



MEMO

Date: November 7, 2006
To: Board of Directors
From: Steve Byone, Vice President & Chief Financial Officer
Subject: Financial Institution Market Participants

Issue for the ERCOT Board of Directors

ERCOT Board of Director Meeting Date: November 14, 2006

Agenda Item No.: 7b

Issue:

May ERCOT use financial institutions that have affiliates that are market participants: (a) to obtain debt financing and/or (b) to invest funds?

Background/History:

Because ERCOT must perform its functions with complete objectivity, it does not engage market participants to procure goods or perform services for ERCOT, except as specifically provided by the Protocols, for electric, telecommunication, and other utility services for ERCOT's own use, and for de minimus retail purchases.

However, over the past year or two, a large number of financial institution affiliates have become market participants, both as Qualified Scheduling Entities and as Transmission Congestion Rights (TCR) holders. As the number of financial institutions with market participant affiliates has increased, the group of qualified financial institutions that are not related to a market participant and from which ERCOT can obtain debt financing has dramatically decreased, causing concern about ERCOT's ability to obtain needed debt financing on a competitive basis. In addition, the number of financial institutions with which ERCOT can temporarily invest excess funds has decreased, although this is not as problematic.

ERCOT staff seeks permission to use financial institutions that have affiliates which are market participants for (A) debt financing and (B) investments, so long as ERCOT can confirm that the market participants and their affiliates have "Chinese Wall" type confidentiality provisions in place that prohibit the market participant affiliate and the financial institution affiliate from sharing information regarding their relationship with ERCOT. Additionally, in order to address any potential conflict (or perception of conflict) of interest by ERCOT staff, ERCOT will implement a procedure that will require that, for any market participant that is an affiliate of a financial institution which is used by ERCOT or is being considered as a potential ERCOT financial institution, ERCOT Credit



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department will make all credit and collateral decisions based upon the formulas set forth in the Protocols. The use of discretion in relation to any such affiliate as permitted by the Protocols for credit or collateral decisions (other than when applied to the market as a whole) will be approved by Finance personnel outside of ERCOT Treasury, with the advice of legal counsel.

Key Factors Influencing Issue:

ERCOT needs to have a sufficient group of qualified financial institutions as options for obtaining debt financing, to ensure that ERCOT can obtain needed debt financing on a competitive basis. ERCOT also benefits by having a sufficiently large group of qualified financial institutions as options for investing funds, to ensure that ERCOT can invest and obtain competitive returns on ERCOT's investments.

Alternatives:

- Allow market participant affiliates to become ERCOT lenders, so long as the market participant and its affiliate sign acceptable confidentiality and/or Chinese Wall agreements and appropriate approvals are obtained if discretionary collateral decisions are made.
- Avoid using market participant affiliates as lenders. This will severely limit ERCOT's options for lenders. Most lenders which are large enough to accommodate ERCOT's financial needs have affiliates that are market participants or have indicated that they intend to have affiliates become market participants. ERCOT is concerned that if it notifies the financial institution affiliate applicants that they can only become market participants if their affiliates do not loan money to ERCOT, these financial institutions might choose to be market participants rather than ERCOT lenders.
- Avoid using market participant affiliates for investing funds. This would reduce the pool of possible investments, potentially reducing the level of return that can be obtained, but at this time, ERCOT still expects to be able to find competitive investments without these affiliates.

Conclusion/Recommendation:

ERCOT Finance Staff recommends that the Board approve ERCOT's ability to use financial institutions that are affiliates of market participants for debt financing and investments, so long as the market participants and the affiliates sign acceptable confidentiality agreements.



RESOLUTION OF
THE BOARD OF DIRECTORS OF
ELECTRIC RELIABILITY COUNCIL OF TEXAS, INC.

November 14, 2006

WHEREAS, the board of directors (the “Board”) of Electric Reliability Council of Texas, Inc., a Texas non-profit corporation (“ERCOT”) deems it desirable to permit ERCOT to use financial institutions that are affiliates of market participants for ERCOT financing and ERCOT and market participant fund investments, so long as the market participant and its financial institution affiliate agree to acceptable confidentiality provisions, in order to provide ERCOT with competitive options;

NOW, THEREFORE, BE IT RESOLVED, that ERCOT is hereby permitted to use financial institutions that are affiliates of market participants for ERCOT debt financing and investments, so long as the financial institution and the market participant execute an acceptable confidentiality agreement with ERCOT.

CORPORATE SECRETARY’S CERTIFICATE

I, James Thorne, General Counsel and Corporate Secretary of ERCOT, do hereby certify that, at the November 14, 2006 ERCOT Board Meeting, the Board of ERCOT passed a Resolution approving the above resolution.

The Motion passed [describe how: by unanimous voice vote; with four voting against; etc.] by the Board.

IN WITNESS WHEREOF, I have hereunto set my hand this ____ day of _____, 2006.

James Thorne
General Counsel and Corporate Secretary