



# Semi-Annual Audit, Compliance, and Enterprise Risk Management Update

Steve Byone  
Chief Financial Officer

**Board of Directors Meeting**  
**February 20<sup>th</sup>, 2007**

# Audit Update

- ERCOT has fully funded its Internal audit department and has approved the 2007 internal audit program
  - When warranted the program is augmented by external resources (i.e. IBM for Nodal)
- ERCOT also conducts external audits and reviews
  - Financial audit
  - SAS 70 Type II
  - Benefit program audit
  - Security and other reviews
- Management has implemented a formalized program to monitor audit findings and remediation plans
  - Subset of Internal Control Management Program (ICMP)

# Recent Audits Completed

## External

Sales Tax Audit  
 State Comptroller Audit  
 Internal Controls Workshop  
 Dept. of Labor (Retirement Plan)  
 2005 SAS70  
 NERC Readiness  
 2005 401K & MPP  
 NERC Compliance Enforcement  
 2005 Financials  
 2006 SAS70  
 Internal Control Review  
 2006 401K & MPP  
 Texas Nodal Program Review  
 Security Assessments (5)  
 2006 Financials  
 Texas Nodal Program Controls  
 Progress Reporting Review #2

2005

Fraud Prevention Testing

2006

2007

Taylor Expansion  
 Travel & Entertainment  
 Contractor & Consultants  
 Ethics Compliance  
 Investments  
 Lodestar System  
 Seibel System  
 Cash System  
 Cyber Receipts & Disbursements  
 Energy Security  
 Operations & Market Management  
 General Ledger (Control Room)  
 Settlement Ledger Adjusting Journal Entries  
 Congestion Disputes & ADR  
 MV90 System  
 Lawson HR System  
 Outage Coordination  
 Payroll & Leave Benefits  
 Onboard/Exit of Employees & Contractors  
 QSE Credit  
 Inventory & Fixed Assets  
 Software License Mgmt.  
 Cash & Investments  
 Selected Nodal Employee & Contractor Expenses  
 Fraud Prevention Program (Q1-Q2 Results)  
 System Operations  
 Fixed Assets  
 Cyber Security  
 Ethics Compliance  
 Business Continuity Follow-up  
 Crisis Communication Plan  
 Procurement & Contract Administration  
 Budget Process  
 SCADA Application Procedures  
 Nodal Time tracking  
 Registration/Qualification of Market Participants  
 PMO Non-Nodal  
 Acts. Payable

## Internal

## 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

### External Audits

- 2006 Financial Audit (PwC)

## Planned Audits

(next 3 months)

### Internal Audits

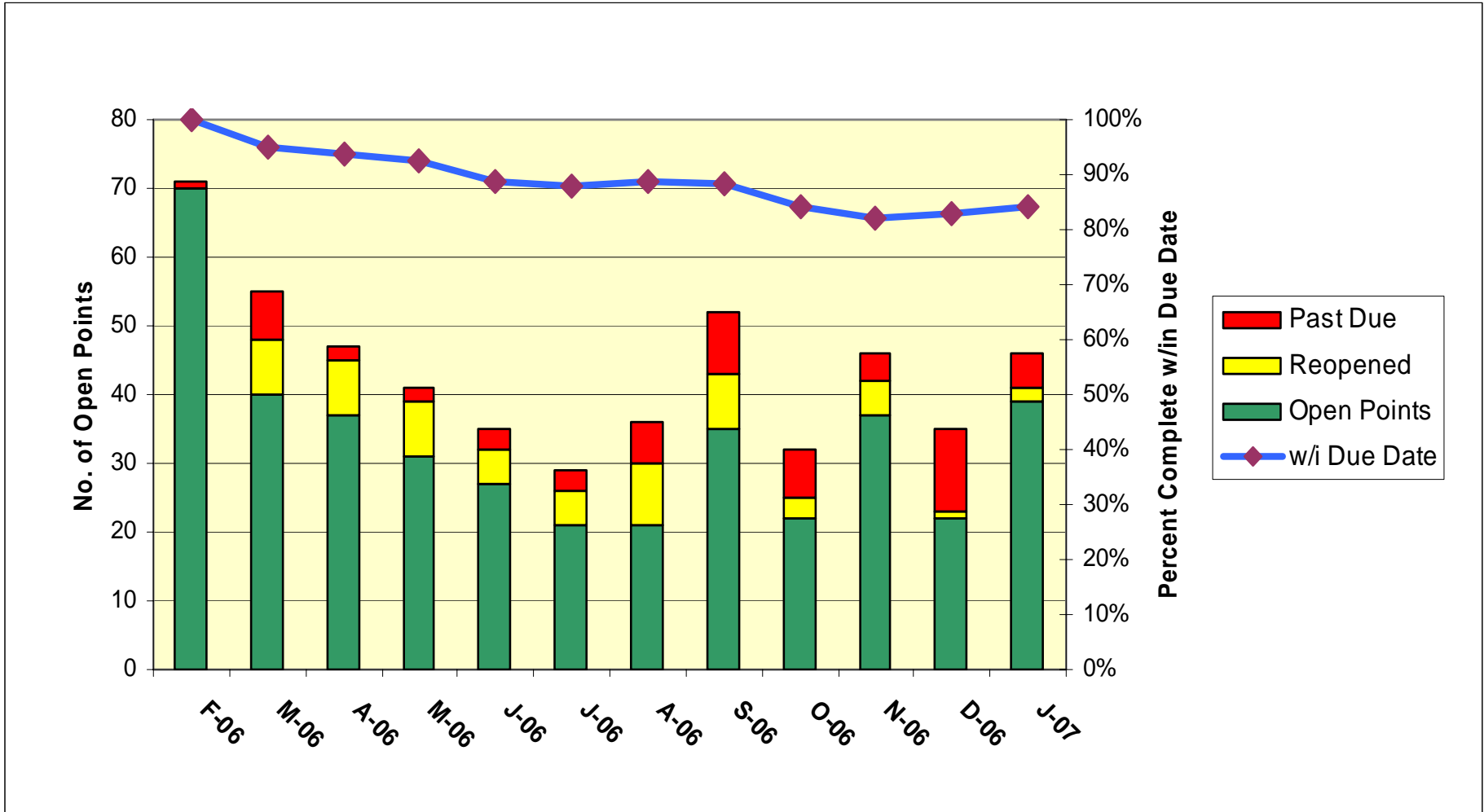
- Nodal PMO
- Nodal Ethics Compliance
- Nodal Recruiting
- Nodal Signing Authority/Delegation of Authority

### External Audits

- Benefit Plan (MPP)

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

## Status of Open Audit Points



# Compliance Update

- Management conducts regular “self assessments” of compliance
  - applicable laws
  - regulations & protocols
  - contractual obligations
  - disclosure mandates
  - etc.
- For each requirement, an assessment is made of whether the area is in compliance, ‘substantially compliant’\*, or not in compliance with any ‘non-yes’ answer requiring further explanation.

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



# Management Compliance “Self Assessment”

- Each ERCOT Officer has completed a signed attestation as to the status of Compliance Requirements within their respective organizations
- Compliance Assessment has been reviewed by outside counsel to confirm completeness and appropriateness
- For each requirement, an assessment is made of whether the area is in compliance, ‘substantially compliant’\*, or not in compliance with any ‘non-yes’ answer requiring further explanation.
- Out of 92 areas identified, 1 was deemed to not be in compliance and 7 were deemed to be ‘substantially in compliance’:
  - Details regarding the areas deemed not in compliance or ‘substantially in compliance’ are included in your Executive Session materials

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- Work closely with external auditors and involved third-parties to address the one area deemed not in compliance by the end of February 2007
- Continue to address 7 ‘Substantially Compliant’ items by Q1 2007 so that ERCOT is in ‘full compliance’ in all areas
- Require quarterly signed Management Attestation as to the accuracy of the Compliance Certification Report
- Continue semi-annual review of compliance results with the Board of Directors

# Enterprise Risk Management Update

- ERCOT established a formal ERM program in 2005
- Management reviews key enterprise risks on a monthly basis
- Changes in management assessment of a key risk are reported to the Finance & Audit Committee monthly
- Governance structure calls for a Board of Directors update semi-annually

# February 2007 Risk Inventory "Stoplight" Report

## 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><b>Strategy Development</b></p> <p><i>Objective setting adequately incorporates informed stakeholder input, market realities and management expertise</i></p>	<p><b>Performance Monitoring</b></p> <p><i>Clearly defined performance metrics linked to mission and goals; actively monitored, status communicated and corrective action taken</i></p>	<p><b>Customer Choice</b></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><b>Grid Operations</b></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><b>Review Practices</b></p> <p><i>Prudent measures are taken to insure that company disclosures are properly vetted and not misleading</i></p>	<p><b>Legal &amp; Legislative</b></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>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>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>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>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>Board of Director's review of management activities on an ongoing basis assists in ensuring proper review and disclosure practices.</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><b>Mission and Goals</b></p> <p><i>Corporate objectives and performance standards are understood and followed</i></p>	<p><b>Business Practices</b></p> <p><i>Business planning, processes and management standards are effective and efficient</i></p>	<p><b>Nodal Implementation</b></p> <p><i>Nodal Implementation is progressing in a timely fashion on budget and schedule within a defined scope.</i></p>	<p><b>Planning</b></p> <p><i>Long-range planning methods enable efficient responses to necessary system changes to maintain reliability standards</i></p>	<p><b>Disclosure</b></p> <p><i>Reporting and other disclosures to intended parties is timely, accurate and effective</i></p>	<p><b>Internal Control Compliance</b></p> <p><i>Internal Control Compliance, processes and management standards are effective and efficient</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>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>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>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>A Disclosure Committee has been institutionalized to discuss and report issues related to external reporting and compliance.</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><b>Reputation</b></p> <p><i>Positive perceptions by stakeholders typically lead to less cost and greater flexibility resulting in enhanced enterprise value</i></p>	<p><b>Human Resources</b></p> <p><i>Organization design, managerial and technical skills, bench strength and reward systems are aligned with corporate goals</i></p>	<p><b>Counterparty Credit</b></p> <p><i>Bankruptcies and other capital deficiencies increase the cost for market participants and potentially impact Grid reliability through</i></p>	<p><b>Bulk System Resources</b></p> <p><i>Market Participants have constructed and made available adequate bulk electric grid resources</i></p>	<p><b>Communication</b></p> <p><i>Internal and external communications are timely and effective</i></p>	<p><b>Industry Standards</b></p> <p><i>Business practices provide stakeholders with required assurances of quality</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>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 contractors 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>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>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>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>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><b>Fiscal Management</b></p> <p><i>ISO design requires competent, prudent and cost effective provision of services</i></p>	<p><b>Technology Infrastructure</b></p> <p><i>Information systems and data are effectively managed and are reliable</i></p>	<p><b>Administration, Settlement &amp; Billing</b></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><b>Operational Responsibility</b></p> <p><i>Market participants conduct their operations in a manner which facilitates consistent grid reliability</i></p>	<p><b>Adequacy and Integrity</b></p> <p><i>Robust processes exist to support management assertions embodied within financial reports</i></p>	<p><b>Regulatory Filings</b></p> <p><i>Evidence, testimony and other supporting materials are compelling and successful</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>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>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>Response of generators to grid operation events has been improving. Enhanced enforcement of NERC standards will exist through the ERO / RE structure.</p>	<p>Financial and Operations management information has been redesigned to enable management to effectively monitor and manage the business.</p>	<p>Filings are completed timely and accurately.</p>

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

