

Board of Directors

November 14, 2006

Credit Update and Proposed Next Steps

Credit objectives for the ERCOT market

- **Provide a financially stable market**
 - Residual credit risk should not endanger the overall financial stability of the market
- **Ensure transparency of potential market participant financial risks associated with residual credit exposure**
 - Credit risk is present in the ERCOT market
 - Mass transition losses (magnitude described herein)
- **Address new credit risks as they are identified**

Numerous improvements have been made including:

- Mass Transition timeline reduced 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

Significant reductions in exposure

Potential loss in exit scenarios

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

	<u>Previous</u>	<u>Today</u>	<u>2Q 2007</u>
Approx number of days for process	22-26	15-17	10-12
Collateral held ⁽¹⁾			
1,000 MWh/day x \$100/MWh =	\$ 140	\$ 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>
x 100% x ? days			
Potential market loss	\$ 2,060	\$ 1,290	\$ 790
For 100 MWh/day	\$ 206	\$ 129	\$ 79
For 10,000 MWh/day	\$ 20,600	\$ 12,900	\$ 7,900
Reduction in exposure		37%	62%

(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.

What is the *appropriate* exposure level?

- **Recognizing the Board of Directors is ultimately charged with developing rules and guidelines which are sufficient to ensure the ERCOT market is financially stable and that:**
 - The Credit Work Group recommended further credit tightening via PRR 683
 - The market provided its input indicating its desire to halt further credit tightening by rejecting PRR 683
- **To aid the BOD in its determination of next steps:**
 - ERCOT staff proposes seeking an independent review of ERCOT's Protocols related to credit within the context of ERCOT market operations
 - Benchmark ERCOT credit risk with other ISOs as well as against best practices
 - ERCOT staff continue to pursue catastrophic coverage via credit insurance
- **ERCOT requests BOD endorsement of proposed staff actions**

Note - PRR 683 - Reduce Timeline for Notice and Cure and Create a Working Credit Limit

**ERCOT Finance & Audit Committee
Self-Evaluation**

November 2006

	Question	Yes	No	Not Sure	Comments
1.	Does the committee have the appropriate number of members? The committee should not be so large that: <ul style="list-style-type: none"> its ability to operate efficiently and effectively is reduced members' ability to raise issues is hampered it is difficult to get a quorum when a time-sensitive issue arises 	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2.	Committee members demonstrate their objectivity during meetings through behaviors such as driving agendas, rigorous probing of issues, consulting with other parties, and hiring experts, as necessary.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3.	Differences of opinion on issues are resolved to the satisfaction of the committee.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4.	Committee members challenge the Chair as appropriate.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
5.	The committee charter is used as a document to guide the committee in its efforts, and to help guide the committee's agenda.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
6.	6.1 Committee members are financially literate, and the committee has determined that it has adequate financial expertise in accordance with its charter.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	6.2 Committee members participate in some form of continuing education to stay abreast of changes in the financial accounting and reporting, regulatory and ethics areas.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	6.3 The committee understands how the organization's performance compares with its budgetary targets and its peers, and how management plans to address any unfavorable variances.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	6.4 The committee discusses the initial selection of or changes in significant accounting policies used in developing the financial statements, the reason for and impact of any changes in policy, and reasons alternative treatments were not adopted.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

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	Question	Yes	No	Not Sure	Comments
	6.5 The committee discusses significant, complex, or unusual transactions with management and the external auditors.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	6.6 The committee understands which areas represent high risk for material misstatement of the financial statements, and discusses assumptions and approaches used with management and the external auditors.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	6.7 The committee forms its own view of the risk of material misstatement due to fraud, discusses with management and the external auditors their views on the risk of material misstatement due to fraud, and is comfortable that any differences in views can be reconciled.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	6.8 The committee fully understands significant changes in financial statements from prior years and from budget, and is provided with sufficient, reliable evidence to support variances.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	6.9 The committee commits sufficient time to review, discuss, and consider the financial statements.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	6.10 The committee meets with financial management to discuss results reported before finalization.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
7.	Committee members have a clear understanding of ERCOT's debt structure and cash management practices.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
8.	Committee members receive sufficient details regarding long-term financial planning.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
9.	The Committee makes appropriate use of workgroups or task forces to investigate issues defined by the Committee.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
10.	The committee engages outside experts as appropriate.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
11.	11.1 The organization's financial reporting processes are stronger as a result of management's interactions with the committee.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

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	Question	Yes	No	Not Sure	Comments
	11.2 The committee understands and agrees with the board on which categories of internal control it oversees. Categories include: <ul style="list-style-type: none"> ▪ Integrity of financial reporting ▪ Compliance with laws and regulations ▪ Operational efficiency and effectiveness 	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	11.3 The committee and the board concur with any changes to the committee's internal control oversight mandate.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	11.4 The committee understands the current high-risk areas - including information technology and computer systems - in the categories of controls it oversees, as well as how management addresses those areas.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
12.	The committee is cognizant of the line between oversight and management, and endeavors to respect that line.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
13.	The committee conducts executive sessions in a manner that offers a "safe haven" to the individual, while at the same time asking tough and necessary questions, evaluating the answers, and pursuing issues that might arise to a satisfactory resolution.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
14.	14.1 The committee does its part to ensure the objectivity of the internal audit team.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	14.2 The committee provides constructive feedback to the chief audit executive at least annually.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	14.3 The committee receives sufficient detail regarding material issues and complaints brought forward which relate to the company's fraud, ethics or accounting practices.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	14.4 The committee has developed the scope of work to be done by the independent auditor and by the internal audit department based upon a reasoned review of the risks or exposures to the company.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
15.	The committee communicates at an appropriate level of detail when informing the Board of its actions.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

**ERCOT Finance & Audit Committee
Self-Evaluation**

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	Question	Yes	No	Not Sure	Comments
16.	Committee members receive clear and succinct agendas and supporting written material sufficiently prior to scheduled meetings.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
17.	Committee members have adequate opportunities to discuss issues and ask questions.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
18.	The frequency of committee meetings is appropriate for the responsibilities assigned to the committee.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
19.	Meeting facilities and presentation materials are effective for the conduct of committee activities.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
20.	Please add additional comments, questions and suggestions here.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Additional comments:

PUC/NERC/FERC Filings - FINANCE and AUDIT Excerpt as of November 14, 2006

Docket / Project No.	Docket Description	Status
P-24055	Protocol Revision Informational Filings by the Electric Reliability Council of Texas (includes Protocol Revisions and Nodal Protocol Revisions)	Systems Implementation – Cost Benefit Analysis
P-24462	PUC Proceeding to Establish Performance Measures Relating to the Competitive Retail Electric Market	11/14/06 2 nd Quarter Report Filing
P-27706	Reports of the Electric Reliability Council of Texas	11/14/06 2 nd Quarter Report (Financials and Audits) Filing
P-28109	Competitive Metering Services Market Readiness Project Subst. R. §25.311(e)	11/14/06 2 nd Quarter Report Filing
P-28320	Reports of Complaints Filed Against the Electric Reliability Council of Texas (ERCOT)	Litigation Cases (not under PUC jurisdiction)
D-30456	PUC Proceeding Regarding ERCOT Fee	File Quarterly Reports and Present at PUC Open Meetings
P-30634	Activities Related to Implementation of Recommendations from the Potomac Economics 2004 Reports on the Operation of the ERCOT Wholesale Electricity Market	Commission Staff Appeal of PRR 590 – Potomac Recommendation #14 request to reprioritize PRR 590 (currently priority 1.2 and rank of 57) – Procedures to Monitor QSE Reserve Obligations in Real-time – System changes and Cost to design and installation of monitoring equipment in ERCOT Control Rooms
P-31111	Rulemaking to Address Independent Market Monitor for the Wholesale Electric Market in ERCOT	Final Order Issued 04/21/06 ERCOT to Fund IMM
D-31166	Complaint of TXU Electric Delivery Company and CenterPoint Energy Houston Electric, LLC to Revoke Retail Electric Provider Certificate No. 10068 of Energy West Resources, LTD	07/17/06 Final Order Issued
D-31243	Complaint of TXU Portfolio Management Company LP and TXU Energy Retail Company LP and Against the Electric Reliability Council of Texas	08/09/06 Final Order Issued 08/29/06 NRG Texas, LP Filed Motion for Rehearing Load Imbalance Charges

PUC/NERC/FERC Filings - FINANCE and AUDIT Excerpt as of November 14, 2006

Docket / Project No.	Docket Description	Status
P-31416	Evaluation of Default Service for Residential Customers and Review of Rules Relating to the Price to Beat and Provider of Last Resort	07/11/06 Order Adopting Amendment to 25.43 - Create two different POLR small non-residential customer classifications - In the event that ERCOT is not capable of having an automated process in place to effectuate the bifurcation by December 31, 2006, ERCOT shall manually bifurcate the small non-residential customer class until the automated process is in place, which shall be no later than July 1, 2007
D-31540	Proceeding to Consider Protocols to Implement a Nodal Market in the Electric Reliability Council of Texas Pursuant to PUC Subst. R. §25.501	04/05/06 Final Order Issued
P-31575	Improvements to the ERCOT Zonal Market Design	
P-31600	Transition to an ERCOT Nodal Market Design	06/26/06 PUC Market Oversight Evaluation of Options PRR 307 Controllable Loads – ERCOT Project Priority List 2001 and Estimates \$500,000 - \$1,000,000
D-31824	2006 – Application of the Electric Reliability Council of Texas for Approval of the ERCOT System Administration Fee (\$0.42 Mwh)	05/15/06 Final Order
P-31852	Rulemaking Relating to Renewable Energy Amendments	12/01/06 ERCOT to File Study of Wind Energy Production Potential State-Wide and Transmission Constraints Limit Deliverability of Electricity from Wind Energy Resources
P-31972	Rulemaking Concerning Resource Adequacy and Market Power in the Electric Reliability Council of Texas Power Region	Potential Resource and System Impacts Texas Third Court of Appeals – Cause No. 03-06-0662-CV Constellation Energy Commodities vs. PUC 09/29/06 – Order Issued Emergency Stay Granted – Implementation of Disclosure Provisions of 16 Texas Administrative Code §25.505(f)(3) are Stayed Pending Further Order of the Court
D-32025	Petition of the Electric Reliability Council of Texas for Approval of Amended and Restated Bylaws	Costs for Unaffiliated Board of Directors and TAC Representative

PUC/NERC/FERC Filings - FINANCE and AUDIT Excerpt as of November 14, 2006

Docket / Project No.	Docket Description	Status
D32174	Petition of Tenaska Power Services Co. d/b/a TPS III for Declaratory Order Interpreting PUC Subst. R. §25.43(n) and §25.272(g)(1)(D)	07/19/06 PUC Order No. 18 Dismissing Petition
P-32401	FY 2006 Activities Related to the Oversight of the Electric Reliability Council of Texas	04/17/06 Rolling Blackout
D-32486	Complaint and Request for Emergency Action of CenterPoint Energy Houston, LLC regarding Retail Electric Provider Ideal Energy, Inc.	08/29/06 Final Order Issued
D-32492	Petition of the Electric Reliability Council of Texas (ERCOT) for Approval of Unaffiliated Director	06/29/06 Final Order of Approval Costs for Unaffiliated Board of Directors
D-32573	Petition of Commission Staff to Revoke the Retail Electric Provider Certificate of Usave Energy Services, Inc.	05/15/06 ERCOT Intervened Amount due by Usave to ERCOT is \$212,202.90
D-32574	Petition of Commission Staff to Revoke the Retail Electric Provider Certificate of Azor Energy, L.P.	08/14/06 Final Order Issued Revoked Azor REP Certification Azor owes ERCOT \$26,394.07
D-32686	Application of the Electric Reliability Council of Texas for Approval of a Nodal Market Implementation Surcharge and Request for Interim Relief	08/29/06 Interim Order Issued 10/27/06 ERCOT Filed Motion for Extension to 03/27/07 - ERCOT to File with PUC Nodal Cost Information
D-32695	Petition of TXU Energy Retail Company for Declaratory Judgment, or in the Alternative, for Approval of a New Time of Use Schedule (TOUS)	06/29/06 Final Order Issued – TXU Energy Time-of-Use Schedule to be implemented by ERCOT in the TXU Electric Delivery Service Territory
P-32853	Evaluation of Demand Response Programs in the Competitive Electric Market	02/01/07 ERCOT to Conduct Study of System and Market Impacts of Implementing Tiered Frequency Response (TFR) Services and File Report with PUC
D-32988	Complaint and Request for Emergency Action of CenterPoint Energy Houston Electric, LLC Regarding Retail Electric Provider Bridgepoint Power & Light, LLC	

PUC/NERC/FERC Filings - FINANCE and AUDIT Excerpt as of November 14, 2006

Docket / Project No.	Docket Description	Status
D-32992	Compliance Proceeding Pursuant to Final Order in Docket No. 31243 (Complaint of TXU Portfolio Management Company LP; and TXU Energy Retail Company LP and Against the Electric Reliability Counsel of Texas)	ERCOT Ordered to Re-settle see TXU Complaint Docket No. 31243
D-33047	Notice of Violation and Settlement Agreement Relating to FPL Energy Power Marketing Inc.'s Violation of PURA §39.151(j) and PUC Subst. R. §25.503(f)(2); Relating to Failure to Adhere to ERCOT Protocols §6.5.4(1) and §6.5.4(7) Concerning Responsive Reserve Service	09/08/06 Final Order – FPL Energy to Pay ERCOT \$2,287 – ERCOT shall distribute amounts refunded Pursuant to Final Order and in Accordance with ERCOT Protocols
D-33177	Notice of Violation and Settlement Agreement Relating to Constellation Energy Commodities Group, Inc.'s Violation of PURA §39.151(j) and PUC Subst. R. §25.503(f)(2); Relating to Failure to Adhere to ERCOT Protocols 6.5.4(1) and 6.5.4(7) Concerning Responsive Reserve Service	09/08/06 Proposed Order – Constellation to Pay ERCOT \$1,103 – ERCOT shall distribute amounts refunded Pursuant to Final Order and in Accordance with ERCOT Protocols
D-33183	Petition of the Electric Reliability Council of Texas (ERCOT) for Approval of Unaffiliated Director (Jan L. Newton)	Costs for Unaffiliated Board of Directors
D-33185	Petition of the Electric Reliability Council of Texas (ERCOT) for Approval of Re-election of Unaffiliated Director (Mark Armentrout)	Costs for Unaffiliated Board of Directors
P-33250	Staff's Activities Related to the ERCOT Wholesale Market Independent Market Monitor	
D-33416	Constellation NewEnergy's Appeal and Complaint of ERCOT Decision to Approve PRR 676, PRR 674 and Request for Expedited Relief	
NERC	ERCOT Regional Entity (RE) Delegation Agreement with NERC Electric Reliability Organization (ERO)	