results similar to those depicted in 2004. There has been virtually no discussion or critical exploration of ERCOT's proposed profitability or net unrestricted asset position.

Insurance providers – ERCOT maintains numerous types of insurance relating to its operations and governance including coverage for directors and officers, errors and omissions, workers compensation, machinery and boiler, and comprehensive automobile insurance. It is ERCOT management's observation that the insurance providers, in determining to do business with ERCOT and in establishing the insurance premiums to be paid for the coverage selected by ERCOT, have been interested in the extent of ERCOT's role in the electric market in Texas; the composition and responsibility of ERCOT's board of directors; the size, quality, and location of ERCOT's physical plant; and the size and professional composition of ERCOT's growing workforce rather than net income, profitability, and net unrestricted asset ratios and analysis. In recent months, ERCOT has renewed several insurance policies and not been denied any coverage by insurance providers.

Vendors – ERCOT's vendors are primarily interested in ERCOT's ability to pay for the goods and services for which it contracts. Each year, a few ERCOT vendors request information on ERCOT's financial position and performance.

OTHER GENERAL OBSERVATIONS

Users of ERCOT's financial statements have generally demonstrated greater interest in ERCOT's relationship with the PUCT and the company's ability to recover fees sufficient to allow repayment of debt service obligations and operating expenses than they have with net income and profitability measures. As a result, in deriving its conclusions management places heightened importance on qualitative factors and quantitative ratios relating to total assets and total expenses.

As a result of its organization as a cost pass-through, not for profit organization, subject to regulatory oversight, ERCOT management believes that many traditional, financial measures of materiality may not be appropriate for the assessment of materiality in connection with ERCOT's financial statements. The situation again leads management to places heightened importance on qualitative factors and quantitative ratios relating to total assets and total expenses when evaluating materiality issues.

- **2007 Project Prioritization Status**

- CO (Corporate Operations) reviewed & approved by PRS and TAC
- IO (IT Operations) reviewed & approved by PRS and TAC
- MO (Market Operations) reviewed & approved by COPS, PRS and TAC
- RO (Retail Operations) reviewed & approved by RMS, PRS and TAC
- SO (System Operations) reviewed & approved by WMS, ROS, PRS and TAC

2007 Project Priority list/funding Level Review

- 2007 Project Prioritization and Funding Request (non-Nodal)**

Program Area	Budget Request	Project Count	<u>Counts By Priority</u>			
			Carryover	Critical	High	High/Med
CO	\$ 5,750,000	31	2	13	16	0
IO	\$ 16,000,000	14	5	8	1	0
MO	\$ 2,058,000	16	7	1	7	1
RO	\$ 7,659,000	13	6	0	7	0
SO	\$ 4,908,000	17	9	8	0	0
Total	\$ 36,375,000	91	29	30	31	1

- **2007 Project Prioritization Notes by Program Area**

- CO

- Significant increase in requested funds due to enhanced ability to deliver projects that were prioritized low in prior years (Security staff is now in place)
- Many efforts in response to audit findings

- IO

- Large increase in funds to enhance data center efficiency and performance
- Improvements in data storage and backup are critical to ongoing support of production environment

- MO

- Reduced budget request due to Nodal resource demands
- Much of the MO list relates to EIS/EDW (data warehousing)

- RO

- Funding request is similar to prior years
- Large Carryover item for Texas SET 3.0/Mass Transition/Terms & Conditions

- SO

- Reduced budget request due to Nodal resource demands
- Only Carryover and Critical projects will be executed

2007 Project Priority list/funding Level Review

- CO Project Highlights - 2007**

Project Type	Budget	Count
CyberSecurity	\$ 2,258,037	7
Facilities	\$ 1,002,559	2
Document Management / Workflow / Reporting	\$ 884,031	9
Physical Security	\$ 562,671	4
Lawson	\$ 458,123	6
Other Projects	\$ 584,579	3
Total Funding Request	\$ 5,750,000	31
Total Unfunded Projects	\$ 1,131,827	4

2007 Project Priority list/funding Level Review

- IO Project Highlights - 2007**

Project Type	Budget	Count
Redesign Data Storage Methodology	\$ 6,428,436	1
Data Center Hardware Efficiencies	\$ 2,819,610	1
Storage Upgrade / Tape Backup Upgrade	\$ 2,811,591	2
Hardware Replacement	\$ 1,301,731	3
Minor Capital	\$ 1,400,000	1
Other Projects	\$ 1,238,632	6
Total Funding Request	\$ 16,000,000	14
Total Unfunded Projects	\$ 23,744,499	14

2007 Project Priority list/funding Level Review

- MO Project Highlights - 2007**

Project Type	Budget	Count
Data Warehouse	\$ 568,572	4
TML Wholesale Enhancements	\$ 497,225	1
Software Upgrades	\$ 431,486	2
Market Requests	\$ 245,000	6
Other Projects	\$ 615,717	3
Total Funding Request	\$ 2,058,000	16

Total Unfunded Projects	\$ 376,686	5
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2007 Project Priority list/funding Level Review

- **RO Project Highlights - 2007**

Project Type	Budget	Count
TX SET 3.0 / Mass Transition / Terms & Cond.	\$ 3,375,000	1
EDW (Enterprise Data Warehouse)	\$ 1,949,012	7
Add'l Market Requests	\$ 1,335,000	2
Other Projects	\$ 999,988	3
Total Funding Request	\$ 7,659,000	13

Total Unfunded Projects	\$ 5,256,422	13
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2007 Project Priority list/funding Level Review

- SO Project Highlights - 2007**

Project Type	Budget	Count
Operator Training Simulator	\$ 1,470,518	1
Compliance	\$ 1,364,194	6
Operations Support Study Environment	\$ 894,240	1
PUCT / IMM	\$ 456,835	4
Market Requests	\$ 110,000	3
Other Projects	\$ 612,213	2
Total Funding Request	\$ 4,908,000	17
Total Unfunded Projects	\$ 5,124,401	34

- **Assumptions and Impact**
 - **Assumption** is that our fee will remain flat
 - **Impact is** an increase in Capital Budget of \$11M over 2006
 - \$4.4M out of General Revenue \$6.6M Debt Funded

- **Options:**
 - Cut \$4.4M out of 2007 expenses
 - Seek reductions services elsewhere out of 2007 to cover 2007 project increase
 - Increase fee for 2007 to collect additional \$4.4M in revenue
 - Change Debt funding ratio (Increase debt financing)
 - From 40/60 to 28/72
 - Reduce 2007 Project List to Historical Levels (\$25M)

<open discussion>



Audit and Compliance, Incidence Response Preparedness, and Enterprise Risk Management Update

Steve Byone
Chief Financial Officer

Board of Directors Meeting
August 15, 2006

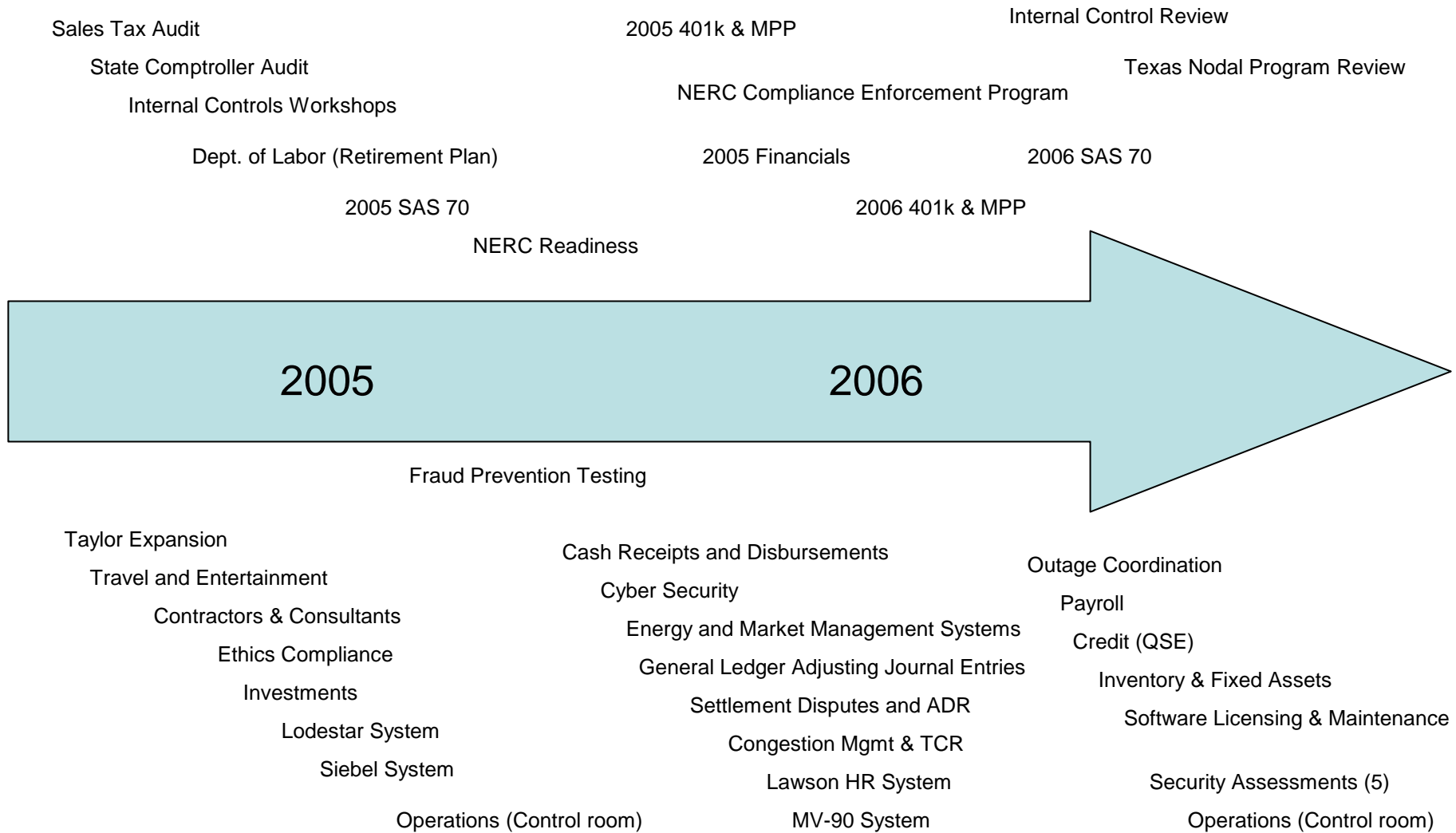
Agenda

- **Audit and Compliance Update**
- **ERCOT Incident Response Preparedness**
- **Enterprise Risk Management Update**

Audit Update

- **ERCOT has been subject to numerous External and Internal Audits and Formal Reviews**
- **In the last 18 months (beginning January 2005), ERCOT has been subject to 12 External Audits/Reviews and 22 Internal Audits**
- **Additionally, Management has recently completed a ‘self assessment’ of ongoing compliance with all applicable laws, regulations, protocols, contractual obligations, disclosure mandates, and other requirements**

Audits – 34 Completed, (12 External, 22 Internal, 13 in Progress)



August 2006 Recently Completed, Opened, and Planned Audits

<u>Audits Completed</u> (last three months)	<u>Open Audits</u>	<u>Planned Audits</u> (next 3 months)
<u>Internal Audits</u> <ul style="list-style-type: none"> • Lawson HR System • MV90 System • Payroll • Outage Coordination 	<u>Internal Audits</u> <ul style="list-style-type: none"> • Credit (QSE) • Inventory & Fixed Assets • Software Licensing & Maintenance • Fraud Prevention (ongoing) 	<u>Internal Audits</u> <ul style="list-style-type: none"> • Ethics Compliance • Consultants, Contractors & Compliance • Investments • Corporate Communications • System Operations • <i>Development of 2007 Audit Plan</i>
<u>External Audits</u> <ul style="list-style-type: none"> • 2005 Financial (PwC) 	<u>External Audits</u> <ul style="list-style-type: none"> • 2006 SAS70 (PwC) • Internal Controls (D&T) 	<u>External Audits</u> <ul style="list-style-type: none"> • Texas Nodal Program Review (managed by IAD) • 401k / MPP (PwC) • Various reviews of ERCOT's network and system security.

Status of Open Audit Points - 2006



Compliance Update

- **Each ERCOT Officer has been asked to identify the Compliance Requirements within their respective organizations**
- **For each requirement, an assessment is made of whether the area is in compliance, ‘substantially compliant’*, or not in compliance with any ‘non-yes’ answer requiring further explanation.**
- **Out of 98 areas identified, none were deemed to not be in compliance although 12 were deemed to be ‘substantially in compliance’:**
 - Details regarding ‘substantially in compliance’ are included in your Executive Session materials

* **Substantially Compliant**” means compliance with essential requirements of a statutory provision, standard, policy or procedure as may be sufficient for the accomplishment of the purpose thereof. As such, there may be an accidental mistake or a good business reason for a minor modification or deviation from the statutory provision, standard, policy or procedure, but that does not affect that substantial compliance has been met of the statutory provision, standard, policy or procedure.

- **Continue to address 12 ‘Substantially Compliant’ items by the end of 2006 so that ERCOT is in ‘full compliance’ in all areas**
- **Seek external review of identified Compliance Areas to confirm completeness and appropriateness**
- **Require quarterly signed Management Attestation as to the accuracy of the Compliance Certification Report**
- **Continue semi-annual review of compliance results with the Board of Directors**

ERCOT Incident Response Preparedness

- **As of the Beginning of 2006, ERCOT had outdated Emergency Preparation and Communications Plans, many dating from 2002 / 2003 and not generally known to Staff and Management**
 - Grid Operations has always had robust Communications and Disaster Recovery plans, however Market Operations and Corporate functions lacked up-to-date actionable procedures
- **During 2006, a comprehensive effort was undertaken to rewrite and update the various Incident Response plans as well as ‘run through’ simulated Emergency Situations.**
- **Additional effort is necessary to update IT Disaster Recovery Plans and System Architecture Recovery Processes**

ERCOT Incident Response Preparedness – August 2006

Managing a Crisis

Communicating About a Crisis

Crisis Management Plan

A plan that gives an overview of how to manage a crisis to minimize loss of grid reliability, injury, destruction or monetary losses. (last revised 2/04, update in progress)

Emergency Response Plan

A plan that details how to respond to an emergency situation at ERCOT. (last revised 06/06 and being rolled out, updated, and tested on an ongoing basis)

Crisis Communications Plan

A plan that details how to communicate with constituencies in a crisis. (Communications group working with other groups—final version ready for review 08/06)

Emergency Reporting & Response Policy

A high-level policy regarding ERCOT's response to emergencies. (last revised 5/05—update in process)

Disaster Recovery Plan

A plan that provides for the back-up and maintenance of electronic data. (last revised 04/03, Internal Disaster Recovery System Architect being hired within IT)

Business Continuity Plan

A plan that details recovery of operations for employees to complete their work in the event of a loss of one or both of ERCOT's operating facilities. (Baseline established 08/06)

Other Incident Response Preparation Activities

- **NERC has issued new Cyber Security (CIP) protocols which are being enacted at ERCOT**
- **Ongoing coordination with Texas Division of Emergency Management / State Operations Center and other State and Federal Resources**
- **ERCOT is in the process of adopting the NERC Guidelines on Pandemic Planning (“Bird Flu”)**
 - Ongoing contact is maintained with regional and national health authorities on current health alerts and ‘best practices’
 - Mechanisms are in place to control access by individuals to ERCOT facilities in case of a pandemic
 - Facilities, System Operations, IT, Legal, and Human Resources staff have been involved in planning for workplace interruptions
 - Medical, disinfectant, and isolation supplies are on hand
 - ERCOT has participated in a recent PJM conference on Avian Influenza planning and will host a Symposium on October 31, 2006

Enterprise Risk Management Update

- **ERCOT established a formal ERM program in 2005**
- **Management reviews key enterprise risks on a monthly basis**
- **Changes in management assessment of a key risk are reviewed by Finance & Audit Committee monthly**
- **Governance structure calls for a Board of Directors update semi-annually**
- **Appendix includes overview of ERCOT's ERM program**

August 2006 Risk Inventory "Stoplight" Report

ELECTRIC RELIABILITY COUNCIL OF TEXAS, INC. RISK MANAGEMENT EVENT PROFILE MATRIX (as of August 4th, 2006)

Strategic Position	Operational Excellence	Market Facilitation	Grid Reliability	Reporting	Compliance
<p>Strategy Development</p> <p>Objective setting adequately incorporates informed stakeholder input, market realities and management expertise</p> <p>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 ERO/RE and nature of a 'Quasi-state' entity environment increases risk.</p>	<p>Performance Monitoring</p> <p>Clearly defined performance metrics linked to mission and goals; actively monitored, status communicated and corrective action taken</p> <p>Management is undertaking a study to review the Executive Dashboard which will include recommendations for Key Performance Indicators (KPI's) to provide more meaningful information on goal performance. Management has instituted regular Quarterly Business Reviews to discuss key business activities.</p>	<p>Customer Choice</p> <p>Market design promotes efficient choice by customers of energy providers with effective mechanisms to change incumbent market participants as desired.</p> <p>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.</p>	<p>Grid Operations</p> <p>Information required to operate the grid is efficiently gathered and appropriate tools are prudently configured to efficiently operate the system</p> <p>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.</p>	<p>Review Practices</p> <p>Prudent measures are taken to insure that company disclosures are properly vetted and not misleading</p> <p>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.</p>	<p>Legal & Legislative</p> <p>Operations are conducted in compliance with all laws and regulations and current and proposed legislation is understood and communicated</p> <p>Increased efforts have been made to inform members of the legislature about ERCOT and the performance of its functions. In addition, ERCOT has initiated increased informational meetings with PUC decision-makers in order to discuss and coordinate our mutual understanding of PUC and ERCOT issues.</p>
<p>Mission and Goals</p> <p>Corporate objectives and performance standards are understood and followed</p> <p>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.</p>	<p>Business Practices</p> <p>Business planning, processes and management standards are effective and efficient</p> <p>Disaster recovery plans, record retention procedures, and safety practices are currently below desired expectations. Additional development activities required to implement and test these procedures. Recent completion and testing of Business Continuity, Crisis Communications, and Emergency Response plans have increased ERCOT's ability to adequately respond to an emergency situation.</p>	<p>Nodal Implementation</p> <p>Nodal Implementation is progressing in a timely fashion on budget and schedule within a defined scope.</p> <p>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</p>	<p>Planning</p> <p>Long-range planning methods enable efficient responses to necessary system changes to maintain reliability standards</p> <p>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. Long range planning issues must address increased load growth forecasts as well as review adequacy of current spinning reserve requirements.</p>	<p>Disclosure</p> <p>Reporting and other disclosures to intended parties is timely, accurate and effective</p> <p>A Disclosure Committee is in the process of being institutionalized to discuss and report on issues related to external reporting and compliance. An initial review has been performed of all ERCOT departmental disclosure requirements and has not discovered any material issues related to the timeliness or accuracy of disclosures.</p>	<p>Internal Control Compliance</p> <p>Internal Control Compliance, processes and management standards are effective and efficient</p> <p>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 Q2 2006, staffing turnover has resulted in new individuals filling positions who have not received adequate ICMP training</p>
<p>Reputation</p> <p>Positive perceptions by stakeholders typically lead to less cost and greater flexibility resulting in enhanced enterprise value</p> <p>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. Impact from the 2004 scandal has been largely mitigated at this point due to ICMP changes, convictions and settlements.</p>	<p>Human Resources</p> <p>Organization design, managerial and technical skills, bench strength and reward systems are aligned with corporate goals</p> <p>While we are beginning to reduce the number of open positions, a large number of openings continues to be a focus of attention for ERCOT. The current compensation structure is outdated, which reduces our ability to effectively attract and retain excellent employees. Some of our current procedures and the employee handbook also need to be reviewed and updated for accuracy and accountability.</p>	<p>Counterparty Credit</p> <p>Bankruptcies and other capital deficiencies increase the cost for market participants and potentially impact Grid reliability through participant failure</p> <p>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%</p>	<p>Bulk System Resources</p> <p>Market Participants have constructed and made available adequate bulk electric grid resources</p> <p>Uncertainty surrounding generation projects, installed and operational capacity, and the high dependency on natural gas in Texas' generation fleet may impact reliability. Further study is underway to determine bulk system resource adequacy given increased load growth beyond current expectations.</p>	<p>Communication</p> <p>Internal and external communications are timely and effective</p> <p>Since the events of April 17th, ERCOT has implemented several corrective measures. Meetings have been conducted with most of the members of the Texas Legislature who have jurisdictional responsibility over ERCOT, a crisis management project for communications is in its final stages and a presentation showing a new External Relations organization for ERCOT will be made at the next Board meeting.</p>	<p>Industry Standards</p> <p>Business practices provide stakeholders with required assurances of quality</p> <p>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 with remediation activities underway to address preliminary findings.</p>
<p>Fiscal Management</p> <p>ISO design requires competent, prudent and cost effective provision of services</p> <p>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. Issues surrounding Nodal implementation budgeting, staffing allocations, and cost recovery have not been fully addressed.</p>	<p>Technology Infrastructure</p> <p>Information systems and data are effectively managed and are reliable</p> <p>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.</p>	<p>Administration, Settlement & Billing</p> <p>Market rules are fairly applied to all participants and accounting is timely and accurately reflects electricity production and delivery</p> <p>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.</p>	<p>Operational Responsibility</p> <p>Market participants conduct their operations in a manner which facilitates consistent grid reliability</p> <p>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.</p>	<p>Adequacy and Integrity</p> <p>Robust processes exist to support management assertions embodied within financial reports</p> <p>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.</p>	<p>Regulatory Filings</p> <p>Evidence, testimony and other supporting materials are compelling and successful</p> <p>Filings are completed timely and accurately. Ongoing management of competing priorities is necessary to avoid impacting the accuracy and timeliness of filings. Recent issues have surfaced in the rate surcharge request for Nodal funding.</p>

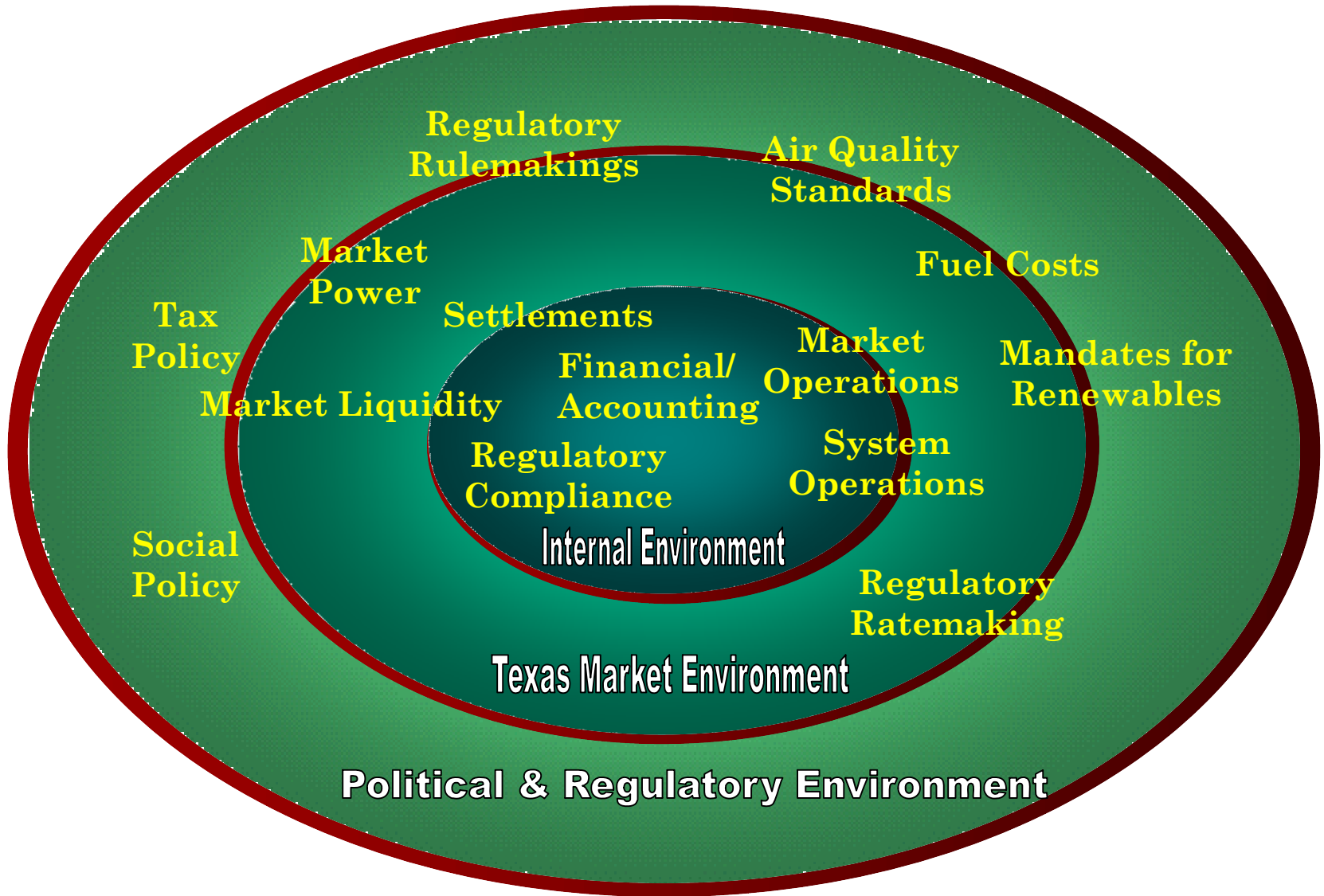
Legend: Elevated Risk Level Reduced Risk Level Special Attention Required (New Risk Categories / Descriptions Indicated in Green)

Comments or Questions?

Appendix: ERCOT ERM Concepts

- **Risk is the potential for loss due to uncertain future business factors:**
 - Internal factors such as employee actions, lack of controls, training deficiencies, etc.
 - External factors such as credit risk, market participant performance, fuel availability, weather (hurricanes), etc.
- **“Loss” refers to falling short of performance expectations**

ERM Concepts: ERCOT Risk Environment



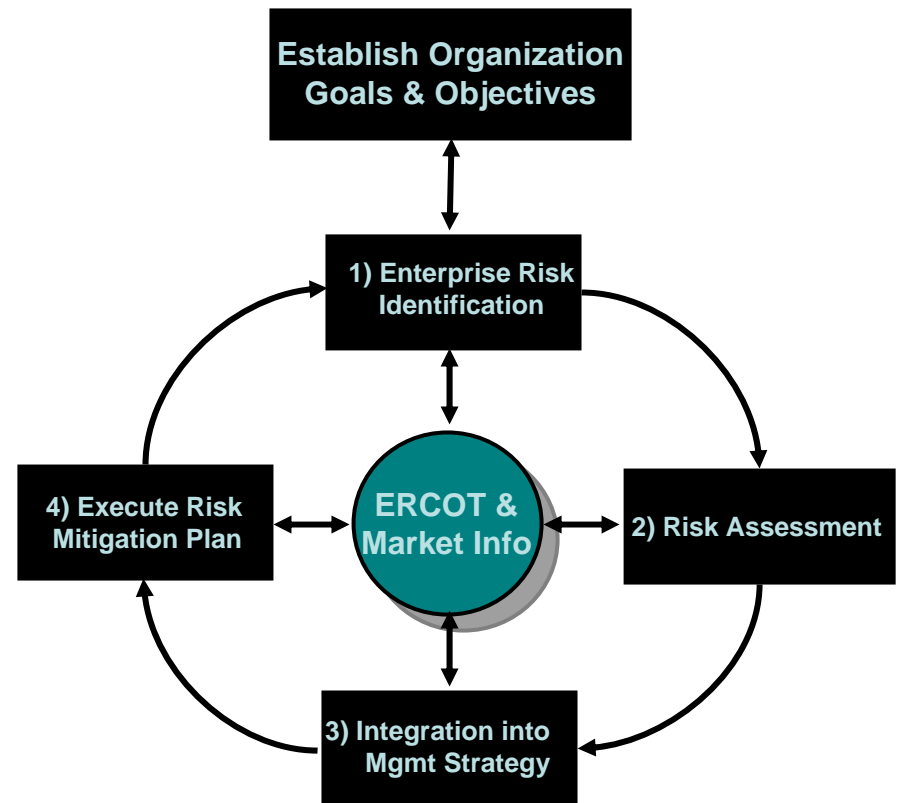
Examples of possible “loss” ERCOT could experience due to risk:

- **Blackout**
- **Unreliable systems**
- **Inaccurate settlements**
- **Credit losses**
- **Compliance failure / fines, penalties**
- **Negative public press**
- **Loss of credibility**
- **Increased regulatory scrutiny**
- **Possible unfavorable legislation**

In short, inability to fulfill core mission

The major goals of the ERCOT ERM Program are to:

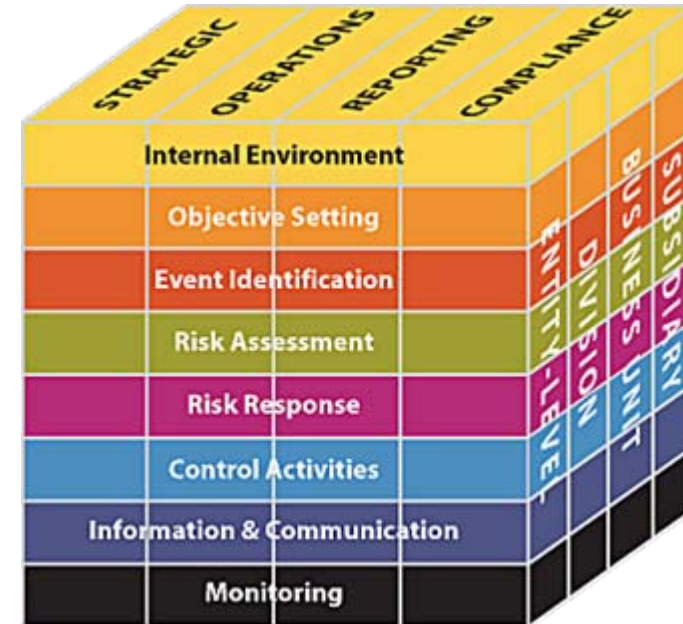
- **Identify risks and how they cross enterprise boundaries.**
- **Quantify risk through analysis and assessment.**
- **Develop plans, strategies, and contingencies for managing identified risks.**
- **Implement and administer the plans developed.**



ERM Concepts: The COSO ERM Framework

- **The COSO ERM framework defines essential components, suggests a common language, and provides clear direction and guidance for enterprise risk management.**
- **ERCOT currently employs the COSO framework for the Internal Control Management Program and the ERM framework is a natural extension.**
- **The COSO framework has the support of leading Financial and Accounting Associations in the United States**
- **The COSO framework is the primary vehicle used by public entities subject to Sarbanes-Oxley compliance.**

COSO ERM Framework



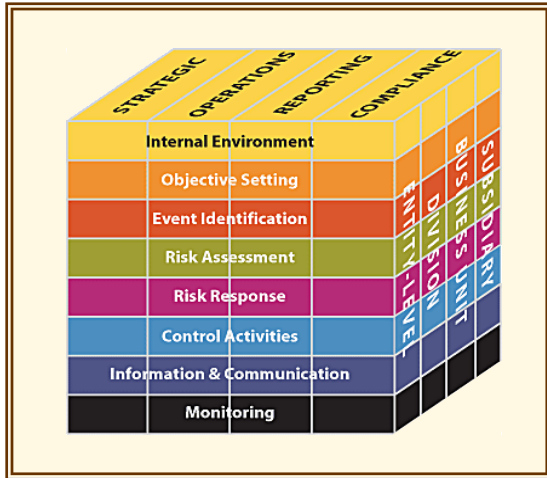
Entity objectives can be viewed in the context of four categories:

- Strategic
- Operations
- Reporting
- Compliance

ERCOT's ERM Framework

The COSO ERM Framework

ERCOT has aligned its ERM program with the COSO Integrated Framework for Enterprise Risk Management



ERCOT Risk Categories

Strategic Position

Operations

- Operational Excellence
- Market Facilitation
- Grid Reliability

Reporting

Compliance

ERCOT ERM Concepts

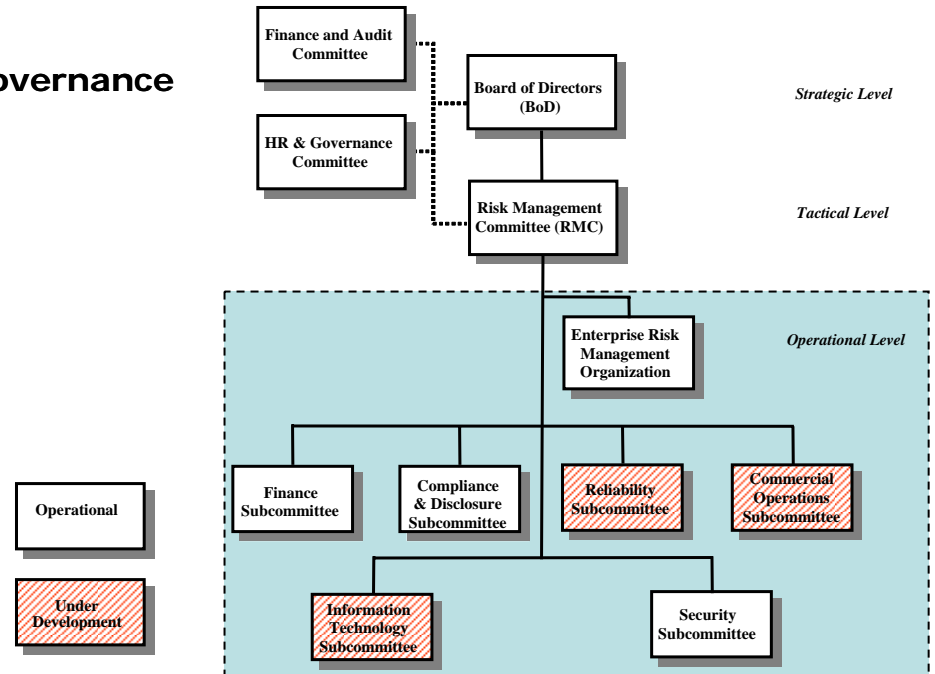
Program's Purpose

Ensure that risks are dynamically identified, evaluated, managed, and monitored across the company within established risk philosophies, policies, standards, and the Board's tolerances;
Provide for consolidated risk measurement analysis & strategy; and
Provide for enterprise-wide risk-adjusted performance measurement capabilities.

Conceptual Design

Dynamic identification, evaluation, management and monitoring of risks throughout the company.
Consolidated risk measurement, analysis and strategy
Formally assigning accountability & responsibility for risk management.

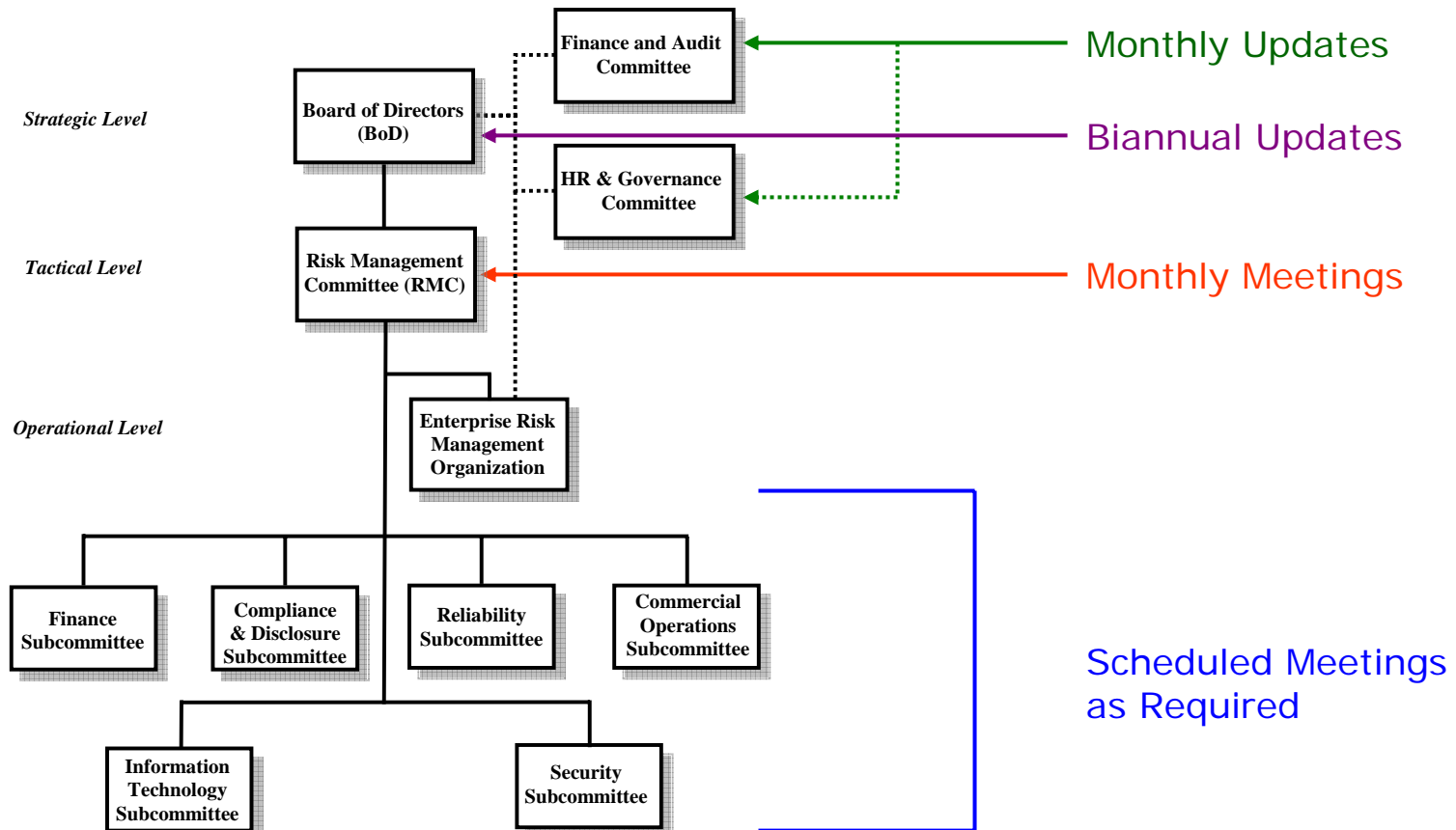
Governance



ERCOT ERM Framework: Oversight and Reporting

ERM Governance Structure

Update Frequency



ERCOT ERM Framework: Key Accountabilities

- **ERCOT Board of Directors** is responsible for recognizing all risks ERCOT is exposed to; and for ensuring that the requisite risk management culture, policies, practices, and resources are in place.
- **ERCOT CEO** is responsible for ensuring that the company's activities are carried out within the parameters of the risk management framework and for informing the Board of risks taken in pursuit of the company's objectives.
- **ERCOT Line Management** is responsible for the comprehensive management of risks arising from activities within their respective areas.

ERCOT has established a Risk Management Committee (RMC) which meets on a monthly basis to oversee ERCOT's management of corporate risks. The current members of the RMC are:

Sam Jones, CEO	Jim Brenton, Security	Steve Byone, CFO
Nancy Capezzuti, HR	Ray Giuliani, CMO	Ron Hinsley, CIO
James Thorne, GC	* Bill Wullenjohn, IA	

* Regular invitee

The Risk Management Committee is assisted by the Manager, ERM and a number of operational subcommittees.

Currently, six subcommittees supporting the Risk Management Committee are contemplated:

- **Finance** – Reviews interest rate, credit, liability mgmt, insurance and other financial exposures.
(Steve Byone – Chair)
- **Reliability** – Reviews generation and transmission adequacy plans, forecast assessments and other reliability related risks.
(Kent Saathoff – Chair; Under Development)
- **Compliance & Disclosure** – Reviews strategies and performance in complying with applicable laws, regulations, codes, contractual agreements and standards.
(James Thorne – Chair)
- **Commercial Operations** – Reviews market structure, market performance, settlements, dispute resolutions and other market related risks.
(Ray Giuliani – Chair; Under Development)
- **Security** – Reviews physical and cyber security plans, potential threats to critical resources, business continuity and other security related risks.
(Jim Brenton – Chair)
- **Information Technology** – Reviews IT strategies and standards for availability and accessibility of ERCOT's IT infrastructure including systems redundancy, systems development, data management and integrity and other IT related risks.
(Ron Hinsley – Chair; Under Development)

Preview of Board Credit Presentation

Cheryl Yager



Board of Directors

August 15, 2006

Credit Update

Some goals for credit policy in the ERCOT market

- **Provide a financially stable and viable market**
 - Amount of any residual credit risk should not endanger the overall financial stability of the market
- **Ensure all market participants understand the financial risks associated with any residual credit exposure accepted in the market**
 - If credit risk is not mitigated, there will be losses whenever there is a Mass Transition. Losses may be of the order of magnitude described in this presentation.
- **Address credit risks as they are identified**

In 2005, the market experienced several Mass Transition events

- The market experienced losses of approximately \$5,800,000 related to these events
- The market began a review of processes and procedures around Mass Transition as a result of these losses

Many market groups and ERCOT staff have worked hard toward improving the ERCOT credit profile:

TAC, PRS, WMS, RMS, COPS, Texas SET task force, and Credit Working Group have all played important roles in the review process

- Current solution reduces Mass Transition timeline from about 22 days to approximately 15 days
 - By June 2007 an additional 5 days will be cut
- PRR 625 increased notice period for QSE dropping an LSE from 5 business days to 12 business days (effectively collateral)
- PRR 568 reduces settlement date from 17 to 10 days after operating day
- PRR 638 changes the settlement invoice due date from 16 calendar days to 5 business days
- PRR 643 reduces the number of days allowed to cure a breach from 3 days to 2 days

Further improvements being considered

Credit WG, as directed by the F&A committee, has initiated a Protocol Revision Request to:

- Reduce time to post collateral from 2 bus days to 1 bus day
 - munis and coops may continue to have 2 bus days
- Reduce time to cure a breach from 2 bus days to 1 bus day
 - This requires all QSEs, LSEs, etc. to sign new or amended contracts, which may not be fully complete until April 2007.
- Create a working credit limit which allows an entity to utilize up to 85% of posted collateral + unsecured credit limit (rather than 100%)

This PRR will be vetted by the full market through the Protocol Revision process.

Credit WG also proposes to leave collateral calculation at 40 days (allowing the 7 days of reduced credit exposure achieved with PRR 568 to be used to compensate for the increased credit exposure related to Mass Transition)

Credit WG and ERCOT staff will continue to evaluate the use of credit insurance separately.

- If the above changes are made, Credit WG would propose to make no additional changes to the EAL calculation for a year unless significant new risk factors are identified.

Revised timelines (in business days)

	<u>Orig</u>	<u>Curr</u>	<u>Long</u>	<u>Further</u>
Identify problem / make collateral call	0	0	0	0
<u>Notice periods</u>				
• Collateral due	2	2	2	1
• Notice of default given	3	2	2	1
• 2 BDays to cure default	6	4	4	2
<u>Mass transition</u>				
• Conference call to begin process	7	5	5	3
• POLRs / ERCOT initiate switches	10-12	8	6	4
• Switch complete by TDSP	16-18	11	8	6
Calendar days (approx)	<u>22-26</u>	<u>15-17</u>	<u>10-12</u>	<u>8-10</u>

Revised potential loss in exit scenario

Potential loss (simplified – w / 3 weeks of collateral) (in 000's)

	Orig	Curr	Long	Further
Collateral held ⁽¹⁾				
1,000 MWh/day x \$100/MWh =	\$140	\$ 210	\$ 210	\$ 210
x 10% x 21 days				
At default				
1,000 MWh/day x \$100/MWh =	<u>\$ 2,200</u>	<u>\$ 1,500</u>	<u>\$ 1,000</u>	<u>\$ 800</u>
x 100% x ? days				
Potential market loss	\$ 2,060	\$ 1,290	\$ 790	\$ 590
For 100 MWh/day	\$ 206	\$ 129	\$ 79	\$ 59
For 10,000 MWh/day	\$20,600	\$12,900	\$ 7,900	\$ 5,900
Reduction in exposure		37%	62%	71%

(1) Collateral held for Mass Transition events increased with the implementation of PRR 568 given that collateral is maintained at 40 days and credit exposure for historical activity was reduced by 7 days with PRR 568.

Historical look – QSE dropping an LSE

Estimated Savings - QSE dropping an LSE

Entity	Est MWh/day	Est ESIDs	Tot Est Exposure	After Interim Changes - Est Savings		After Final Changes - Est Savings	
LSE 1	350	3,000	410,000	355,000	87%	391,000	95%
LSE 2	3,500	12,250	5,160,000	4,941,000	96%	5,100,000	99%
LSE 3	1,500	10,000	(liab paid)	-		-	
			<u>5,570,000</u>	<u>5,296,000</u>	95%	<u>5,491,000</u>	99%
Estimated residual liability				<u>274,000</u>		<u>79,000</u>	

Note: Savings are primarily due to the **combined** impact of reducing the mass transition timeline and increasing the QSE's required notice (from 5 to 12 business days)

Historical look – QSE and LSE are the same entity

Estimated Savings - QSE and LSE the same entity

Entity	Est MWh/day	Est ESIDs	Tot Est Exposure	After Interim Changes - Est Savings		After Final Changes - Est Savings	
QSE 1	50	500	30,000	10,000	33%	24,000	80%
QSE 2	65	550	200,000	91,000	46%	121,000	61%
QSE 3	125	2,500	(liab paid)	-		-	
			230,000	101,000	44%	145,000	63%
Estimated residual liability				129,000		85,000	

Note: Savings are primarily due to reducing the mass transition timeline.

Other options being considered to further reduce risk

- **Reduce timeline for Mass Transition**
 - Most benefit has been obtained or will be obtained with combination of current, proposed and long term solution

- **Increase collateral requirements**
 - Currently considered on only a limited basis
 - See next slide for cost analysis of full collateralization

- **Purchase credit insurance**
 - Cost analysis still being completed
 - Will not cover all entities

- **Create a self-funded default reserve**
 - Potentially risk adjusted (higher risk entities pay at a higher rate)
 - Funded based on either their use of the BES, base amount of load, or a combination of both

- **Accept some level of residual credit exposure**

Estimated cost of collateral (for those that must post collateral) vs. Estimated cost of losses (as absorbed by the entire market)

	Estimated Load (000's)	# of days of add'l collateral?	Estimated \$/MWh	Estimated cost of capital	Add'l coll req'd marketwide (000's) (1)	Potential annual cost of req'd collateral (000's) (1)	In cents / MWh	
Load that meets credit standards	23%	230	6	\$ 100	none			
Load that posts Guaranty	41%	410	6	\$ 100	2%	\$ 246,000	4,920	0.033 paid by those posting collateral
Load that posts LC or cash	36%	360	6	\$ 100	12%	\$ 216,000	25,920	0.197 paid by those posting collateral
Total estimated MWhs/day in the market	100%	<u>1,000</u>						
Losses in 2002		1,000				-	-	paid by entire market
Losses in 2003		1,000				15,000	0.041	paid by entire market
Losses in 2004		1,000				-	-	paid by entire market
Losses in 2005		1,000				5,800	0.016	paid by entire market
Average losses over the past four years						<u>20,800</u>	(2) <u>0.014</u>	paid by entire market
Future? (0-\$30,000 or more?)		<u>1,000</u>				<u>30,000</u>	<u>0.082</u>	
Sample cost of capital								
	Cap Struc	Cost	WAC					
Debt	65%	10%	6.50%					
Equity	35%	15%	5.25%					
Total	100%		11.75%					

Notes

- (1) Balances are based on collateralizing for 100% of load for 6 days, which is approximately what it would take to fully collateralize for potential Mass Transition events after all other planned or proposed actions are taken.
- (2) Historical losses are not a predictor of future losses

- **Risk of catastrophic losses**

- From previous slides, have some quantification of potential losses related to Mass Transition scenarios for entities up to 10,000 MWh/day
 - Other scenarios can exist
 - Other types or size of entities can be involved
- Should we seek to insure or mitigate in some way?
 - At what cost?

- **Risk of losses from smaller defaults**

- Should we seek to insure or mitigate in some way?
 - At what cost?

Questions?

Audits Completed (last three months)

Internal Audits

- Lawson HR System
- MV90 System
- Payroll
- Outage Coordination

External Audits

- 2005 Financial (PwC)

Open Audits

Internal Audits

- Credit (QSE)
- Inventory & Fixed Assets
- Software Licensing & Maintenance
- 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
- Corporate Communications
- System Operations
- *Development of 2007 Audit Plan*

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.

ERCOT Market Credit Status

	as of 06/30/2006					as of 07/31/2006				
	# 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	
Exposure in the ERCOT Market (owed to ERCOT)										
<u><i>QSEs that meet ERCOT Creditworthiness Standards</i></u>										
Ratings over BBB-	6	22,049,374	7%	60,454,206	U	5	22,044,644	7%	36,454,206	U
<u><i>QSEs that do not meet ERCOT Creditworthiness Standards</i></u>										
Ratings below BBB- or not rated										
Cash & Letters of Credit	38	149,408,282	48%	292,504,282	S	43	201,522,638	68%	302,167,695	S
Guarantee Agreements	11	138,772,412	45%	304,217,000	S	14	74,167,371	25%	336,361,000	S
Total Exposure	55	310,230,068	100%			62	297,734,653	100%		
Other QSEs in the ERCOT Market (ERCOT owes)										
<u><i>QSEs that meet ERCOT Creditworthiness Standards</i></u>										
Ratings over BBB-	10	(11,931,460)	-15%	118,473,505	U	12	(16,391,996)	-22%	142,473,505	U
<u><i>QSEs that do not meet ERCOT Creditworthiness Standards</i></u>										
Ratings below BBB- or not rated										
Cash & Letters of Credit	45	(37,245,563)	-46%	94,473,527	S	42	(43,808,270)	-60%	64,553,420	S
Guarantee Agreements	13	(31,848,296)	-39%	120,544,000	S	10	(13,063,766)	-18%	92,400,000	S
Total	68	(81,025,319)	-100%			64	(73,264,032)	-100%		
Total	123					126				

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

ELECTRIC RELIABILITY COUNCIL OF TEXAS, INC.
RISK MANAGEMENT EVENT PROFILE MATRIX (as of August 4th, 2006)

Strategic Position	Operational Excellence	Market Facilitation	Grid Reliability	Reporting	Compliance
<p> Strategy Development</p> <p><i>Objective setting adequately incorporates informed stakeholder input, market realities and management expertise</i></p> <p>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 ERO/RE and nature of a 'Quasi-state' entity environment increases risk.</p>	<p> Performance Monitoring</p> <p><i>Clearly defined performance metrics linked to mission and goals; actively monitored, status communicated and corrective action taken</i></p> <p>Management is undertaking a study to review the Executive Dashboard which will include recommendations for Key Performance Indicators (KPI's) to provide more meaningful information on goal performance. Management has instituted regular Quarterly Business Reviews to discuss key business activities.</p>	<p> Customer Choice</p> <p><i>Market design promotes efficient choice by customers of energy providers with effective mechanisms to change incumbent market participants as desired.</i></p> <p>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.</p>	<p> Grid Operations</p> <p><i>Information required to operate the grid is efficiently gathered and appropriate tools are prudently configured to efficiently operate the system</i></p> <p>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.</p>	<p> Review Practices</p> <p><i>Prudent measures are taken to insure that company disclosures are properly vetted and not misleading</i></p> <p>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.</p>	<p> Legal & Legislative </p> <p><i>Operations are conducted in compliance with all laws and regulations and current and proposed legislation is understood and communicated</i></p> <p>Increased efforts have been made to inform members of the legislature about ERCOT and the performance of its functions. In addition, ERCOT has initiated increased informational meetings with PUC decision-makers in order to discuss and coordinate our mutual understanding of PUC and ERCOT issues.</p>
<p> Mission and Goals</p> <p><i>Corporate objectives and performance standards are understood and followed</i></p> <p>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.</p>	<p> Business Practices</p> <p><i>Business planning, processes and management standards are effective and efficient</i></p> <p>Disaster recovery plans, record retention procedures, and safety practices are currently below desired expectations. Additional development activities required to implement and test these procedures. Recent completion and testing of Business Continuity, Crisis Communications, and Emergency Response plans have increased ERCOT's ability to adequately respond to an emergency situation.</p>	<p> Nodal Implementation </p> <p><i>Nodal Implementation is progressing in a timely fashion on budget and schedule within a defined scope.</i></p> <p>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</p>	<p> Planning</p> <p><i>Long-range planning methods enable efficient responses to necessary system changes to maintain reliability standards</i></p> <p>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. Long range planning issues must address increased load growth forecasts as well as review adequacy of current spinning reserve requirements.</p>	<p> Disclosure</p> <p><i>Reporting and other disclosures to intended parties is timely, accurate and effective</i></p> <p>A Disclosure Committee is in the process of being institutionalized to discuss and report on issues related to external reporting and compliance. An initial review has been performed of all ERCOT departmental disclosure requirements and has not discovered any material issues related to the timeliness or accuracy of disclosures.</p>	<p> Internal Control Compliance</p> <p><i>Internal Control Compliance, processes and management standards are effective and efficient</i></p> <p>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 Q2 2006, staffing turn-over has resulted in new individuals filling positions who have not received adequate ICOMP training</p>
<p> Reputation </p> <p><i>Positive perceptions by stakeholders typically lead to less cost and greater flexibility resulting in enhanced enterprise value</i></p> <p>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. Impact from the 2004 scandal has been largely mitigated at this point due to ICOMP changes, convictions and settlements.</p>	<p> Human Resources</p> <p><i>Organization design, managerial and technical skills, bench strength and reward systems are aligned with corporate goals</i></p> <p>While we are beginning to reduce the number of open positions, a large number of openings continues to be a focus of attention for ERCOT. The current compensation structure is outdated, which reduces our ability to effectively attract and retain excellent employees. Some of our current procedures and the employee handbook also need to be reviewed and updated for accuracy and accountability.</p>	<p> Counterparty Credit</p> <p><i>Bankruptcies and other capital deficiencies increase the cost for market participants and potentially impact Grid reliability through participant failure</i></p> <p>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%</p>	<p> Bulk System Resources</p> <p><i>Market Participants have constructed and made available adequate bulk electric grid resources</i></p> <p>Uncertainty surrounding generation projects, installed and operational capacity, and the high dependency on natural gas in Texas' generation fleet may impact reliability. Further study is underway to determine bulk system resource adequacy given increased load growth beyond current expectations.</p>	<p> Communication </p> <p><i>Internal and external communications are timely and effective</i></p> <p>Since the events of April 17th, ERCOT has implemented several corrective measures. Meetings have been conducted with most of the members of the Texas Legislature who have jurisdictional responsibility over ERCOT, a crisis management project for communications is in its final stages and a presentation showing a new External Relations organization for ERCOT will be made at the next Board meeting.</p>	<p> Industry Standards</p> <p><i>Business practices provide stakeholders with required assurances of quality</i></p> <p>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 with remediation activities underway to address preliminary findings.</p>
<p> Fiscal Management </p> <p><i>ISO design requires competent, prudent and cost effective provision of services</i></p> <p>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. Issues surrounding Nodal implementation budgeting, staffing allocations, and cost recovery have not been fully addressed.</p>	<p> Technology Infrastructure</p> <p><i>Information systems and data are effectively managed and are reliable</i></p> <p>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.</p>	<p> Administration, Settlement & Billing</p> <p><i>Market rules are fairly applied to all participants and accounting is timely and accurately reflects electricity production and delivery</i></p> <p>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.</p>	<p> Operational Responsibility</p> <p><i>Market participants conduct their operations in a manner which facilitates consistent grid reliability</i></p> <p>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.</p>	<p> Adequacy and Integrity</p> <p><i>Robust processes exist to support management assertions embodied within financial reports</i></p> <p>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.</p>	<p> Regulatory Filings</p> <p><i>Evidence, testimony and other supporting materials are compelling and successful</i></p> <p>Filings are completed timely and accurately. Ongoing management of competing priorities is necessary to avoid impacting the accuracy and timeliness of filings. Recent issues have surfaced in the rate surcharge request for Nodal funding.</p>

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

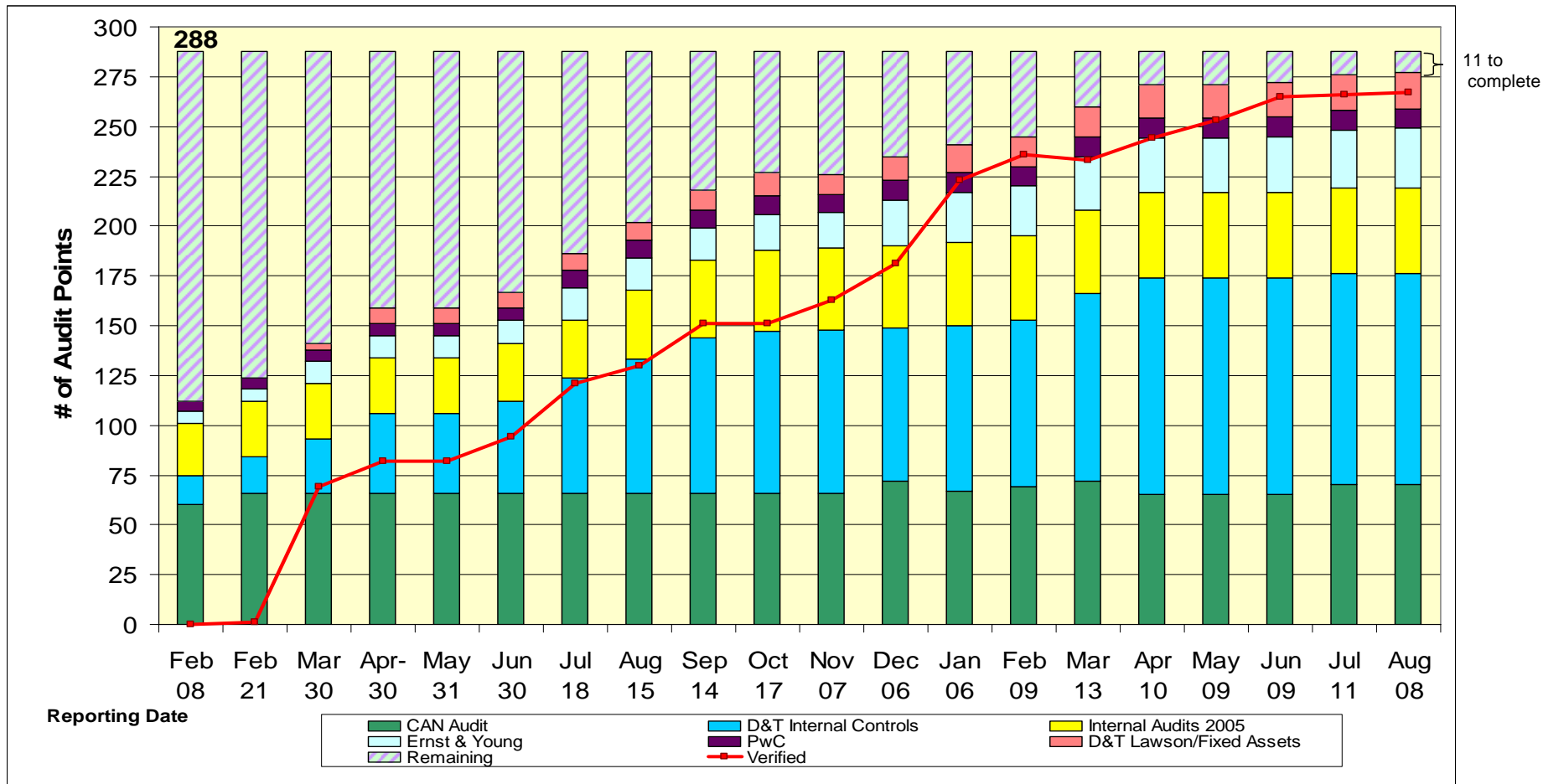
Rationale for Category Risk Assessment Changes

Reputation
Fiscal Management
Communication
Legal & Legislative

Upgrade
Downgrade
Upgrade
Upgrade

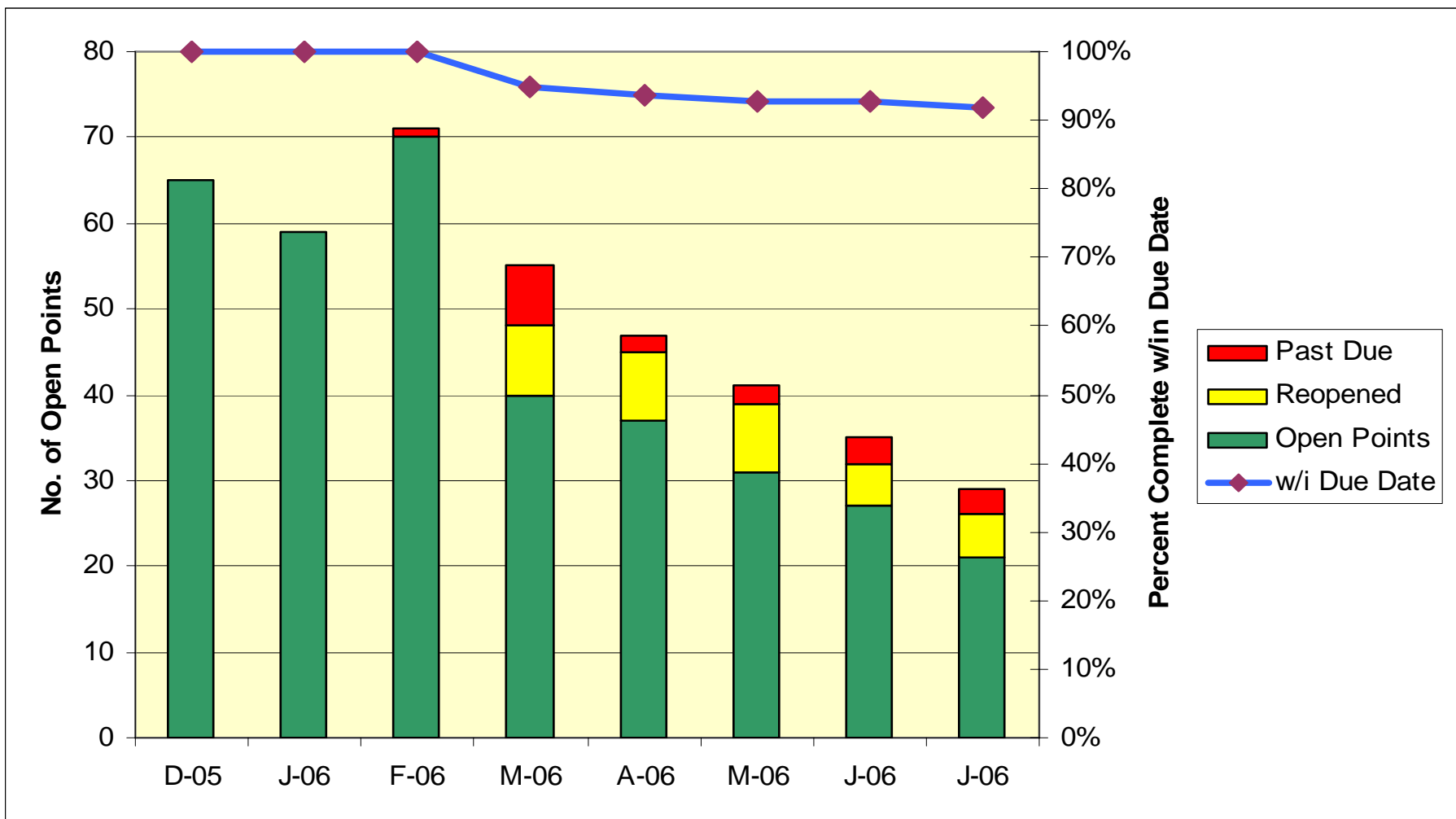
Impact of past negative events has been largely mitigated by recent activities and resolution of 2004 scandal prosecutions
Budgetary issues related to short and long term Nodal Cost and Revenue Recovery Impact have not been fully addressed
Development of a Crisis Communications plan and Regulatory and Market Participant input has reduced communications risk
Direct and ongoing interaction with legislative and regulatory stakeholders has helped in developing heightened mutual understanding

Completion Status by Audit 2004-05 Audit Points

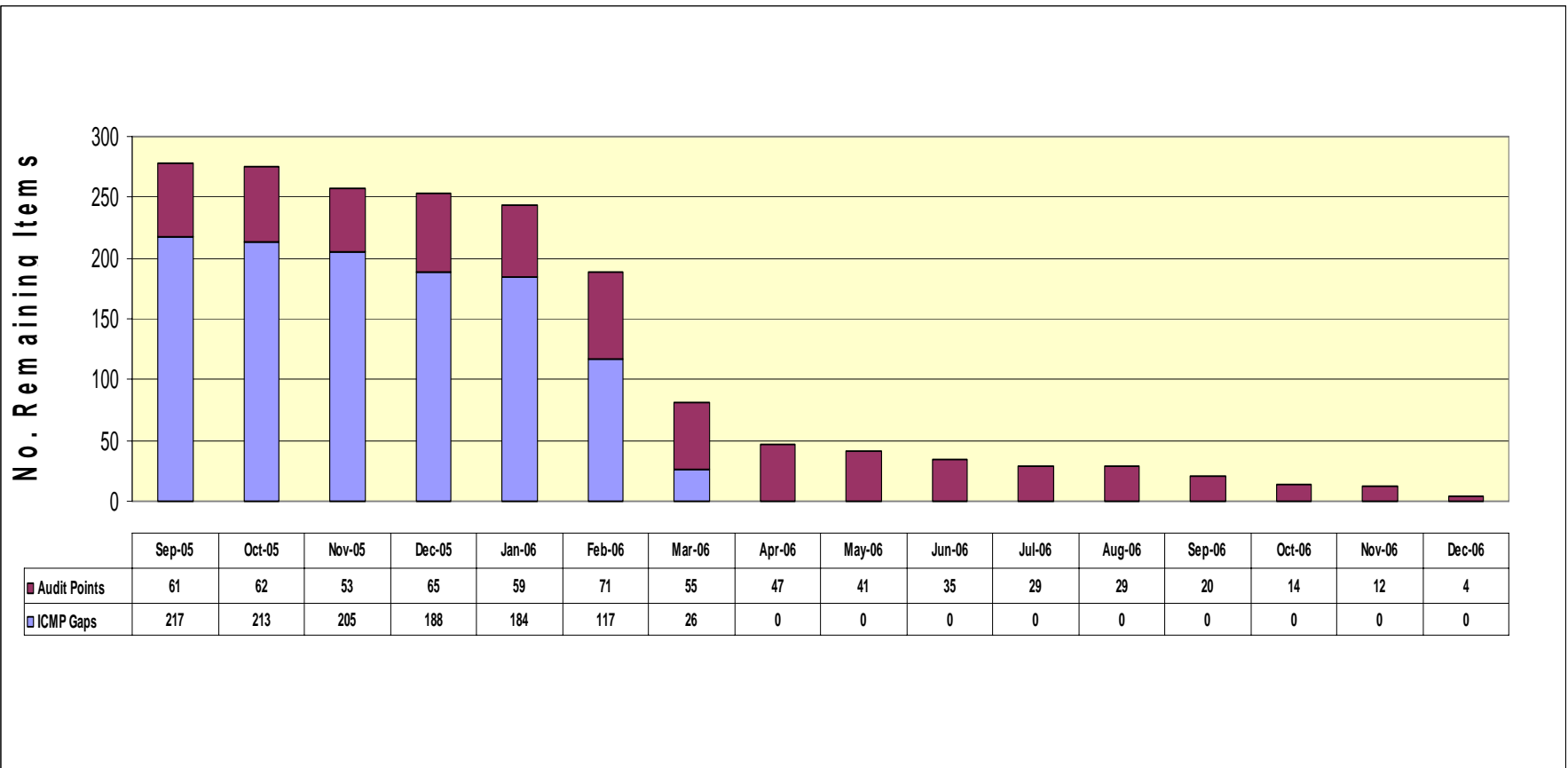


11 to complete

Status of Open Audit Points - 2006



Projected Audit Point and ICMP Gap Progress

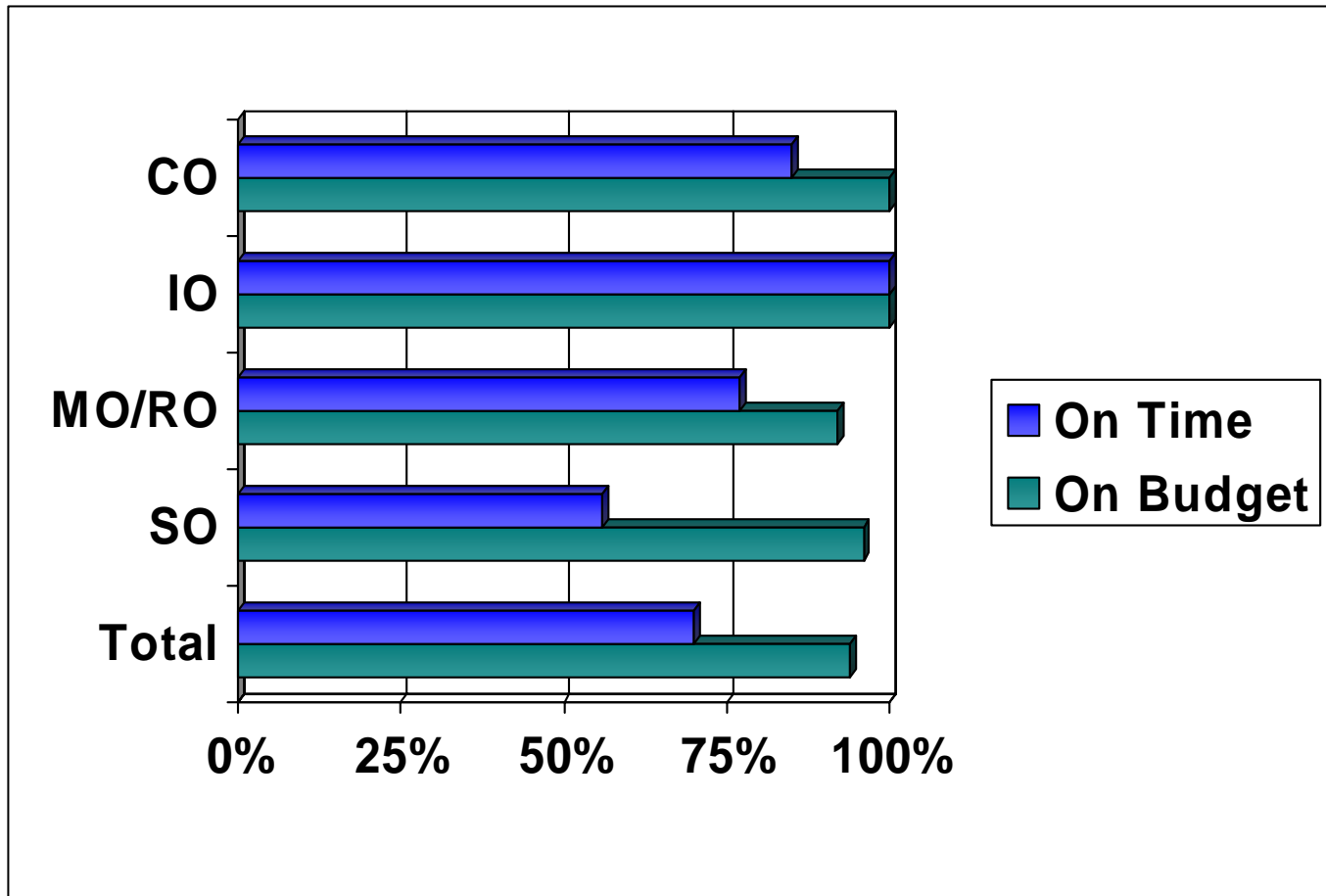


















2006 Year to Date Project Activity by Division

	Phase	Not Started	Initiation	Planning	Execution	Closing	Completed *	Cancelled	On Hold	Totals by CART
CART	CO	0	0	3	7	1	2	0	0	13
	IO	0	1	2	4	2	7	0	0	16
	MO/RO	0	0	8	11	4	2	1	2	28
	SO	2	3	4	9	1	10	2	4	35
	Totals by Phase	2	4	17	31	8	21	3	6	92

*NOTE: 2 projects completed in the month of July

2006 Year to Date Completed and Active Projects Performance



Projects Over \$1M	Total Budget	Actual 07/31/06	Metrics	
Duration/Information (Sponsor)	Phase/Scheduled Completion		Schedule	Budget
Service Oriented Architecture (2004-2006)	\$8.3M	\$6.5M		
<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	\$1.6M		
<i>Training Simulator System for Operators (S. Jones)</i>	<i>Execution Phase/2nd Qtr 2007</i>			
Enhancements to FasTrak Tools (2005-2006)	\$2.5M	\$2.3M		
<i>Schedule moved from 6/17/06 to 8/26/06 with Market input. On track to complete on 8/26/06.</i>				
<i>Tool for Tracking Market Issues (R. Giuliani)</i>	<i>Execution Phase/3rd Qtr 2006</i>			
Enhancements to SCR727 (2005-2006)	\$1.9M	\$534K		
<i>Entered into Execution (R. Giuliani)</i>	<i>Execution Phase/3rd Qtr 2006</i>			
Austin QA Build out (2005-2006)	\$1M	\$857K*		
<i>*Outside services and hardware reclassified resulting in decreased actuals from June to July.</i>				
<i>Entered into Testing (R. Hinsley)</i>	<i>Execution Phase/3rd Qtr 2006</i>			
Enhancements to AREVA Study Tools (2006)	\$1.2M	\$300K		
<i>Entered Execution (S. Jones)</i>	<i>Execution Phase/1st Qtr 2007</i>			
SBC Fiber Build Out (2005-2006)	\$1.4M	\$247K		
<i>Fiber Build Out from Taylor to Austin (R. Hinsley)</i>	<i>Execution Phase/3rd Qtr 2006</i>			

Projects Completed in July

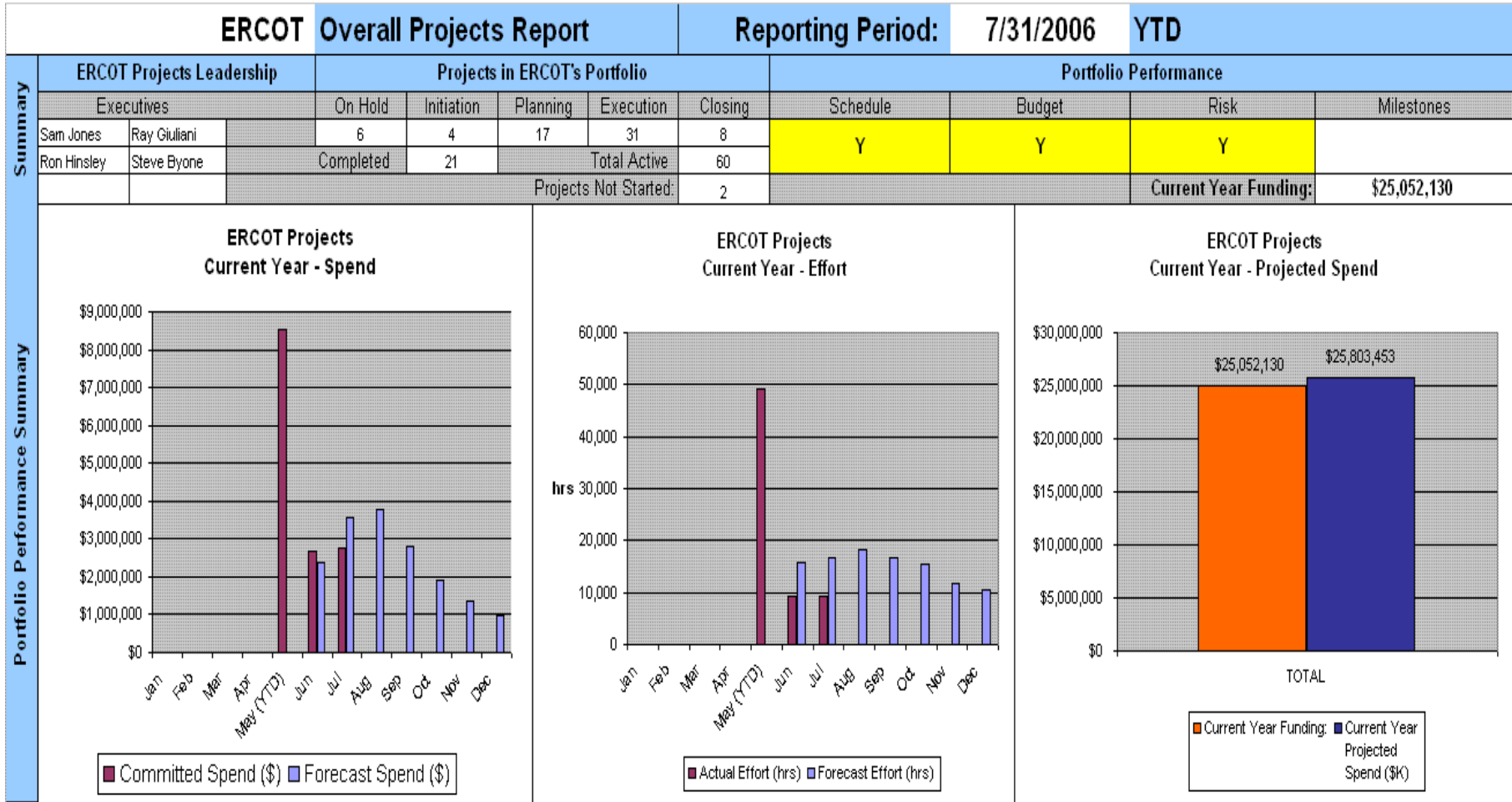
- **PR-50106_01 Security Camera Enhancements**

- **Scope:** Enhance the Closed Circuit Television (CCTV) system monitoring capability of the Austin/Taylor data centers and Operations Control Centers, the EMMS test lab, the IDF rooms, and the Blue Building.
- **Deliverables:** Replaced those existing cameras that were malfunctioning or poorly utilized. Placed additional cameras where required. Redeployed some existing cameras to more appropriate locations. Replaced existing monitors due to age and operational problems.
- **Timeline:** January 2006 - June 2006

- **PR-50027 Disk Based Recovery**

- **Scope:** This project facilitated the implementation of a disk-based recovery solution to minimize unplanned outage downtime in order to maintain market service availability, increase restore reliability, increase performance, reduce tape usage, and provide stability while lowering overall operational costs.
- **Deliverables:** Implement Disk Based Recovery System. Demonstrate Ability to recover data from Production systems. Demonstrate Ability to replicate data to lower environments
- **Timeline:** March 2006 – July 2006

Enterprise Projects Summary Preliminary Report



Future Agenda Items – September

- **Texas Nodal Market Implementation Program**
- **2007 Budget Status Report**
- **2006 Project Delivery Checkpoint**
- **Review Results of Annual Benefit Plan Audit**
- **Options to Increase Liquidity**

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