



ERCOT
Finance & Audit Committee Meeting
7620 Metro Center Drive, Room 168, Austin, Texas
February 20, 2007 7:30 a.m. – 10:00 a.m.**

Agenda Item #	Description/Purpose/Action Required	Presenter	Time
	Call to order	C Karnei	7:30 a.m.
1.	Adjourn to executive session		
	• Significant audit findings	B Wullenjohn	7:30 a.m.
	• EthicsPoint update	E Arterberry	7:35 a.m.
	• Update on Internal Audit staffing	B Wullenjohn	7:40 a.m.
	• Update on Internal Audit goals	B Wullenjohn	7:45 a.m.
	• Discussion with executive management	Jones/Byone	7:50 a.m.
	• Assessment of the adequacy & effectiveness of IA staff	B Wullenjohn; then committee discussion	8:00 a.m.
	Reconvene to general session		8:15 a.m.
2.	Approval of Minutes* (Vote) (1/16/07)	C Karnei	8:15 a.m.
3.	Review Finance and Audit Committee charter	S Byone	8:20 a.m.
4.	Lessons learned from 2006 SAS 70	S Barry/ J Brenton	8:35 a.m.
5.	Review of 2006 financial results & vote on use of surplus funds (VOTE)	M Petterson	8:45 a.m.
6.	Approval of selected auditors for final audit of MPP (VOTE)	M Petterson	8:55 a.m.
7.	Assessment of compliance, the internal control environment and systems of internal controls	C Moseley/ M Petterson	9:00 a.m.
8.	Briefing on nodal surcharge filing	S Byone	9:10 a.m.
9.	Liquidity Update	C Yager	9:20 a.m.
10.	Capital Project Update	D Troxtell	9:30 a.m.
11.	Committee Briefs (Q&A only)	n/a	9:40 a.m.
12.	Future Agenda Items	S Byone	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 March 20, at ERCOT, 7620 Metro Center Drive, Austin, Texas.*

Draft MINUTES OF THE ERCOT FINANCE & AUDIT COMMITTEE MEETING

Austin Met Center

9:00 A.M.

January 16, 2007

Pursuant to notice duly given, the meeting of the Electric Reliability Council of Texas, Inc. Finance & Audit Committee convened at 9:00 A.M. on **January 16, 2007**. The Meeting was called to order by **Clifton Karnei** who ascertained that a quorum was present. Mr. Karnei noted that, because of the inclement weather forcing some of the Committee members to be available only via conference call and limiting the duration of the meeting, the Committee would address the urgent matters.

Meeting Attendance

Committee members:

Clifton Karnei, Chair	Brazos Electric Cooperative	Cooperative	Present
Miguel Espinosa, Vice Chair	Independent Board Member	Independent Board Member	Present
Nick Fehrenbach	City of Dallas	Consumer	Present
R. Scott Gahn	Just Energy	Ind. Retail Electric Provider	Present via telephone
Tom Standish	Centerpoint Energy	Investor-Owned Utility	Present via telephone
William Taylor	Calpine Corporation	Ind. Generator	Not Present
Dan Wilkerson	Bryan Texas Utilities	Municipal	Present via telephone

ERCOT staff and guests present:

Barry, Sean	PricewaterhouseCoopers (PwC) via telephone
Byone, Steve	ERCOT (CFO)
Giuliani, Ray	ERCOT
Petterson, Mike	ERCOT
Vincent, Susan	ERCOT
Yager, Cheryl	ERCOT via telephone
Wullenjohn, Bill	ERCOT via telephone

Approval of Previous Minutes

Scott Gahn moved to approve the minutes for the previous meetings held on December 12, 2006; Clifton Karnei seconded the motion. The motion passed unanimously.

Financial Qualifications of Committee Members and Committee Charter Review

The Committee determined that it would move the discussion of committee member qualification and modifications to its charter, including a provision to require a majority to serve as a quorum, to its February meeting. The Committee also noted that certain of the Charter provisions should be discussed after completion of the Credit Workshop.

Election of Committee Officers for 2007

The Committee discussed its selection of officers for 2007. **Nick Fehrenbach nominated Clifton Karnei to continue to serve as Committee Chair. Miguel Espinosa seconded the motion. The motion passed unanimously.**

Scott Gahn nominated Miguel Espinosa to serve as Committee Vice Chair; Nick Fehrenbach seconded the motion. The motion passed unanimously.

PwC Annual Disclosure of Auditor Independence and Quality Control Process

Sean Barry of PwC summarized the steps that PwC takes to annually confirm its independence of audit clients and confirmed that PwC had taken these steps with regard to its representation of ERCOT. Mr. Barry confirmed that PwC had found no relationships and had provided no services that would impair its independence. Mr. Barry also informed the Committee that PwC performed a number of quality control steps, including training, redundant review, and, in areas of heightened risk, implemented higher risk procedures.

PwC Report on 2007 SAS 70 Audit

Sean Barry informed the Committee that PwC had issued the 2006 SAS 70 audit report in December and, as anticipated, 17 of the 18 areas audited had no exceptions, but one area – Logical Security was qualified. Mr. Barry told the Committee that Ray Giuliani had hosted a conference call with market participants, whereby ERCOT presented the results and answered any questions, and that PwC was involved in this presentation to the market participants. Mr. Barry confirmed that market participants had not raised any significant issues resulting from the SAS 70 report. Mr. Barry stated that PwC would issue a recommendation letter and, together with ERCOT staff, would review lessons learned as well as remediation actions with the Committee at its February meeting.

Update and Approval of Nodal Fee Filing

Steve Byone provided the Committee with an overview of the history of the currently approved interim Nodal Surcharge in the amount of \$0.0663 cents per MWh. Mr. Byone presented the Nodal Program Budget and proposal for the Nodal Surcharge filing that would be presented to the full Board, and explained how ERCOT staff had arrived at the costs to be recoverable via the surcharge, including the debt financing costs that would be paid during development and through the useful life of the assets. Mr. Byone explained that the rate proposed for the Nodal Fee filing (\$0.1270 per MWh) was based upon the assumption that the new rate would go into effect on June 1, 2007. Mr. Byone also explained that the new rate would be in effect through 2012, but that the rate for 2007 would be blended, since the rate would change from the interim rate to \$0.1270 per MWh June 1, 2007. Mr. Byone informed the committee that ERCOT would also request approval of an expedited process to approve potential new rates which might be needed should key assumptions used in determination of the proposed rate materially change.

Miguel Espinosa asked if ERCOT staff had discussed the fee amount with the Public Utility Commission (PUC), and Mr. Byone explained that, although the specific rate had not been individually discussed with the PUC, the same material had been discussed at the December Board meeting, with the PUC Commissioners present. Mr. Espinosa also asked Mr. Byone when the funding ratio for capital expenditures would return to 60% debt /40% revenue. Mr. Byone confirmed that ERCOT was committed to having funding of capital projects for the base budget return to 60% debt/40% revenue by the end of 2008 and that only the Nodal portion of

the budget would have a higher debt funding ratio which is currently estimated at 62% debt/38 revenue.

Mr. Karnei and Mr. Espinosa both noted that if the debt funding ratio became a problem, the fee would need to be increased. Mr. Byone noted that he expected resistance to fee increase and the only other way to control the fee level would be to extend the debt, which ERCOT does not support beyond the useful life of the assets. Mr. Karnei and Mr. Espinosa agreed that ERCOT should not extend debt beyond the useful life of the assets. Mr. Espinosa stated that he would rather have a "pay as you go" fee, but that this would lead to a high and an undesirably lumpy fee. Mr. Fehrenbach noted that some of the assets of the Nodal program might extend beyond 2012 while some might require replacement before the end of 2012. Mr. Barry noted that while there are no specific standards for asset lives, the typical useful life would be 3 years for hardware and 5 years for software. Mr. Byone informed the Committee that the assumption used for the Nodal Program budget and requested fee assumed a 4-year average useful life for all capitalized assets with an assumed "go live" date of January 1, 2009.

After a full and detailed discussion by the Committee, Miquel Espinosa made a motion to recommend the staff's proposed Nodal Budget and proposed Nodal Surcharge filing to the Board. Dan Wilkerson seconded the motion. The motion passed. Nick Fehrenbach abstained and the remainder of the Committee members voted in favor of the motion.

Credit Workshop Update

The Committee discussed potential dates for the Credit Workshop and requested that, subject to confirmation with William Taylor and a time confirmation with Mr. Fehrenbach, the Credit Workshop be held on March 5, 2007 from 1 P.M. to 5 P.M. The Committee requested that Cheryl Yager confirm the date and time with Mr. Taylor and Mr. Fehrenbach, and then send notice of the Credit Workshop to all Board members, with encouragement for the other Board members to attend.

Quarterly Investment Results

Cheryl Yager reviewed the Quarterly Investment results with the Committee and confirmed that the investments are being managed within the parameters of the Investment Standard. Ms. Yager noted that the ERCOT prime fund had fallen out of the top 10, but the rates were fairly flat among all of the top groups.

Adjournment

At 9:53 A.M., the meeting was adjourned. The next Committee meeting will be held on the morning of February 20, 2007.

Susan Vincent, Secretary

**THE ELECTRIC RELIABILITY COUNCIL OF TEXAS, INC.
FINANCE & AUDIT COMMITTEE CHARTER**

Purpose

The Finance and Audit committee of the Board of Directors of ERCOT shall:

1. oversee the Company's budget process and adherence to budget, and providing recommendations to the Board of Directors for establishing levels of financing and in setting the Company's fees, including its administrative fee;
2. review the Company's credit policies and make recommendations to the Board of Directors re same;
3. ensure that the Company's financial statements are properly and effectively audited by qualified accountants who are independent;
4. assist the Board of Directors in fulfilling its oversight responsibility with respect to the Company's maintenance of an effective internal audit function;
5. perform such other duties and responsibilities enumerated in and consistent with this Charter.

Comment [ERCOT1]: ERCOT Staff proposes that the review of this section be deferred and made in conjunction with the pending Credit Workshop.

The Committee's function is one of oversight, recognizing that the Company's management is responsible for preparing the Company's financial statements, and the independent auditor is responsible for auditing those statements. In adopting this Charter, the Board of Directors acknowledges that the Committee members are not employees of the Company and are not providing any expert or special assurance as to the Company's financial statements or any professional certification as to the external auditor's work or auditing standards. Each member of the Committee shall be entitled to rely on the integrity of staff and external auditors to provide accurate, complete financial and other information to the Committee, absent actual knowledge to the contrary.

While the Committee has the responsibilities, duties and powers set forth in this Charter, it shall be the responsibility and duty of the Company's management and/or independent auditor, and not the responsibility or duty of the Committee, to plan or conduct audits, to make any determination that the Company's financial statements are complete, accurate and in accordance with generally accepted accounting principles and to assure compliance with laws, regulations and the Company's ethics policies. It is the responsibility of the Committee to conduct investigations and resolve disagreements regarding financial reporting, if any, between management and the independent auditor.

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Comment [ERCOT2]: These edits would conform the Charter to the requirements of Section 301(m)(2) of the Sarbanes-Oxley Act of 2002.

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The Committee shall provide assistance to the Board in fulfilling its oversight responsibility relating to the Company's financial statements and the financial reporting process, the systems of internal accounting and financial controls, the annual independent audit of the Company's financial statements and the legal compliance and ethics programs as established by management and the Board. In so doing, it is the responsibility of the Committee to maintain free and open communication between the Committee and the Company's independent auditors, internal accounting personnel and management.

Membership

The Finance and Audit Committee of the Board of Directors of ERCOT (the “Committee”) shall be comprised of at least five Board members, at least three of which are from market Segments and ~~two~~ or more of which must be an Independent Board members of ERCOT (the “Company”). Each Member must be able to read and understand fundamental financial statements, including the balance sheet, income statement and cash flow statement. At least one Member must have past employment experience in finance or accounting, requisite professional certification in accounting or any other comparable experience or background which ensures the individual’s financial sophistication, including a past or current position as a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

Comment [ERCOT3]: ERCOT believes that the Committee should consider changing this requirement given that the number of independent BOD members has increased from three to five.

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The board members shall decide from among themselves who shall participate in the Committee. The term shall be for one year.

The Chair of the Committee shall be selected through a majority vote of the Committee members. The Committee Chair shall not be the Chief Executive Officer of the Company and shall have accounting or related financial management expertise.

The Committee may request that any officers or employees of ERCOT, or any other person, whose advice and counsel are sought by the Committee, attend any meeting of the Committee to provide such pertinent information as the Committee requests.

Board members (other than Committee members) may attend and participate in Committee meetings but may not participate in Committee voting.

Non-Committee members may attend Committee meetings at the discretion of the Committee. The Committee may exclude any persons who are not Directors, the Segment Alternate or the Director’s Designated Representative from any meeting or portion of any Committee meeting that the Committee determines, in its discretion, needs to be held in closed session to discuss personnel issues, confidential legal matters, negotiations or other business of the Committee involving confidential information.

Qualifications

Each member of the Committee shall also meet any experience requirements as may be established from time to time by the Board of Directors. The Board of Directors shall endeavor to appoint at least one member to the committee who is a financial expert as such term may be defined from time to time by the Board of Directors, the accounting industry or other regulatory authorities.

Authority

In discharging its oversight role, the Committee is empowered to investigate any matter brought to its attention with full access to all books, records, facilities and personnel of the Company and the power to retain outside counsel or other experts for this purpose. All employees are directed

to cooperate as requested by the Committee or any of its Members for Committee purposes. The Committee may request any officer or employee of the Company, the Company's outside counsel or the Company's independent auditor to attend a meeting of the Committee or to meet with any Member or any consultants to the Committee.

The Company's senior internal auditor shall report directly to the Committee. For administrative purposes, the senior internal auditor shall report to the CEO. The Committee shall approve an Annual Audit Plan prepared by the senior internal auditor. The senior internal auditor shall (1) manage the execution of the Annual Audit Plan, (2) conduct investigations at the direction of the Chair and the Committee, and (3) make periodic reports to the Committee at regularly scheduled Committee meetings and as otherwise directed by the Chair and the Committee.

The Committee may appoint workgroups or task forces to investigate issues defined by the Committee. Members of such workgroups or task forces need not be Directors. Such workgroups or task forces shall have no authority to bind the Committee or the Company.

Structure

~~The presence of at least half of the~~ members of the Committee shall constitute a quorum. At any meeting at which a quorum exists, the act of a majority of the members present at a meeting shall be the act of the Committee.

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The Chair, in consultation with the Chief Financial Officer, shall develop the agenda, the frequency, and length of meetings and shall have unlimited access to management and information for purposes of carrying out functions of the Committee. The Chair shall establish such other rules, as may from time to time be necessary and proper for the conduct of the Committee.

Duties and Responsibilities

The following shall be the prominent recurring duties and responsibilities of the Committee in carrying out its oversight functions. The duties and responsibilities are set forth below as a guide to the Committee with the understanding that the Committee may alter or supplement them as appropriate under the circumstances to the extent permitted by applicable law, and by the Company's Articles of Incorporation and Bylaws:

With respect to budget oversight and financing:

1. Annually, on a schedule to be established by the Board of Directors, the Committee shall review staff's proposed budget for the following year, including proposed staffing levels, proposed capital expenditures, and other proposed expenditures.
2. The Committee shall review the staff's estimate of revenues to support all proposed expenditures, including staff's recommendations for fee levels for the following year.
3. The Committee shall review the staff's recommendation of the amount and type of financing that may be needed to support the proposed budget, including the staff's proposed financial performance measures (e.g. ratios).

4. Following the Committee's review of the above items, the Committee shall recommend to the Board of Directors a staffing level, a proposed budget, proposed fees, and proposed financial performance measures for the following year.

With respect to the Company's credit policy:

1. The Committee shall review staff's recommendations concerning changes to the credit policy established to ensure creditworthiness of market participants.
2. Following the Committee's review of staff's recommendations, the Committee shall recommend to the Board of Directors any proposed changes to the previously approved credit policy.

Comment [ERCOT4]: ERCOT staff notes that this section should be updated. However, Staff proposes that the review and revision of this section be done in conjunction with the pending Credit Workshop.

With respect to the independent auditors:

1. Annually, the Committee shall recommend to the Board of Directors the selection and employment of the Company's independent auditor. The Committee shall fulfill the oversight responsibility of the Board of Directors with respect to the independent auditors' audit of the books and accounts of the Company and for the fiscal year for which it is appointed.
2. The Committee shall approve the provision of all auditing and non-audit services (in excess of \$5,000) by the independent auditor to the Company in advance of the provision of those services and shall also approve the fees for all non-audit services provided by the independent auditor.
3. Provision of non-audit services of less than or equal to \$5,000 by the independent auditor to the Company do not require pre-approval from the Committee, but shall be communicated in writing to the members of the Committee at the first meeting following the engagement for the non-audit services at issue.
4. In connection with the Committee's approval of non-audit services, the Committee shall consider whether the independent auditor's performance of any non-audit services is compatible with the external auditor's independence.
5. At least annually, the Committee shall obtain and review a report by the independent auditor describing:
 - a. the independent auditor's internal quality control procedures;
 - b. all relationships between the independent auditor and the Company, in order to assess the auditor's independence
6. The Committee shall also review any report by the independent auditor describing:
 - a. significant accounting policies and practices used by the Company;
 - b. alternative treatments of financial information as required to be discussed by the independent auditors with the Committee; and
 - c. any other material written communication between the independent auditors firm and the Company's management.
7. Establish the Company's hiring policies for employees who are former employees of the Company's independent auditors

With respect to the Company's financial statements:

1. The Committee shall discuss the annual audited financial statements with management and the independent auditor, including the Company's disclosures.

2. The Committee shall review disclosures made to the Committee by the Company's CEO and CFO about any significant deficiencies in the design or operation of the internal controls or material weaknesses therein and any fraud involving management or other employees who have a significant role in the Company's internal controls.
3. In connection with its review of the Company's financial statements, the Committee shall review and discuss with the independent auditor the matters relating to the conduct of the audit as they may be modified or supplemented, including, but not limited to, significant judgments, significant estimates, critical accounting policies, and unadjusted differences.
4. Review major changes to the Company's auditing and accounting principles and practices as suggested by the independent auditor, internal auditors or management.
5. Review with management and the independent auditor any correspondence with regulators or governmental agencies and any employee complaints or published reports that raise material issues regarding the Company's financial statements or accounting policies.
6. Review with management and the independent auditor the effect of regulatory and accounting initiatives as well as off-balance sheet structures on the Company's financial statements.
7. Review any and all press stories that relate to the Company's accounting and disclosure, require that management or the auditor explain any negative comments and determine whether these comments necessitate a change in the accounting structure of the Company.
8. Based on its review and discussions with management, the internal auditors and the independent auditor, the Committee shall provide a recommendation to the Board of Directors whether the Company's financial statements should be accepted.

With respect to periodic reviews and reports:

1. Periodically, the committee shall meet separately with senior management, internal auditors and the independent auditors.
2. The Committee shall review with the independent auditor any audit problems or difficulties and management's response to them.
3. The Committee shall review the Company's policies with respect to risk assessment and risk management.
4. The Committee shall communicate to the Board of Directors the matters discussed at each meeting of the Committee, including any issues with respect to the quality or integrity of the Company's financial statements, the performance and independence of the Company's independent auditors or the performance of the internal audit function.
5. The Committee shall discuss with the Board of Directors the matters discussed at each meeting of the Committee.
6. The Committee shall review and assess the adequacy of this Charter annually and recommend any proposed changes to the Board of Directors.

With respect to the other matters:

1. The Committee shall inquire of management and the independent auditors about significant risks or exposures to the Company and the ERCOT market and assess the steps management has taken to minimize such risks.
2. The Committee shall establish procedures for:

- a. The receipt, retention and treatment of complaints received by the Company regarding accounting, internal accounting controls, or auditing matters; and
 - b. The confidential, anonymous submission by the Company's employees of concerns regarding accounting or auditing matters.
3. The Committee shall review, based on the recommendations of the independent auditors and the CFO, the scope and plan of the work to be done by the Company's internal auditor, and the results of such work.
4. The Committee shall establish the Company's hiring policies for employees who are former employees of the Company's independent auditor's review the appointment and replacement of the senior internal auditing executive, the scope of the internal audit plan and the significant reports to management prepared by the internal auditing department and management's responses.
5. Meet at least biannually with the independent auditor, the chief financial officer and the senior internal auditing executive in separate executive sessions.

Meetings

The Committee shall meet at least once during each fiscal quarter, and as many additional times as the Committee shall deem necessary or appropriate.

Minutes

The Committee shall designate a secretary, who shall prepare or cause to be prepared the minutes of each meeting and file such minutes with the corporate records of the Company. The secretary shall send, or cause to be sent, copies of such minutes to each of the Members.

Evaluation

The Committee shall undertake an annual evaluation assessing its performance and, in light of this, consider changes in its membership, charter or procedures. The Committee shall report to the Board the results of its evaluation, including recommended charter, membership and other changes, if any.

CY-2006 SAS70: Remediation Status and Lessons Learned

- **Remediation Status**

- All short term deliverables due by Dec 31 have been completed
- Long term tasks are in process and will be completed in March 2007 in accordance with schedule

- **Lessons Learned**

- Perform self assessments to evaluate audit readiness
- Perform self assessments to identify continuous process improvement
- Ensure that Control Activities document “key controls”
- Obtain agreement on Control Activities definitions (same page)



<The following materials are also included in the board packet, and are included here for your convenience>

Date: February 13, 2007
To: ERCOT Board of Directors
From: Clifton Karnei, Chairman of the Finance and Audit Committee
Subject: Application of the Expected 2006 Actual vs. Budget Revenue Requirement Variance

Issue for the ERCOT Board of Directors

ERCOT Board of Director Meeting Date: February 20, 2007

Agenda Item No.: 7c

Issue:

At the February 20, 2007 meeting of the ERCOT Finance and Audit Committee, Committee members reviewed estimates of the expected 2006 Actual vs. Budget variance and considered alternatives for the use of the funds made available by the favorable budget variance. At this time, the Finance and Audit Committee recommends the following action to the Board:

The Finance and Audit Committee recommends that the Board direct ERCOT staff to apply any favorable budget variances from the 2006 budget year to reduce debt-funding of 2007 projects.

Background/History:

ERCOT staff presented financial forecasts of its results of operations for fiscal 2006 to the Finance & Audit Committee and Board of Directors at various times throughout 2006. Each time, ERCOT indicated that a favorable budget variance was expected.

Based on preliminary financial information, ERCOT expects that it will likely have recorded income totaling approximately \$7.3 million in excess of revenue requirements for the year. The projected favorable budget variance is primarily the result of favorable energy consumption (leading to higher-than-budgeted System Administration Fee revenue), interest income, and non-operating income relating to insurance recoveries.

The Committee considered several options regarding how to address the utilization of ERCOT’s projected favorable financial variance, including (1) reducing the ERCOT System Administration Fee, (2) refunding of a portion of ERCOT System Administration Fee proceeds, (3) increasing 2007 project funding, and (4) reducing ERCOT debt or reducing the debt-funded portion of 2007 capital project expenditures. The first two options would require approval of the Public Utility Commission.

After final discussion at the February 2007 Committee meeting, the Committee arrived upon the recommendation described above.

Key Factors Influencing Issue:

In approving ERCOT’s 2007 budget the Board of Directors resolution included authorization



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for a temporary debt funding ratio of 27 percent revenue and 73 percent debt in 2007 but required ERCOT management to reinstate the standard ratio of 40 percent revenue and 60 percent debt by December 31, 2008.

During the discussion and deliberation leading to the approval of ERCOT's 2007 budget, PUCT Commissioner Smitherman stated that he recommended the PUCT consider entering an order requiring that ERCOT restore the Debt/Revenue ratio of 60/40 by December 31, 2008.

Alternatives:

1. Approve the recommendation of the Finance and Audit Committee, as recommended or as modified by the Board;
2. reject the recommendation of the Finance and Audit Committee;
3. remand this issue to the Committee with instructions; or
4. defer action until a later Board meeting.

Conclusion/Recommendation:

The Finance and Audit Committee recommends that the Board approve Alternative "1" as described above.



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

WHEREAS, the Board of Directors (“Board”) of Electric Reliability Council of Texas, Inc. (“ERCOT”) deems it desirable and in the best interest of ERCOT to formalize its direction to ERCOT management with regard to favorable financial variance realized from its operations in 2006.

THEREFORE, be it RESOLVED that ERCOT is hereby directed to apply any favorable budget variances from the 2006 budget year to reduce outstanding debt or reduce debt-funding of 2007 projects.



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Date: February 13, 2007
To: ERCOT Board of Directors
From: Clifton Karnei, Chairman of the Finance and Audit Committee
Subject: Approval of Maxwell Locke & Ritter, LLP as Auditor for 2006 – 2008 Retirement Benefit Plan Audit

Issue for the ERCOT Board of Directors

ERCOT Board of Director Meeting Date: February 20, 2007

Agenda Item No.: 7d

Issue:

ERCOT management seeks Board approval to select and negotiate terms of an agreement with the firm of Maxwell Locke & Ritter, LLP for the performance of an independent audit of the financials of ERCOT’s retirement benefit plans, for the years 2006 – 2008. In October 2005, the Board approved PricewaterhouseCoopers LLP (“PwC”) as the auditor to audit ERCOT financial statements (including the financial statements of ERCOT’s retirement benefit plans) for a three-year period. However, as described in more detail below, ERCOT has discovered that it must quickly complete an audit of the Money Purchase Plan (“MPP”), which was terminated and combined with the 401(k) Savings Plan (“401(k)”) in March 2006, in order to avoid accruing interest and penalties. Because of the urgent need to quickly complete this audit, PwC suggested that ERCOT use a different accounting firm for these audits. ERCOT competitively bid the final audit of the financials of the MPP, along with the audit of the financials of the newly combined 401(k), and has tentatively selected Maxwell Locke & Ritter, LLP.

Background/History:

Section 4.10(d) of the ERCOT Bylaws (“Bylaws”) require the Board to approve the annual selection of a qualified public accounting firm (“Auditor”) to audit the financial statements of ERCOT. Section 9.6 of the Bylaws establishes that at least annually, an audit of the financial statements of ERCOT shall be performed by the Auditor approved by the Board. The Auditor’s opinion and the audited financial statements will be made available to all Members.

Sections 4.10 and 9.6 of the Bylaws do not distinguish between the financial statements of ERCOT and the financial statements of ERCOT’s retirement benefit plans. In October 2005, following a competitive bid process and based on recommendation from ERCOT staff and the Finance and Audit Committee, ERCOT’s Board of Directors selected PwC as the auditor of ERCOT’s financial statements, including as well as the financial statements of ERCOT’s retirement benefit plans. The selection was for a three year period covering audit years 2005 – 2007 (audit field work to be conducted in 2006 – 2008).

PwC completed the audit of the 2005 financials statement as planned and has commenced work on the audit of ERCOT’s 2006 financial statements. Historically, the retirement benefit plan financial statement audit is executed in July or August. PwC was planning on completing audit



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field work for the retirement benefit plans during this time.

However, in March 2006, ERCOT terminated its MPP and combined it with ERCOT's amended 401(k). Within six months following termination of the MPP, ERCOT was required to have a final financial statement audit for the plan. Unfortunately, this requirement was not recognized until after more than six months and the audit deadline had passed. Penalties and fines stemming from failure to timely complete financial statement audits of terminated plans can be assessed at rates up to \$1,100 per day.

To limit exposure to potential penalties and interest, ERCOT is attempting schedule the final financial statement audit of the terminated MPP as quickly as possible. For efficiency, ERCOT would like to have the same accounting firm do the 2006 financial statement audit of the 401(k). In addition, ERCOT would like to have the same accounting firm do the 2007 and 2008 financial statement audit of the 401(k) to provide continuity and reduce the annual price.

PwC committed to meet ERCOT's audit needs, but after considering salient factors including staff expertise, staff availability, and the price of the benefit plan audit engagements ERCOT management decided, with the approval of PwC, to competitively bid services to perform the final audit of ERCOT's terminated MPP as well as the 2006 – 2008 comparative financial statement audit of its amended 401(k). Maxwell Locke & Ritter, LLP was selected as the audit firm preferred by management as a result of the competitive process. The cost for both audits is estimated to be less than \$50,000. The 401(k) audits for 2007 and 2008 are estimated to be less than \$25,000 per year.

Key Factors Influencing Issue:

Key factors influencing the issue include the need expedite the benefit plan audits due to benefit plan administration compliance issues that expose ERCOT to risk of significant potential penalties and fines and the desire to engage a firm that through their audit team can help ensure future regulatory compliance.

Alternatives:

1. Approve the recommendation of the Finance and Audit Committee, as recommended or as modified by the Board;
2. Reject the recommendation of the Finance and Audit Committee;
3. Remand this issue to the Committee with instructions; or
4. Defer action until a later Board meeting.

Conclusion/Recommendation:

The Finance and Audit Committee recommends that the Board authorize ERCOT management to negotiate with Maxwell Locke Ritter, LLP for the audit of the 2006 financial statements of ERCOT's MPP and 401(k) and 2007-2008 for the 401(k).



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

WHEREAS, the Board of Directors (“Board”) of Electric Reliability Council of Texas, Inc. (“ERCOT”) deems it desirable and in the best interest of ERCOT to select Maxwell Locke & Ritter, LLP to conduct the final audit of its terminated Money Purchase Plan and the 2006 – 2008 financial statement audit of its 401(k) Savings Plan;

THEREFORE, be it RESOLVED that:

1. Maxwell Locke & Ritter, LLP is selected as the 2006 financial statement auditor of ERCOT’s 401(k) Savings Plan and its terminated Money Purchase Plan;
2. Maxwell Locke & Ritter, LLP is selected as the 2007 and 2008 financial statement auditor of ERCOT’s 401(k) Savings Plan;
3. ERCOT is hereby authorized and approved to negotiate terms and execute an engagement letter with Maxwell Locke & Ritter, LLP for the final financial statement audit of ERCOT’s terminated Money Purchase Plan and the 2006 financial statement audit for ERCOT’s 401(k) Savings Plan and the 2007 and 2008 financial statement audit for ERCOT’s 401(k) Savings Plan.

- **Internal Control Environment**

- ERCOT has adopted the COSO framework as the foundation for the control environment
- ERCOT has formally documented controls for Corporate Governance and Financial Reporting-related processes (including Human Resources, Capital Projects and general IT controls).
- Controls for the business processes covered by SAS70 have also been documented, but are not currently included in the control repository

- **Management:**

- has established a strong tone at the top in support of internal controls
- has promoted stabilization of the control environment
- communicates expectations to employees and contractors and holds them accountable
- periodically conducts control self-assessments on formally documented controls
- approves policies and procedures and ensures access to approved documentation for all ERCOT staff and contractors
- conducts training to communicate processes and controls to employees and contractors
- reviews reports from internal audit, external auditors and staff to ensure the control environment is functioning as intended

- **Board of Directors and oversight authority:**
 - active monitoring of management activities
 - receive independent reports from qualified third parties
- **Current activities include:**
 - stabilizing the control environment through:
 - continued focus on a company culture of a balanced state of good financial management and operational reliability
 - providing additional education to employees to increase awareness of control requirements
 - ongoing monitoring and updating of controls based on business risk
- **While ERCOT is not required to comply with the provisions of the Sarbanes-Oxley act**
 - ERCOT's internal control environment has been designed with the requirements of Sarbanes-Oxley in mind and to provide reasonable assurance to constituents and stakeholders that ERCOT is meeting its business objectives and complying with laws and regulations

- **ERCOT filed for approval of Final Nodal Market Implementation Surcharge on January 29, 2007 (prior to the Jan 30th deadline)**
Filing requests:
 - A \$0.127 per MWh Surcharge to be included on invoices beginning June 1, 2007
 - Continuation of the “flat-fee” method of calculating the Nodal Surcharge adopted by the Commission in the interim fee case
 - Allocation of the final Nodal Surcharge on the same basis as the Commission determined the interim surcharge should be allocated
 - Approval of an expedited process for Commission review and approval of proposed changes to the Nodal Surcharge

- **The filing requests a \$0.127 per MWh surcharge to be included on invoices beginning June 1, 2007 based on:**
 - the need to recover \$248.9 million (the cost of the Nodal Program to be recovered by the Nodal Surcharge, including financing costs)
 - a “flat fee” method of collecting those costs over the combined development period (through Dec 2008) and estimated average useful life of the assets (est Jan 2009 – Dec 2012)
- **ERCOT supports continuation of the “flat-fee” method of calculating the Nodal Surcharge adopted by the Commission in the interim fee case as a reasonable balance among competing objectives, as long as the surcharge is implemented timely.**

- **The filing provides a schedule showing the sensitivity to a delay in implementation beyond June 1, 2007. (see next page)**
 - ERCOT proposes that the surcharge be increased (as outlined in the schedule) for any delay in implementation date through September 2007.
 - ERCOT indicates that it would no longer support a flat fee if implementation is expected to be delayed beyond September 2007 because the revenue contribution during development drops below 30%.
 - At that time, ERCOT would consider supporting a higher fee during the development phase

**Texas Nodal Market Implementation Program Funding
Summary of Incremental Fees**

Implementation date	Surcharge (in \$)	Revenue contribution during development	Nodal costs to be financed	Debt financing costs	Total recoverable cost
1-May	0.126	32%	215.4	33.3	248.7
1-Jun	0.127	32%	215.4	33.5	248.9
1-Jul	0.128	31%	215.4	33.9	249.3
1-Aug	0.130	30%	215.4	34.3	249.7
1-Sep	0.131	30%	215.4	34.6	250.0
1-Oct	0.132	29%	215.4	35.0	250.4

Recommended

Overview

- New information since the September 2006 update
- Debt capacity expected to be needed through 2008
- Near term debt capacity needs
- Key assumptions / Unknowns
- Existing short term debt as of January 31, 2007
- Interest rate risk management
- Next steps
- Current rate environment

- **New information since the September 2006 update, ERCOT has**
 - Firmed up the estimated cost of the Nodal project
 - Finalized its 2007 operating budget
 - Including impact from Zonal / Nodal Dependencies
 - Including capital funding plan for 2007 through 2008
 - Filed for recovery of Nodal costs through a surcharge
- **Given the updated assumptions noted above, ERCOT has reevaluated its liquidity requirements and desires to update F&A.**

- **Debt capacity expected to be needed through 2008 (includes Nodal and base operations)** ⁽¹⁾ (in millions)

– Actual debt at Dec 31, 2006	\$ 47
– 2007 projections	
• Baseline capital spend (\$44 less \$12 rev) ⁽²⁾	\$ 32
• Nodal spend (\$114 minus \$28 from Surcharge)	<u>\$ 86</u>
Expected outstanding debt at Dec 31	\$165
– 2008 projections	
• Baseline capital spend (\$21 less \$14 rev) ⁽²⁾	\$ 7
• Nodal spend (\$55 less \$32 from Surcharge)	<u>\$ 23</u>
Expected outstanding debt at Dec 31	\$195
• Estimated liquidity requirement (\$ 30 - \$ 40)	<u>\$ 40</u>
Total expected capacity needed at Dec 31, 2008	\$ 235
– Current revolver capacity	<u>\$ 125</u>
– Expected increase needed in debt capacity	\$ 110

⁽¹⁾ Assumes Nodal Surcharge of 12.7 cents implemented June 1, 2007

⁽²⁾ Assumes capital expenditures in accordance with the approved 2007 Budget / Strategic Financial Plan

• **Near term debt capacity needs** (in millions)

– Actual debt at Dec 31, 2006	\$ 47
– 2007 projections ⁽¹⁾	
• Baseline capital spend (\$44 less \$12 rev) * ½	\$ 16
• Nodal spend (\$114 less \$28 Surcharge) * ½	<u>\$ 43</u>
Expected outstanding debt at June 30	\$106
• Estimated liquidity requirement (\$ 30 - \$ 40)	<u>\$ 40</u>
Total expected capacity needed at June 30, 2007	\$146
– Current revolver capacity	<u>\$125</u>
– Projected liquidity shortfall at June 30, 2007	\$ 21
– Expanded borrowing capacity needed prior to June 30 given current expected Nodal spending.	

(1) Assumes straight line spending

- **Key assumptions**

- Nodal Surcharge is 12.7 cents / MWh and implementation begins June 1, 2007
- Capital expenditures made per 2007 Budget and Strategic Financial Plan
- Spending occurs straight line through out the year

- **Unknown**

- Although ERCOT has an Board approved Nodal budget and has requested a recovery method, we do not yet have final PUCT approval for the surcharge amount and recovery period.

Existing short term debt as of January 31, 2007 (excluding current portion Senior Notes/Term Loan)

(in millions)

	STD Outstanding	Remaining Availability
– Revolver (drawn)	\$ 5	\$ 120
– TCR borrowings (internal funds)	<u>\$ 45</u>	<u>\$ 0</u>
Total	\$ 50	\$ 120

TCR borrowings must be repaid over the remainder of the year.
ERCOT will draw under the Revolver to repay TCR borrowings.

Interest rate risk management

- ERCOT’s Financial Policy requires that: “in no event will ERCOT allow unhedged, variable rate debt to be more than 40% of total debt outstanding”
 - Action will need to be taken before June 30 to remain compliant with this requirement

	Dec 31, 2006	Est Jun 30, 2007
Current and projected debt outstanding		
Senior Notes	109.09	95.45
Term Loan	25.00	25.00
Revolver / new borrowing	47.00	106.00
Borrowing	<u>181.09</u>	<u>226.45</u>
Fixed / floating blend		
Fixed rate debt (%)	74.0%	53.2%
Floating rate debt (%)	26.0%	46.8%
Total	<u>100.0%</u>	<u>100.0%</u>
Target max floating rate debt	40.0%	40.0%

- **Next steps**

- ERCOT is exploring financing alternatives. Key requirements are that financing alternatives:
 - Meet near term need for liquidity and interest rate risk management
 - Meet two-year needs efficiently (be expandable and/or minimize admin cost to move from near term to two-year solution)
 - Be cost effective
 - Provide flexibility around pay down of debt (given that surcharge is not yet approved and even when approved is dependent on MWh, etc)
 - Be flexible to fund as dollars are spent

- **Next steps (continued)**
 - Options being considered include:
 - Expanded or new bank facility to add capacity with an interest rate swap component to address interest rate risk management
 - Consider broadening number of financial institutions with whom we do business
 - Private placements at fixed rate
 - Staff will make recommendation by April Board meeting

- **Current rate environment**

- LIBOR (floating) rates are currently projected to be relatively flat over the next year. The yield curve is actually slightly inverted.
 - Economist opinions vary on whether rates will go up or down beyond a 9-month window. JPMorgan and Wachovia currently predict increasing rates.

EXAMPLE as of February 12, 2007

- 3-month LIBOR is 5.36%
 - A forward starting interest rate swap (floating to fixed) beginning June 1, 2007, with four equal annual pay downs on November 1 from 2009 to 2012 (four years) could be set at a fixed rate under 5.25%.⁽¹⁾
- Credit spreads remain relatively tight / both bank and private placement markets continue to be attractive.

⁽¹⁾Excludes ERCOT credit spread

Agenda

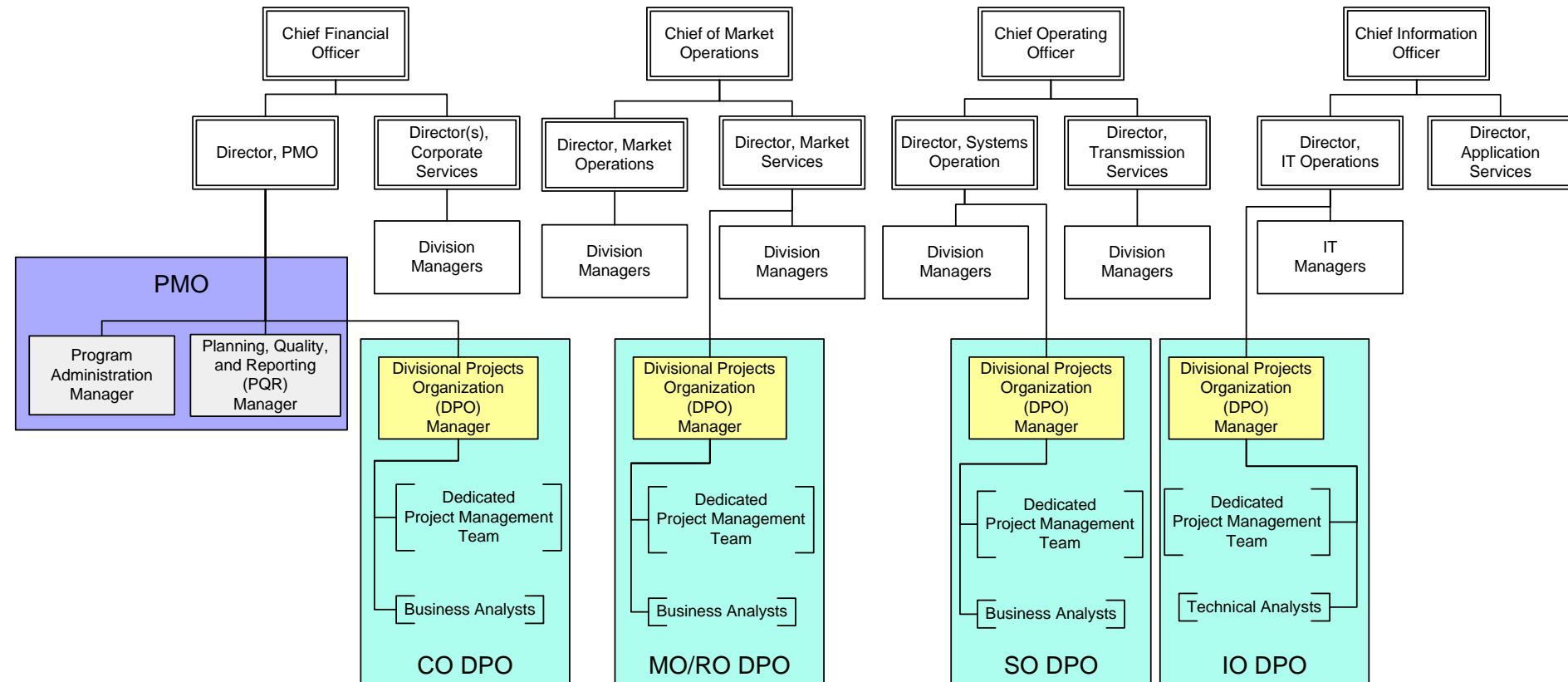
- **Review of PMO Changes in 2006**
- **2006 Projects Delivered**
- **Look Ahead to 2007**

Organizational Change Summary

- **Implemented the following organizational structures:**
 - **Centralized** *Program Management Office (PMO)* focusing on fostering project management excellence through standardized processes, procedures, tools, training and support functions for all ERCOT projects
 - **Decentralized** *Divisional Projects Organization (DPO)* focusing on accountability and responsibility for business area project portfolio management and delivery
- **Established divisional-PPL's, assigning accountability and responsibility to each ERCOT executive for managing their resulting business area projects portfolio**
- **Clarified, documented and communicated roles and responsibilities to revised organizational structures**

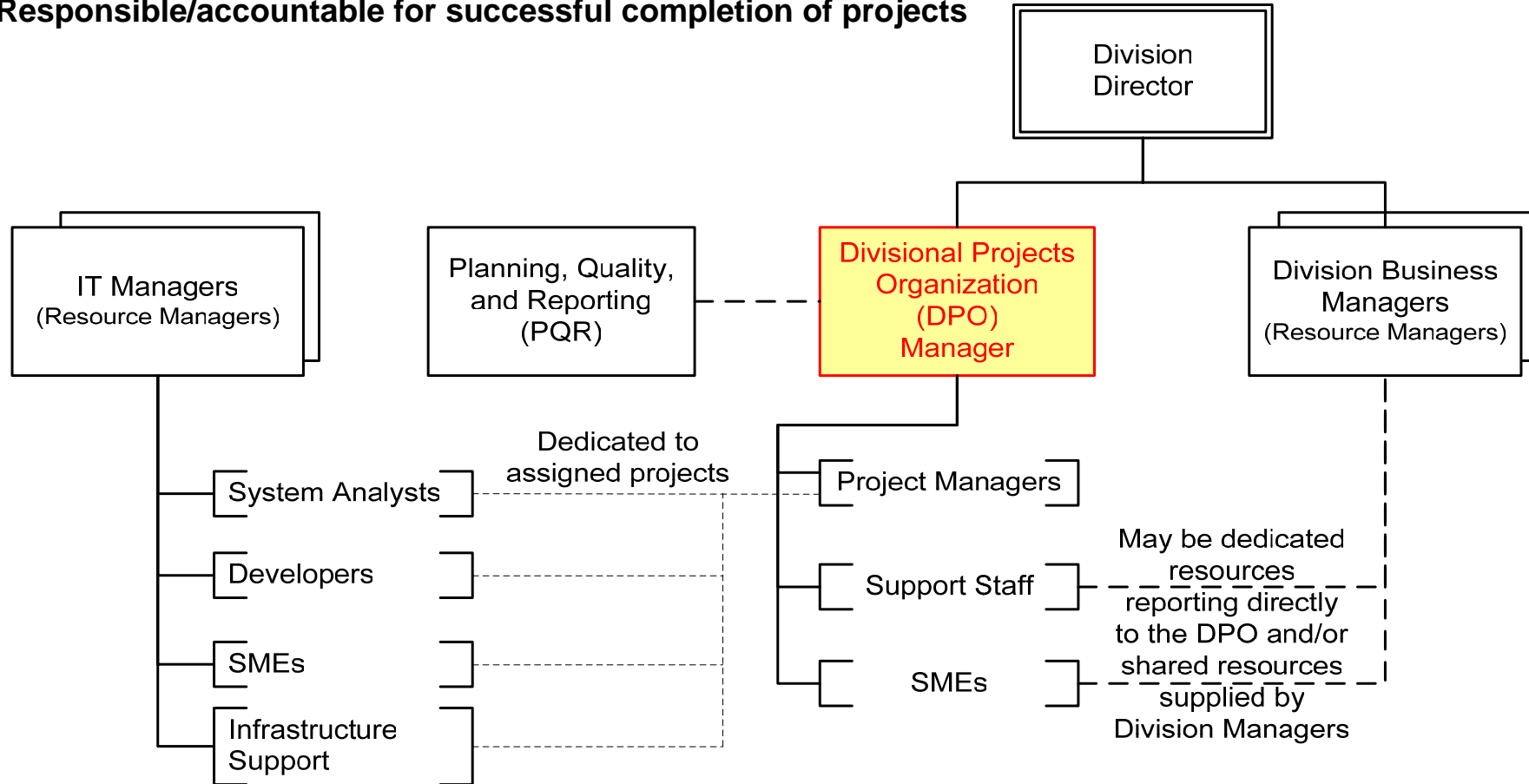
Project Team Organization Structure

The project management teams report directly to their corresponding business area, establishing a **Divisional Projects Organization (DPO)** that is supported by the **Program Management Office (PMO)**.

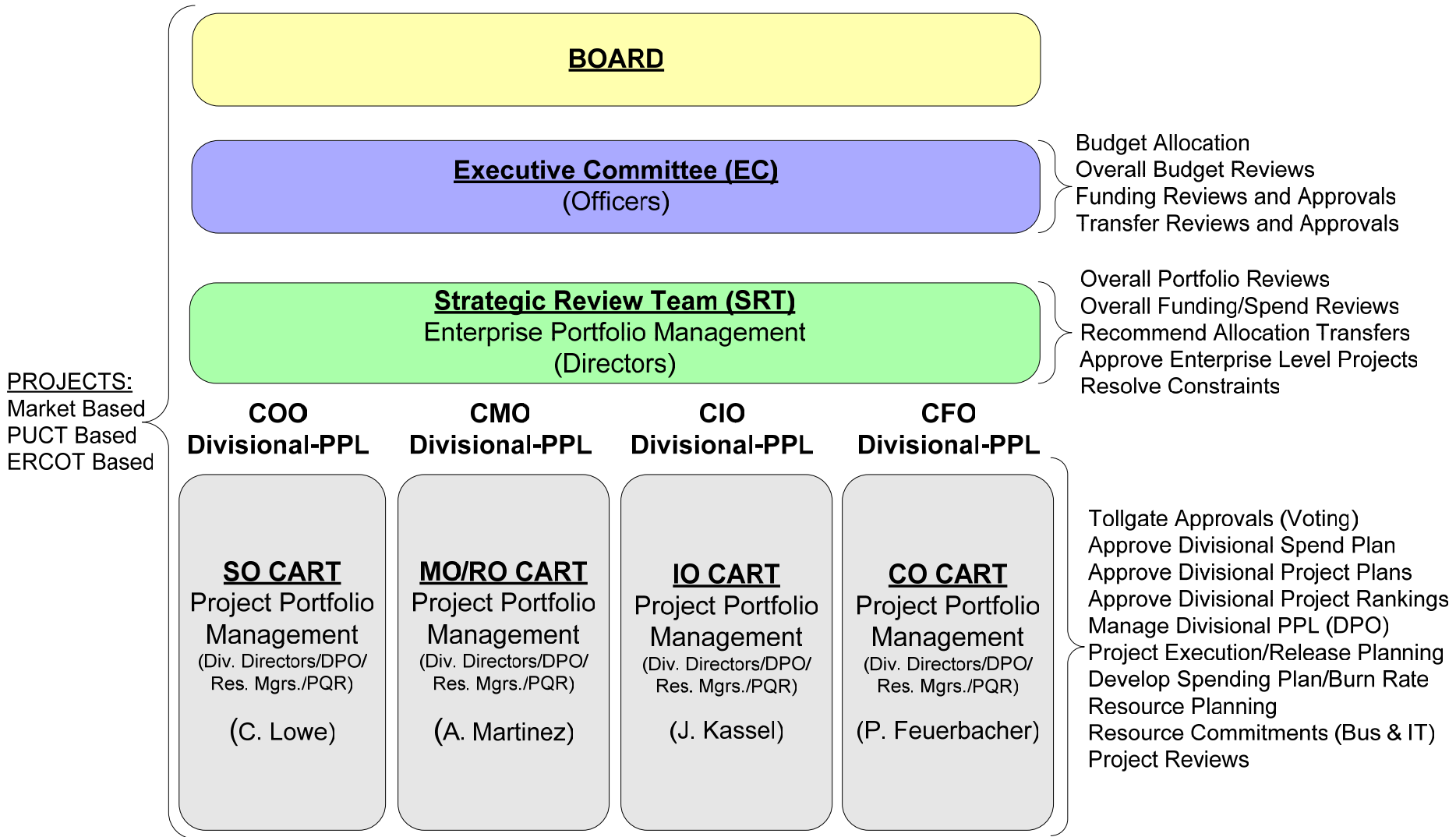


The Divisional Projects Organization (DPO) is:

- Responsible/accountable for business area project portfolio management
- Responsible/accountable for successful completion of projects



Governance Hierarchy



2006 Projects Delivered

- **Delivered 63 Projects**
- **Utilized \$26.874MM Plus \$9.280MM For Nodal-related Projects (\$36.154MM Total)**
- **91% on Budget and 73% on Time (both above industry standards)**
- **Breakout by Size**

Under \$100k	13
\$100k-\$500k	31
Over \$500k and Under \$1M	12
Over \$1M (Large Projects)	7

- **Large Projects Completed/concluded**
 - Service Oriented Architecture (9 projects over 2004-2006)
 - Enterprise Data Warehouse (9 projects over 2003-2006)
 - Enhancements to FasTrak Tools (2005-2006)
 - Austin QA Build out (2005-2006)
 - Enhancements to MOMS Study Market Clearing Engines (2006)
 - SBC Network Replacement (2005-2006)

2007 Projects Delivery Forecast

- **Forecasted Projects: 66**
- **Budget: \$30MM Plus \$14MM Nodal Critical Path-related Projects**
- **Breakout by Size**

Under \$100k	22
\$100k-\$500k	29
Over \$500k and Under \$1M	6
Over \$1M (Large Projects)	9

- **Large Projects :**
 - Operator Training Simulator (2005-2007)
 - Enhancements to SCR727 (2005-2007)
 - TxSET 3.0 (2006-2007)
 - TCC1 Finish and Annex Construction (2007)
 - Lawson Application Outsourcing (2007)
 - Minor Capital (2007)
 - Tools and Strategy for Information Lifecycle Management (2007)
 - Enterprise Service Management (2007)
 - Virtual Tape Backup (2007)

PMO 2007 Significant Initiatives

- **Improve/Streamline PMO Processes**
- **Develop plan to continue performance improvements consistent with Capability Maturity**
- **Together with nodal PMO, develop transition plan to merge Nodal and Zonal PMOs**
- **Perform Impact Analysis on PUCT, Market and ERCOT proposed changes**
- **Make decision on future of MET Center utilization**
- **Establish PMO & Project Management Training Program**
- **Implement Resource Planning Method utilizing automated tools when possible**
- **Develop and implement a method to fund on-going projects beyond the planning phase**
- **Provide EC a “deep dive” into project statuses**
- **Impact analysis on all proposed projects and conduct periodic post-project reviews**
- **Establish a CBA Review Team**

Committee Brief – Credit

Cheryl Yager

ERCOT Market Credit Status

as of 12/31/2006

as of 1/31/2007

Exposure in the ERCOT Market (owed to ERCOT)

QSEs that meet ERCOT Creditworthiness Standards

Ratings over BBB-

	# 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	
	4	24,561,600	8%	58,000,000	U	5	21,784,950	7%	48,000,000	U
	46	113,307,090	39%	223,795,550	S	44	107,326,901	33%	228,675,970	S
	16	154,977,295	53%	611,367,000	S	13	195,088,214	60%	440,442,122	S
Total Exposure	66	292,845,985	100%			62	324,200,065	100%		
	14	(5,552,041)	-15%	101,026,345	U	13	(26,030,948)	-34%	106,028,345	U
	41	(12,482,504)	-34%	22,118,635	S	45	(40,836,845)	-53%	30,356,751	S
	9	(18,944,381)	-51%	101,900,000	S	9	(9,613,285)	-13%	185,200,000	S
Total	64	(36,978,926)	-100%			67	(76,481,078)	-100%		

Other QSEs in the ERCOT Market (ERCOT owes)

QSEs that meet ERCOT Creditworthiness Standards

Ratings over BBB-

QSEs that do not meet ERCOT Creditworthiness Standards

Ratings below BBB- or not rated

Cash & Letters of Credit
Guarantee Agreements

Total

Total

130

129

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 February 9th, 2007)

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 Board and Staff need awareness of ERCOT's short and long-range strategic plan. The Nodal project and the proposed ERO/RE environment have been adequately factored into plans.</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 has rolled out a revision of the Executive Dashboard based on defined KPI's and have instituted regular Quarterly Business Reviews to discuss key business activities in addition to weekly executive team meetings, constant grid monitoring, IT SLA's, and generation / transmission assessments.</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 has had a significant impact on Customer Choice operations which has reduced overall levels of risk, however other IT related Retail issues continue.</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) need further improvement. An Operator Training Simulator will not be operational until April. Increasing and more difficult to forecast system loads represent a risk in the shoulder months.</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>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. Enhanced efforts are being undertaken to maintain records according to established record retention policies.</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 the development of Key Performance Indicators (KPI's) have increased awareness of organizational goals and 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 are currently below desired expectations. Additional development activities required to implement and test these procedures. However solid overall business practices are confirmed via: Internal and External audit, Operational review, Regional Entity / Compliance, and RMC and Disclosure Committee review.</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 scope management, vendor resources and deliverable tracking. Project team burn-out, including non-Nodal staff in Procurement, Legal and HR, is a high-risk item. The recent hiring of the Executive Director and other managers has stabilized this risk. Scope management remains a significant risk to project time line and budget</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 and insufficient ability to conduct long-range (6-10 years out) planning resulting in possible inefficiencies in ERCOT's transmission expansion plan.</p>	<p>Disclosure</p> <p><i>Reporting and other disclosures to intended parties is timely, accurate and effective</i></p> <p>A Disclosure Committee has been institutionalized to discuss and report issues related to external reporting and compliance.</p>	<p>Internal Control Compliance</p> <p><i>Internal Control Compliance, processes and management standards are effective and efficient</i></p> <p>Audit findings are actively monitored by management as well as Internal Audit. Additional training activities are required to ensure all staff members are aware of ongoing internal control compliance processes and procedures.</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 impact ERCOT reputation as could increased scrutiny on ERCOT activities occurring during the bi-annual state legislative session. Additional focus is on ERCOT's transmission and generation adequacy planning as a valued, objective, and knowledgeable resource to regulators, legislators, and the market.</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>The Nodal project adds stress on the time demands of ERCOT employees. With the continued staffing-up of needed positions, our number of openings remains at 60-65 positions and contactors usage continues to increase. The turnover rate is 11%. The revised compensation plan is on schedule with the April merit reviews. Employee manual will replace the outdated handbook effective March 1, 2007.</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. The risk exists for a hotter than normal summer or cooler winter to increase load demand to a level that reduces reserve margins below acceptable minimum levels.</p>	<p>Communication</p> <p><i>Internal and external communications are timely and effective</i></p> <p>A crisis management project for communications has been completed and ERCOT has restructured its legal and communications departments. Issues remain relating to the effective communications of retail systems outages on an ongoing and consistent basis.</p>	<p>Industry Standards</p> <p><i>Business practices provide stakeholders with required assurances of quality</i></p> <p>SAS 70 Audit Issues and qualifications remain to be addressed with remediation activities underway to address preliminary findings. Also, new NERC Physical / Cyber Security Standards have been approved and are in the process of being adopted. In addition to SAS 70 Audit Issues, ERCOT has outstanding issues with filings related to its retirement and benefit plans.</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. Adequacy of Nodal budget and staffing allocation to be addressed through the updated Nodal surcharge filing.</p>	<p>Technology Infrastructure</p> <p><i>Information systems and data are effectively managed and are reliable</i></p> <p>Risks in Retail system stability still exist. Infrastructure and application review by an outside firm will be initiated and stability implementation plan will be developed by end of Q2 2007.</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 significant number of ADR's related to the RPRS policy debate outstanding, however these are being addressed in a timely fashion. Increased levels of ADR's may pose a future risk if they are no longer able to be timely addressed.</p>	<p>Operational Responsibility</p> <p><i>Market participants conduct their operations in a manner which facilitates consistent grid reliability</i></p> <p>Response of generators to grid operation events has been improving. Enhanced enforcement of NERC standards will exist through the ERO / RE structure.</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 has been redesigned to enable management to effectively monitor and manage the business.</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.</p>

Legend: Elevated Risk Level

Reduced Risk Level

(New Risk Categories / Descriptions Indicated in Green)

Rationale for Category Risk Assessment Changes

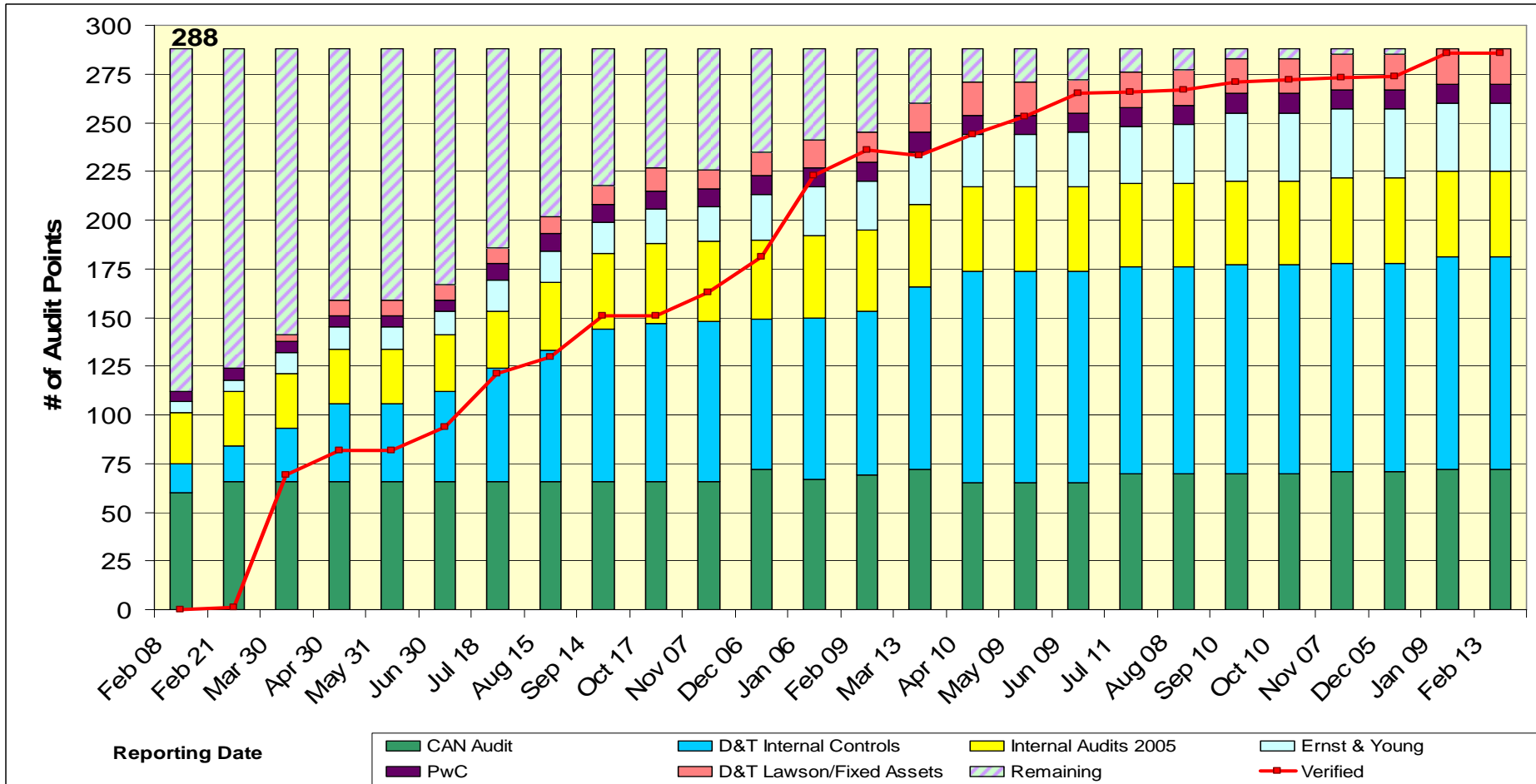
Strategy Development
Fiscal Management
Performance Monitoring
Legal & Legislative

Upgrade: Yellow > Green
Upgrade: Green-Yellow > Green
Upgrade: Green-Yellow > Green
Upgrade: Green-Yellow > Green

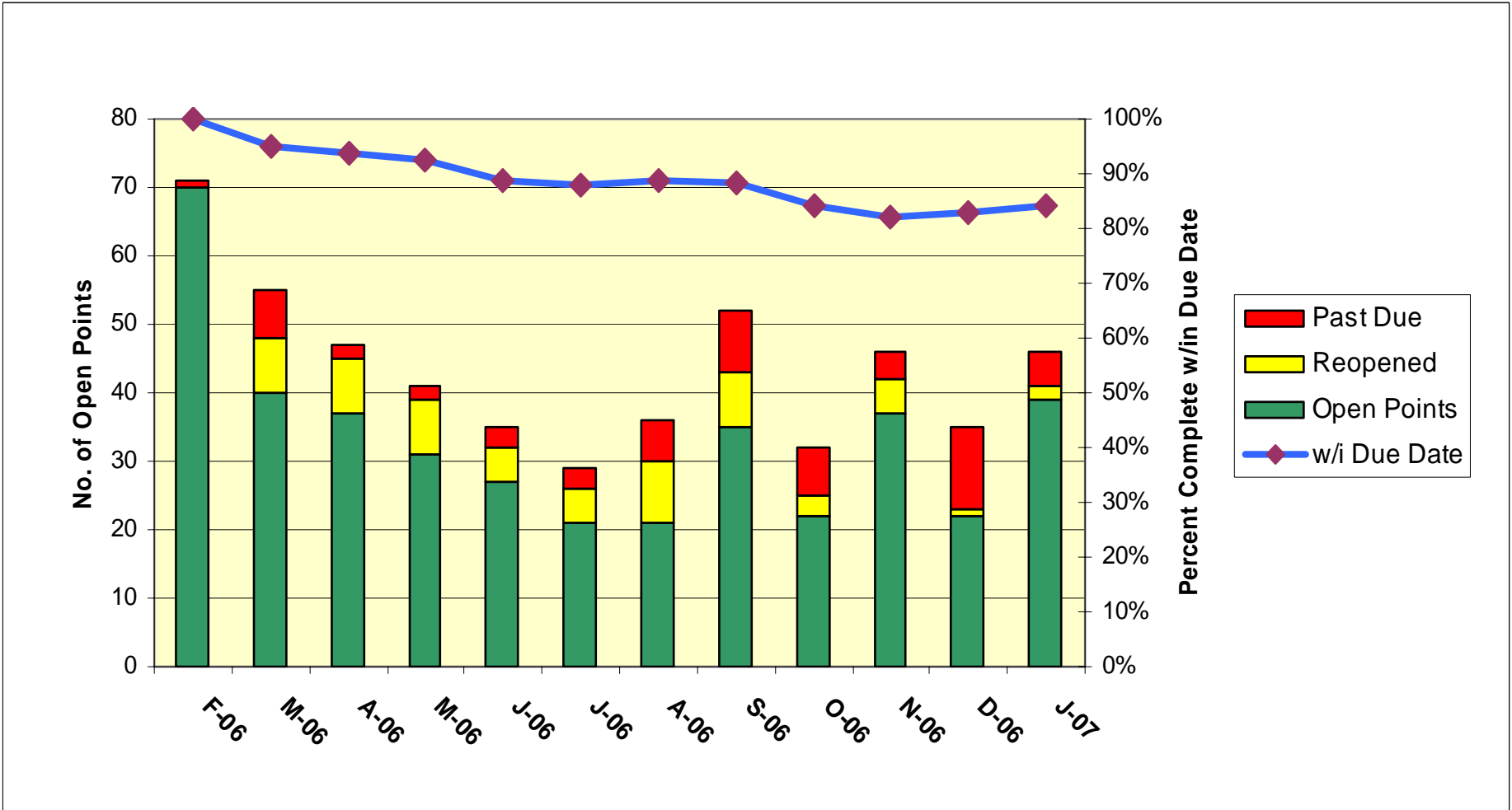
ERCOT has set a strategic direction which management feels is appropriate to its role within the Texas environment
Resolution of Nodal financing issues and adequate liquidity / debt financing planning arrangements
Roll-out of extensive review activities including QBR's, Executive Staff meetings, Grid / Transmission / Generation Assessments
ERCOT is in compliance with all laws and regulations and has established a legal framework for ensuring ongoing compliance

Completion Status by Audit 2004-05 Audit Points

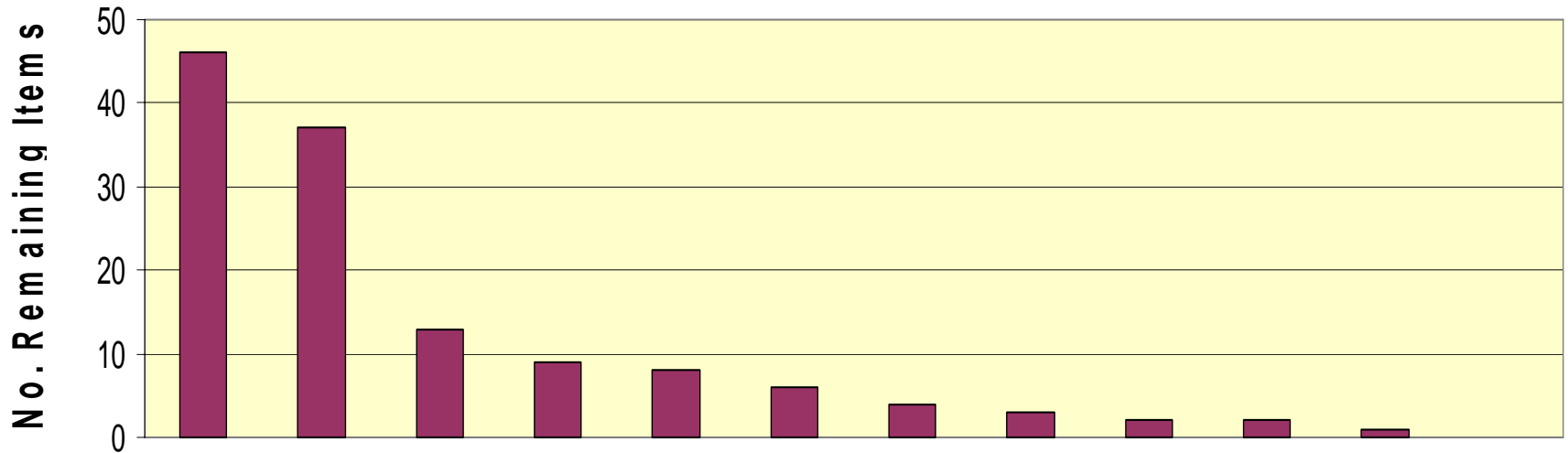
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Status of Open Audit Points



Projected Audit Point Progress



	Jan-07	Feb-07	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07
Series2	46	37	13	9	8	6	4	3	2	2	1	0

Audits Completed (last 3 months)

Internal Audits

- Crisis Communication Procedures
- Business Continuity Plan
- Procurement & Contract Administration
- Cyber Security (follow-up)
- Ethics Compliance

External Audits

- Texas Nodal Program Controls - Review #2 (IBM-managed by IAD)
- 2006 SAS70 (PwC)
- Internal Controls (D&T)

Open Audits

Internal Audits

- Budget Process
- SCADA Applications
- SAS70 Pre-Audit Testing
- Accounts Payable
- Nodal Timetracking
- PMO (Non-nodal)
- Registration/Qualification of Market Participants
- Fraud Prevention (ongoing)
- MAPS Follow-up (ongoing)

External Audits

- 2006 Financial Audit (PwC)

Planned Audits (next 3 months)

Internal Audits

- Nodal PMO
- Nodal Ethics Compliance
- Nodal Recruiting
- Nodal Signing Authority/Delegation of Authority
- MAPS Follow-up (ongoing)

External Audits

- NOTE: Internal Audits performed by IAD, unless otherwise noted.

**Consultation/
Analysis Reports
Completed**
(last 3 months)

External Assessments

- 3 security assessments completed in December

**Open Consultation/
Analysis Reviews**

External Assessments

- 1 security assessment with combined consulting service currently underway to complete by the end of February

**Planned Consultation/
Analysis Reviews**
(next 3 months)

External Assessments

- 1 security assessment planned

2007 Year to Date Project Activity by Division (January)

	Phase	Not Started	Initiation	Planning	Execution	Closing *	Completed *	Cancelled	On Hold	Totals by CART
CART	Corporate Operations	17	1	4	6	3	0	0	0	31
	IT Operations	7	1	3	3	0	0	0	1	15
	Market Operations	14	2	3	9	9	0	0	1	38
	System Operations	2	3	6	6	5	1	0	4	27
	Totals by Phase	40	7	16	24	17	1	0	6	111





*NOTE: 1 project went live in the month of January

Year to Date Project Priority List (PPL) Status (January)

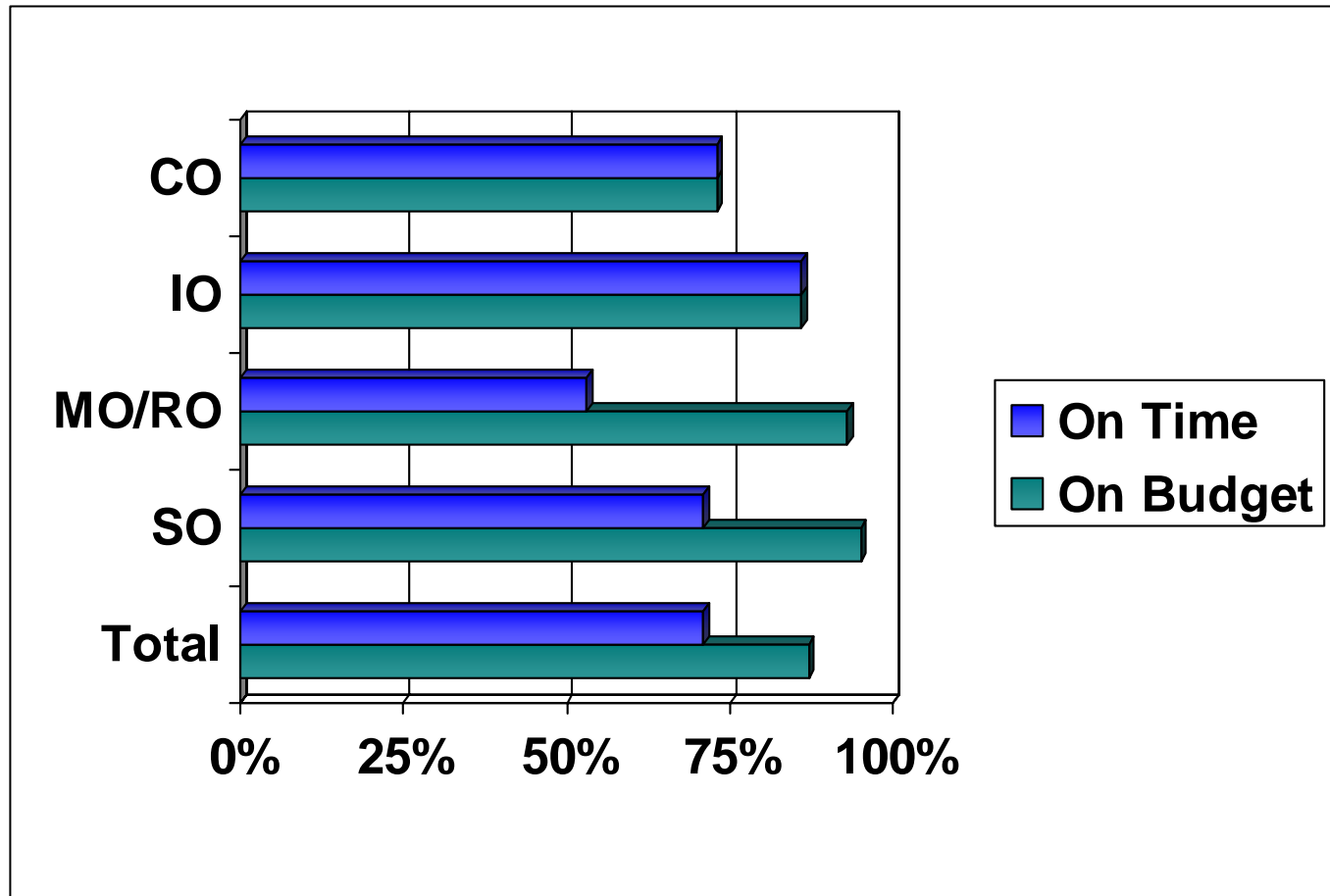
PPL Iterations	Origination	Project Phases								Subtotal	Grand Total
		Not Started	Initiation	Planning	Execution	Closing	Completed	On Hold	Cancelled *		
Original 2007 PPL*											77
	PUCT	1			2	1		2	1	7	
	Market	4	1	1	3	1		1	1	12	
	ERCOT	32	1	6	9			2	2	52	
	Compliance		2	2				1	1	6	
	System Maintenance									0	
Unexpected Carry Over From 2006											29
	PUCT					2				2	
	Market	1			2	2				5	
	ERCOT			2	7	13				22	
	Compliance									0	
	System Maintenance									0	
New Projects Added in 2007											8
	PUCT									0	
	Market	2								2	
	ERCOT	1		4	1					6	
	Compliance									0	
	System Maintenance									0	
2007 PPL totals as of January 31, 2007											114
	PUCT	1	0	0	2	3	0	2	1	9	
	Market	7	1	1	5	3	0	1	1	19	
	ERCOT	33	1	12	17	13	0	2	2	80	
	Compliance	0	2	2	0	0	0	1	1	6	
	System Maintenance	0	0	0	0	0	0	0	0	0	
Totals by Project Phase		41	4	15	24	19	0	6	5	114	

* Five projects were cancelled in 2006

Projects Over \$1 Million

Projects Over \$1M	Total Budget	Committed Actuals 01/31/07	Metrics	
Duration/Information (Sponsor)	Phase/Scheduled Completion		Schedule	Budget
Operator Training Simulator (2005-2007)	\$3.8M	\$2.465M		
<i>Training Simulator System for Operators (S. Jones)</i>	<i>Execution Phase/2nd Qtr 2007</i>			
Enhancements to SCR727 (2005-2007)	\$1.9M	\$1.379M		
<i>Entered into Execution (R. Giuliani)</i>	<i>Execution Phase/2nd Qtr 2007</i>			

2007 Completed and Active Projects Performance (January)



Note: Includes projects started in previous years

Capital Projects – Budget vs. Actuals for Projects Completed YTD (January)

Completed Projects	Baseline Budget	Actuals	\$ (Over)/Under Baseline Budget	% (Over)/Under Baseline Budget		
PR-50005 (EDW EMMS Extract)	327,190	315,035	12,155	4%	-	12,155
Count = 1			<u>12,155</u>		-	<u>12,155</u>
						(1 project)

NOTES:

- (a) Baseline Budget does not include change controls that were approved without granting a new baseline budget.
- (b) Completed Project List may not contain projects waiting for final production verification and/or administrative close out.

Go Live Projects for January

- **PR-50005 EDW EMMS Extracts**
 - **Scope:** Transition PUCT, Market and Public EMMS extracts from the legacy Data Archive to the ODS environment utilizing the EIS Data Delivery Model.
 - **Deliverables:** 4 extracts for Market Participants and 12 extracts for the general public
 - **Timeline:** January 2005 – January 2007

Large Project Moving to Execution

- **PR-40038_01 TX SET 3.0, Mass Transition, T&C**
 - **Scope:** There are three main components that comprise the PR40038 - TX SET 3.0 project:
 - Mass Transition
 - Implementation of PUCT Rule 25.43 and Definition C
 - Market-wide implementation of PRR660
 - Term and Conditions
 - Phase 1 Implementation of PUCT Rule 25.214
 - TX SET Change Controls
 - Miscellaneous change controls from TX SET
 - **Deliverables (Execution):** Paperfree Map Changes, NAESB Configuration, Siebel Code Build, TIBCO Configuration, TML Retail Build, Siebel and EIF Database Changes, EIS Configuration, Extract Build, User Acceptance Regression and Performance Testing, Retail Market Testing, MCT Release Coordination.
 - **Timeline:** February 2007 – June 2007
 - **Board Request:**
 - Costs expected to exceed \$1 million.
 - Seeking Board Approval to move into Execution.

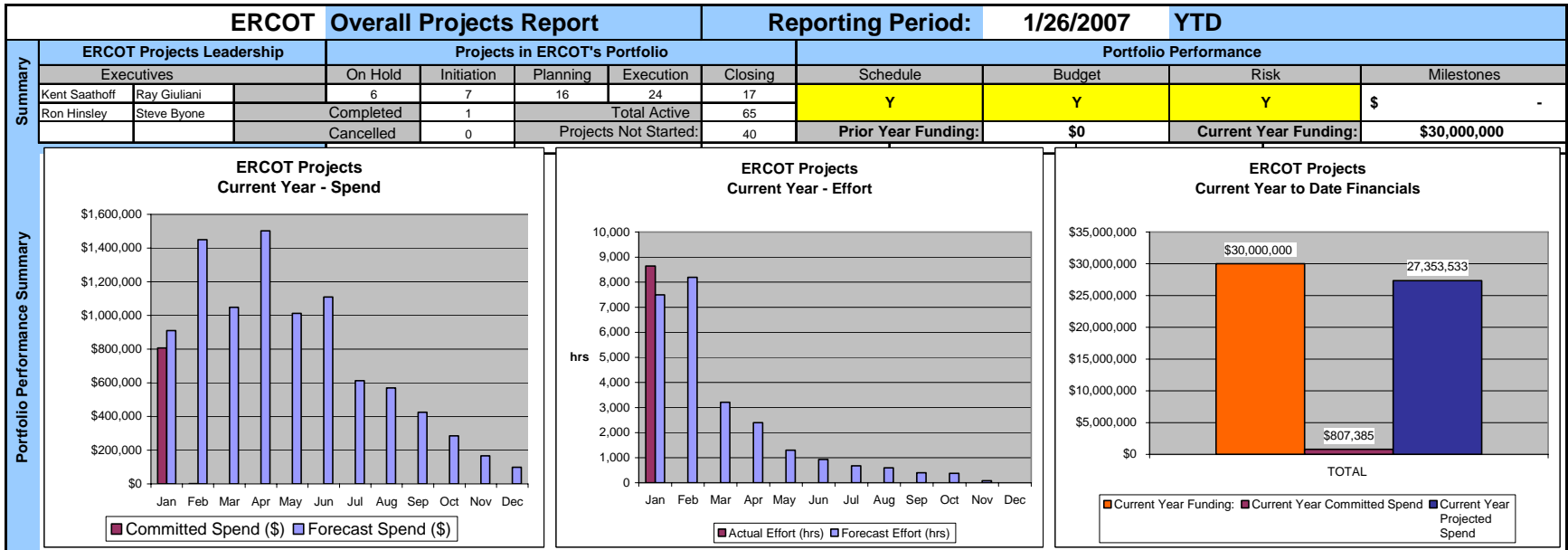
Large Project Moving to Execution

- **PR-60099_01 TCC2 Finish-out and Annex Construction**
 - **Scope:**
 - Reconfigure cubicles and modify conference rooms to utilize existing space;
 - Skeletal build-out SW and SE corner of 2nd floor of Taylor-2 complex
 - Build 12,000 sq ft annex behind existing Taylor complexes
 - **Deliverables:**
 - 130 space parking lot at Taylor-2 complex
 - 12,000 sq ft building behind Taylor complexes
 - Skeletal build-out of SW and SE corner of 2nd floor of Taylor-2 complex
 - Maximum utilization of space at Taylor facilities through cubicle reconfiguration and conference room conversion.
 - **Timeline:**
 - Reconfigure and skeletal build – March, 2007 -- July, 2007
 - Build 12,000 sq ft annex – March, 2007 -- December, 2007
 - **Board Request:**
 - Costs expected to exceed \$1 million
 - Seeking Board Approval to move into Execution

Large Project Moving to Execution

- **PR-60020_01 Lawson Managed Application Service Provider**
 - **Scope:**
 - ERCOT's ERP system -- Lawson
 - **Deliverables:**
 - Transfer of application management responsibility for ERCOT's ERP system to a Managed Application Provider
 - **Timeline:**
 - Project Execution: February, 2007 – August, 2007
 - **Board Request:**
 - Costs expected to exceed \$1 million
 - Seeking Board Approval to move into Execution

Enterprise Projects Summary Report



Nodal / Zonal Funding Review - Overview

Desc	Alloc . %	2006 Zonal Budget	2006 Project Actuals	Max 2006 Zonal Contribution	2006 Zonal Actuals	2007 Zonal Budget	2007 Project Actuals	Max 2007 Zonal Contribution	2007 Zonal Actuals	2008 Zonal Budget
NMMS/State Estimator	94%	3,000,000	3,658,614	3,439,097	3,439,097	7,680,000	-118,049	-110,966	0	1,320,000
EMS Upgrade	46%	1,920,000	2,195,011	1,009,705	1,009,705	4,480,000	58,748	27,024	27,024	1,600,000
Hardware	31%	4,360,500	19,311,643	5,986,609	4,831,697	1,795,500	3,174,335	984,044	984,044	2,394,000
Totals		9,280,500	25,165,268	10,435,412	9,280,500	13,955,500	3,115,034	900,102	1,011,068	5,314,000

Note: January balances are lower than expected due to 2006 accruals without offsetting vendor invoices.

Future Agenda Items – March/April 2007

- **Internal Audit Report**
- **Credit workshop debrief (Mar)**
- **Vote on F&A Charter (Mar)**
- **Vote on CWG Charter (Mar)**
- **Vote to approve CWG Chair / Vice Chair (Apr)**
- **Report by CWG Chair on credit policy (Apr)**
- **Update on liquidity/liability management (Mar or Apr)**
- **Financial audit update**
- **Committee briefs**

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
- Vote on CWG Chair/Vice Chair

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 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
- 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
- Review investment results quarterly