MEMO

Date: November 7, 2006
To: Board of Directors
From: Sam Jones, President & Chief Executive Officer
Subject: Texas Regional Entity Agreement & Bylaws Changes

Issue for the ERCOT Board of Directors

ERCOT Board of Director Meeting Date: November 14, 2006
Agenda Item No.: 11a

Issue:
Does the Board approve ERCOT staff moving forward with a Delegation Agreement filing with North American Electric Reliability Corporation (NERC), which will be sent to Federal Energy Regulatory Commission (FERC) for approval, with the understanding that the Board must approve all required changes to the Bylaws and the final Delegation Agreement (as agreed to by NERC and FERC) prior to execution by ERCOT?

Background/History:
Title XII, Subtitle A of the Energy Policy Act of 2005 (EPAct) added new section 215 to the Federal Power Act (FPA), mandating enhanced federal oversight of the bulk-power system (essentially, the transmission grid and interconnected generation facilities) throughout the US, including in the ERCOT region. Section 215(c) specifically provides for a new Electric Reliability Organization (ERO) that is authorized to establish and enforce Reliability Standards for the bulk-power system, subject to Federal Energy Regulatory Commission (FERC) oversight. On July 20, 2006, FERC named the North American Electric Reliability Corporation (NERC) as the ERO.

EPAct authorizes NERC, as the ERO, to delegate authority to Regional Entities (REs) for the purpose of proposing and enforcing federal Reliability Standards and working with the ERO to set regional variances as needed. As discussed at previous Board meetings, ERCOT has proposed to form a functionally separate division (Texas Regional Entity or "TRE") that will act as the RE for the ERCOT Region and will perform (1) the new federal statutory RE duties (proposing and enforcing federal Reliability Standards and variances) and (2) ERCOT compliance monitoring and enforcement under the Protocols. The cost of the ERCOT compliance activities under the Protocols would continue to be funded as part of the ERCOT System Administration Fee. The cost of the federal statutory RE duties would be funded by NERC, in accordance with a separate budget by TRE, pursuant to a negotiated Delegation Agreement that must be approved by FERC. The TRE will be led by a Chief Compliance Officer, who reports directly to the Board and must be acceptable to the Public Utility Commission of Texas ("PUCT").

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NERC and ERCOT are currently negotiating a Delegation Agreement to define the interactions of NERC, ERCOT, and TRE, including ERCOT's billing and collection of ERO and RE fees from load-serving entities, ERCOT's submission of all such fees to NERC, and remittance by NERC to TRE funding for its federal activities under EPAct, pursuant to a signed Delegation Agreement. The current draft Delegation Agreement, including exhibits, which is dated October 19, 2006, is attached as Exhibit A. The proposed Texas Regional Entity Standards Development Process is attached hereto as Exhibit B, and the draft Bylaws, including redlines to show the proposed modifications needed to implement the TRE are attached hereto as Exhibit C.

ERCOT has been communicating with and has received input from the PUCT regarding the proposed Delegation Agreement, ERCOT and TRE governance, and TRE activities. ERCOT, PUCT and TRE have proposed certain modifications to the standard Compliance Enforcement Program ("CEP") procedures required by NERC, including that the PUCT serve as the hearings body for TRE enforcement proceedings at the regional level and that the PUCT make recommended findings to the Chief Compliance Officer ("CCO") of the TRE. NERC has indicated agreement to these modifications to CEP.

ERCOT has prepared a budget for the costs it estimates will be incurred by the TRE during 2007. This budget estimates that the fees and expenses for TRE's EPAct delegated responsibilities will be $4,870,755 and the fees and expenses for ERCOT compliance monitoring and enforcement functions will be $643,464 (which latter amount is included in the base ERCOT budget). FERC's October 24, 2006 Order conditionally accepting NERC's and all REs' budgets and proposed assessments for fiscal year 2007 indicated that load-serving entities in the ERCOT region shall be assessed: (1) 100 percent of the cost of TRE's EPAct delegated responsibilities; and (2) a proportionate share of the cost of NERC's ERO responsibilities. FERC approved the proportionate share of NERC's ERO responsibilities in the ERCOT Region for 2007 at $1,394,183; so, the total amount of ERO and EPAct funding in the ERCOT Region for 2007 is set at $6,264,938. TRE staff will track time and expenses to ensure that the costs are accurately allocated for TREs different functions, so that TRE can make any required adjustments when it prepares its 2008 budget. NERC will invoice ERCOT for the full Electric Reliability Organization

In order to allow NERC to begin the process of obtaining FERC approval of TRE, ERCOT and TRE have been requested to file an updated proposed Delegation Agreement with NERC by November 17, 2006, including all exhibits, proposed Bylaws, TRE's standards development process, and TRE's exceptions to the Compliance Enforcement Program as currently promulgated by NERC. NERC does not require that ERCOT have formal Board approval prior to the filing of the draft Delegation Agreement. However, ERCOT staff

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requests that the Board confirm that the basics of the TRE and the required governance changes to ERCOT are acceptable, so that ERCOT can begin serious negotiations with NERC. Before ERCOT can sign a final Delegation Agreement with NERC, NERC and FERC must approve the Delegation Agreement and all Exhibits, ERCOT membership and the PUCT must approve all required modifications to the Bylaws, and the ERCOT Board must formally approve the final Delegation Agreement, including Exhibits.
Key Factors Influencing Issue: ERCOT and the PUCT contend that it is in the best interest of the Texas electric market to have a RE that is familiar with the ERCOT Region, the ERCOT Protocols, and the Texas electric market, and that a functionally separate division of ERCOT is the most efficient means to propose and enforce the federal Reliability Standards.
Alternatives: • Allow NERC to propose and enforce federal Reliability Standards in the ERCOT Region • Create the TRE as a separate legal entity • Create or locate a different entity to become the Regional Entity for the ERCOT Region • .Propose modifications to the proposed Delegation Agreement or governance structure of ERCOT
Conclusion/Recommendation: ERCOT Staff recommends that the Board approve ERCOT's beginning negotiations with NERC regarding the proposed Delegation Agreement.

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 for ERCOT to create a functionally separate division ("TRE") that will contract for and become the regional entity for the ERCOT Region, pursuant to the Energy Policy Act of 2005;

NOW, THEREFORE, BE IT RESOLVED, that ERCOT staff is hereby permitted to negotiate with NERC regarding a Delegation Agreement, on terms similar to those in the October 19, 2006 draft Delegation Agreement, understanding that before ERCOT can sign a final Delegation Agreement with NERC:

- NERC and FERC must approve the Delegation Agreement and all Exhibits;
- ERCOT membership and the PUCT must approve all required modifications to the Bylaws; and
- The Board must formally approve the final Delegation Agreement, including Exhibits

CORPORATE SECRETARY'S CERTIFICATE

I, James Thorne, General Counsel and Corporate Secretary of the Electric Reliability Council of Texas, Inc., a Texas nonprofit corporation ("ERCOT"), do hereby certify that, at the November 14, 2006 ERCOT Board Meeting, the Board of Directors 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