

ERCOT Finance & Audit Committee Meeting

ERCOT

7620 Metro Center Drive, Austin, Texas

Room 168

May 16; 7:30 to 10:00 a.m.**

Agenda Item #	Description/Purpose/Action Required	Presenter	Time
	Call to Order	C Karnei	7:30 a.m.
1.	Approval of Minutes* (Vote) (04/18/06; 04/26/06, 05/05/06)	C Karnei	7:30 a.m.
2.	Credit Update	M Davies	7:35 a.m.
3.	Quarterly Investment Results	C Yager	7:55 a.m.
4.	Nodal Surcharge Filing Status	S Byone	8:00 a.m.
5.	2006 Fee Filing Update	M Petterson	8:05 a.m.
6.	2006 Forecast	M Petterson	8:15 a.m.
7.	2007 Budget Planning Assumptions Review	M Petterson	8:25 a.m.
8.	Committee Briefs		8:50 a.m.
	• Compliance Update	D Meek	
	• Risk Stop Light Changes	D Meek	
	• Large Project Update – MOMS	D Troxtell	
	• Q & A – Credit Statistics – Audit Points – Project Status	All	
9.	Finance Goal Performance and Staffing Review	S Byone	9:00 a.m.
10.	Adjourn to Executive Session		9:05 a.m.
	• Review and Approval of New Internal Audit Charter	B Wullenjohn	
	• Proposed Changes to Annual Audit Plan	B Wullenjohn	
	• Timing for Quality Assurance Review	B Wullenjohn	
	• Significant Audit Findings	B Wullenjohn	
	• Ethics Point	B Wullenjohn	.
	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 June 20, at ERCOT, 7620 Metro Center Drive, Austin, Texas.*

Draft MINUTES OF THE ERCOT FINANCE & AUDIT COMMITTEE MEETING

Taylor TCC 2
8:00 A.M.

April 18, 2006

Pursuant to notice duly given, the meeting of the Electric Reliability Council of Texas, Inc. Finance & Audit Committee convened at approximately 8:00 A.M. on **April 18, 2006**. The Meeting was called to order by **Clifton Karnei** who ascertained that a quorum was present. Mr. Karnei notified the Committee that, at the request of Credit Work Group (CWG) and the Technical Advisory Committee (TAC), as a part of Agenda Item #7, CWG and TAC would brief the Committee regarding a PRR (with credit implications) that was not up for a vote at the April Board meeting.

Meeting Attendance

Committee members:

Clifton Karnei, <i>Chair</i>	Brazos Electric Cooperative	Cooperative	Present
Darrell Hayslip, <i>Vice Chair</i>	Calpine Corporation	Ind. Generator	Present
Robert Manning	H-E-B Grocery Co.	Consumer	Present
Miguel Espinosa	Independent Board Member	Independent Board Member	Present
R. Scott Gahn	Just Energy	Ind. Retail Electric Provider	Present
Tom Standish	Centerpoint Energy	Investor Owned Utility	Present

ERCOT staff and guests present:

Barry, Sean	PricewaterhouseCoopers
Brenton, Jim	ERCOT
Byone, Steve	ERCOT (CFO)
Connell, Robert	ERCOT
Doolin, Estrellita	ERCOT
Dreyfus, Mark	Austin Energy
Garcia, Jennifer	Direct Energy
Giuliani, Ray	ERCOT (CMO)
Meek, Don	ERCOT
Moseley, Cheryl	ERCOT
Petterson, Mike	ERCOT
Vance, Cathy	ERCOT
Vincent, Susan	ERCOT
Walker, Mark	NRG Texas
West, James	PricewaterhouseCoopers
Wullenjohn, Bill	ERCOT
Yager, Cheryl	ERCOT

Approval of Previous Minutes

Darrell Hayslip moved to approve the Minutes for the previous regular meeting held March 17, 2005; Tom Standish seconded the motion. The motion passed unanimously.

Update on 2005 Financial Audit

Sean Barry of PriceWaterhouseCoopers (PwC) informed the Committee that he was providing the Committee with copies of financials that were substantially complete, because the audit was not yet complete.

Steve Byone explained that management was hoping to have the Committee tentatively accept the substantially complete financials immediately, with a final recommendation that the Board accept the final audited financials at the May Board meeting. Mr. Byone explained that the request for a tentative acceptance was because ERCOT was required to provide its lenders with its audited 2005 financials by the end of April.

Mr. Petterson explained the approximately \$2.8 million difference between the January preliminary 2005 year-end financial statements presented to the Committee in January, 2006 and the substantially complete audited financial statements, included the following: lower revenues (\$500,000), higher depreciation expense (\$1.1 million), higher sales tax expense accrual based upon the March 21, 2006 notification of audit results received from the Texas Comptroller of Public Accounts (\$800,000), and higher variable compensation expense accrual (\$600,000) partially offset by audit adjustments net to approximately \$200,000 lower expenses in 2005.

James West of PwC reviewed the PwC audit plan, including a summary of the mutual understanding and expectations between management and PwC, an analysis of key risks, the PwC audit approach, reporting and audit timetable and other matters. Mr. West discussed five key risk areas: (1) reserves and accruals, specifically including sales and use tax liabilities; (2) accounting for contracts with third-party vendors that provide services and software development activities; (3) management and accounting for fixed assets including physical identification and costs capitalized as fixed assets, (4) detection of fraudulent activity; and (5) evaluation and assessment of intangibles, including software amortization lives and usefulness of capitalized software costs. Mr. West confirmed that he anticipated no negative surprises from the audit, and PwC expected to provide an unqualified audit opinion.

Mr. Espinosa asked Mr. Barry whether PwC had received full support and cooperation during the audit and whether any negative issues had arisen during the audit. Mr. Barry confirmed that they had received full cooperation and support and that he did not know of any new negative issues. Mr. Espinosa asked what items remained on the audit, and Mr. Barry explained that PwC had eight or nine details remaining to complete. Mr. Espinosa stated that he wanted the Committee to have at least a telephone conference call meeting to discuss the financials before ERCOT staff released them to lenders or anyone else. Mr. Karnei stated that he would like the meeting to be on Wednesday or Thursday. Mr. Byone confirmed that he would arrange for and have notice of the meeting posted for the next week.

Mr. West confirmed that internal procedures and staffing had improved in 2005, and that their substantial testing of pre-2005 issues had reflected no major issues or difficulties. Mr. West explained that the scope of the financial audit was not intended to detect fraud, but that, because no new issues of potential fraud were noted, PwC did not need to incorporate fraud specialists into the financial audit for 2005, as had been done for the 2004 audit. Mr. Barry noted that the actual loss by ERCOT for 2005 was \$9.5 million, and the budgeted loss had been

\$15.5 million. He noted that ERCOT was in a net deficit position, with \$18 million as of December 31, 2005, as opposed to the previous deficit of \$9 million as of December 31, 2004. Mr. Barry confirmed that the ability of the organization to exist was not in doubt, that cash flows were positive, ERCOT was in compliance with all debt covenants, and he did not have any negative matters to report. Mr. Espinosa asked if ERCOT was in danger of violating any debt covenants, and Cheryl Yager confirmed that ERCOT was not. Mr. Karnei asked Mr. Barry if he had received full cooperation and support of management during the audit, and Mr. Barry stated that he absolutely had, and that the ERCOT management had a high level of ownership in the financials.

Review of Employee Conduct Documents

Susan Vincent gave an overview of the ERCOT Ethics Agreement, Code of Conduct and Fraud Prevention Standard, which were provided to the Committee, and asked the Committee members to notify Legal or Finance if they had any questions or comments about these or if these did adequately reflect Committee expectations regarding employee conduct.

Review Finance & Audit Self Assessment Results

Steve Byone summarized the responses he had received from the self assessments completed by the Committee members. Survey results showed that the Committee structure, composition, and member expertise were strong and the members believed that they were kept aware of significant issues and were receiving good and sufficient information from which they could make decisions. The assessments reflected that areas for improvement included allowing more time for questions and discussion on high risk matters and more time for in-depth discussion on Internal Audit matters; continued diligence to avoid micro-managing the business; and potential educational opportunities for the members. Mr. Karnei noted that it was positive that the Committee had, for the first time, completed a self assessment which was reduced to writing. Mr. Espinosa stated that he expected the presentations before the Committee and the Board to be of “budget quality”, with all loose ends completed. Mr. Karnei noted that since they frequently had packed agendas where items needed to be skipped, if anyone wanted to start earlier in the morning or to meet the afternoon before the Board Meeting, they should let him know and he would help schedule meetings as requested. Mr. Manning noted that the Committee might tend to micromanage or “drift into the weeds” on occasion. Mr. Karnei agreed but he thought that the Committee then quickly returned to the bigger picture. Mr. Karnei stated that he welcomed comments and suggestions about the agenda and the scheduling of meetings.

PMO Update

Rob Connell reviewed the organizational changes that had been implemented to the project management structure and reporting process, creating a divisional project management framework. Mr. Connell reported that three additional projects had been completed (for a total of 10 completions for the first quarter) and noted that one large project (Retail Business Processes), was ready to move into execution, would be presented in executive session to the Board. Mr. Connell reported that the Taylor Facilities Build Out for Nodal project, which had been discussed at the previous Committee meeting, had been revised to provide for finish-out of only one additional space in which to place the Nodal team. This revision in scope reduced the project below the \$1 Million threshold.

Audit Preparedness - Internal Controls

Steve Byone notified the Committee that Deloitte & Touché ("D&T") was scheduled to begin the Internal Controls Review, with testing to occur in June and July and the report expected in late July or August. Mr. Byone reported that ERCOT staff was in the final stages of implementing updated internal controls to address gaps previously identified by D&T. Mr. Byone noted that the gap remediation process was nearly complete, with certain documentation and training still required. Mr. Byone stated that he thought that, although some issues might be identified by the audit, ERCOT was in good shape and should show great improvement. Mr. Karnei asked the effective date of the audit and Mr. Byone stated that the audit would be for the period April 1, 2006 forward.

Audit Preparedness - SAS 70

Jim Brenton reported that the 2006 SAS 70 test period began April 1, 2006, and that, although the remediation of SAS 70 security items identified in 2005 audit was not fully implemented by April 1 as expected, ERCOT staff continues to actively work the remediation plan. Mr. Brenton informed the Committee that, he had implemented compensating controls pending completion of an automated solution to access control, including (a) recertifying all user access to systems (finding only 204 or less than 0.5% issues in 36,000 access points), and (b) implementing a 100% monthly audit for facility access. Mr. Brenton informed the Committee that the update of CCTV cameras and standardized server hardening had been completed; noting that layered security architecture was a significant risk mitigation measure.

Committee Brief – Enterprise Risk Management

Mr. Meek reviewed changes to the Risk Stop Light report with the Committee. Don Meek noted that the yellow status of Reputation would likely change because of the events of April 17th. Mr. Meek also noted that the Human Resources area had an increase in risk since the previous month, because of (a) issues relating to the salary freeze and other cost management directives by the PUC, which are expected to cause an overall reduction in ERCOT's ability to attract and retain quality personnel, particularly as ERCOT attempts to hire for Nodal, and (b) the loss of significant HR personnel, including the Vice President and one director. Mr. Espinosa asked what ERCOT's turnover had been. Mr. Byone stated that the turnover rate was approximately 9% and that he understood ERCOT had hired about 20 (net) people year to date. Mr. Espinosa requested that the Committee be provided the number of people hired and the number of people that had resigned, at the next meeting.

Committee Brief – Credit

Clifton Karnei confirmed that no member had questions regarding the materials presented by Credit and asked if ERCOT staff was closely monitoring credit issues, particularly given the previous day's electricity demands. Cheryl Yager responded that ERCOT continues to carefully monitor credit each day and make collateral calls as needed. Ms. Yager also noted that ERCOT had billed the first uplift from the short payments in the Fall of 2005, in the amount of approximately \$24,000.

Morgan Davies, CWG Chairman, and Mark Dreyfus, TAC Vice Chairman, provided the Committee with a mass transition (PRR 660) update. Mr. Dreyfus informed the Committee that, because of the potential substantial benefits to the market, TAC was seeking to authorize ERCOT to begin planning immediately for the implementation of PRR 660, even though the PRR had not yet been approved. Rich Gruber noted that beginning planning before the PRR

was approved was not in accordance with ERCOT approved procedures and explained that Texas Set needed three additional meetings to complete the requirements before detailed planning could begin. Mr. Hayslip asked when the Board could obtain the requirements and costs of the project. Mr. Gruber explained that the estimated cost of the project, subject to finalizing the requirements, was approximately \$1.5 Million, but that the project would have benefits of decreasing the time of a mass transition, decreasing credit risk, and smoothing out back office processes. Rob Connell explained that the final requirements were needed to determine the final estimate of project cost. Mr. Karnei noted that, even if the Board allowed planning work to begin on the project, since the project would likely exceed \$1 million the Board would need to vote to allow the project to begin execution.

Darrell Hayslip made a motion that the Committee recommend the Board take action to authorize planning for implementation of PRR 660 to begin, on an exception basis, even though the PRR had not yet been approved by the Board.. Bob Manning seconded the motion. The motion passed unanimously.

Mr. Hayslip and Mr. Karnei reminded Mr. Davies that the CWG meetings agendas needed to be posted at least seven days in advance of the meetings, so full and fair notice was provided to all market participants and thanked the CWG for the hard and diligent work and updates.

Future Agenda Items

Mr. Byone reviewed items suggested for future Committee agendas. Mr. Hayslip requested that the Committee receive a summary of pending PUC filings.

Adjournment

At approximately 9:30 A.M., the meeting was adjourned and the Committee went into Executive Session. The next regularly scheduled meeting will be held on the morning of May 16, 2006.

Susan Vincent, Secretary

Draft MINUTES OF THE ERCOT FINANCE & AUDIT COMMITTEE MEETING

Austin Met Center

2:30 P.M.

April 26, 2006

Pursuant to notice duly given, the meeting of the Electric Reliability Council of Texas, Inc. Finance & Audit Committee convened at approximately 2:35 P.M. on **April 26, 2006** for a Special Meeting to discuss the 2005 Financials. The Meeting was called to order by Darrell Hayslip who ascertained that a quorum was present.

Meeting Attendance

Committee members:

Clifton Karnei, <i>Chair</i>	Brazos Electric Cooperative	Cooperative	Not Present
Darrell Hayslip, <i>Vice Chair</i>	Calpine Corporation	Ind. Generator	Present
Robert Manning	H-E-B Grocery Co.	Consumer	Present
Miguel Espinosa	Independent Board Member	Independent Board Member	Present
R. Scott Gahn	Just Energy	Ind. Retail Electric Provider	Present
Tom Standish	Centerpoint Energy	Investor Owned Utility	Not Present

ERCOT staff and guests present:

Barry, Sean	PricewaterhouseCoopers
Byone, Steve	ERCOT (CFO)
Petterson, Mike	ERCOT
Vincent, Susan	ERCOT
West, James	PricewaterhouseCoopers
Yager, Cheryl	ERCOT

Update on 2005 Financial Audit

Mike Petterson explained that the 2005 Financial Statement audit reports were not yet complete, due to additional audit testing being conducted by PriceWaterhouseCoopers (PwC) relating to year-end cut-off and expense accrual accounting.

Sean Barry of PwC informed the Committee that if ERCOT could conclude their work by the next day, he thought he would be able to complete the audit by the end of the week, April 30, 2006.

Mike Espinosa asked how and why the delay happened. Steve Byone explained that staff was looking into the root cause of these issues and that by the May meeting he would be able to better explain in detail. Mr. Byone said that the Accounting staff was now looking at all invoices for services that were received year-to-date 2006, to confirm whether they were properly accounted for as 2005 or 2006 expenses.

The Committee discussed whether it should call a meeting on short notice, due to exigent circumstances, to accept the Financial Statement audit report, and Darrell Hayslip asked if ERCOT would default on its finance agreements if it did not submit its audited financial statements to the lenders by May 1, 2006. Cheryl Yager informed the Committee that ERCOT's finance agreements provided that, although the audited 2005 financial statements were due to the lenders by May 1st, ERCOT had a 30-day cure period before its delay in submitting the audited financial statements to the lenders was considered a "Default" under the agreements.

After discussing potential dates for a Special Meeting for the Committee to accept the audited financial statements, Mr. Byone confirmed that he would arrange for and have notice of the meeting posted.

Adjournment

At approximately 3:00 P.M., the meeting was adjourned. The next meeting of the Committee will be the Special meeting scheduled for the morning of May 5, 2006.

Susan Vincent, Secretary

Draft MINUTES OF THE ERCOT FINANCE & AUDIT COMMITTEE MEETING

Austin Met Center

8:00 A.M.

May 5, 2006

Pursuant to notice duly given, the meeting of the Electric Reliability Council of Texas, Inc. Finance & Audit Committee convened at approximately 8:00 A.M. on **May 5, 2006** for a Special Meeting to discuss the 2005 Financials. The Meeting was called to order by Clifton Karnei who ascertained that a quorum was present.

Meeting Attendance

Committee members:

Clifton Karnei, <i>Chair</i>	Brazos Electric Cooperative	Cooperative	Present
Darrell Hayslip, <i>Vice Chair</i>	Calpine Corporation	Ind. Generator	Present
Robert Manning	H-E-B Grocery Co.	Consumer	Not Present
Miguel Espinosa	Independent Board Member	Independent Board Member	Present
R. Scott Gahn	Just Energy	Ind. Retail Electric Provider	Present
Tom Standish	Centerpoint Energy	Investor Owned Utility	Present

ERCOT staff and guests present:

Barry, Sean	PricewaterhouseCoopers
Byone, Steve	ERCOT (CFO)
Petterson, Mike	ERCOT
Vincent, Susan	ERCOT
West, James	PricewaterhouseCoopers
Yager, Cheryl	ERCOT

Update on 2005 Financial Audit

Steve Byone requested that the Committee recommend that the Board accept the audited 2005 Financial Statements, which had previously been sent to them, and asked if any Committee members had any questions.

Mike Petterson reminded the Committee that by the meeting on April 26, 2006, ERCOT had determined that an additional \$40,000 accrual should be made for 2005 to the draft financials that had been provided to the Committee on April 18, 2006. Mr. Petterson informed the Committee that, since the April 26, 2006 meeting, PriceWaterhouseCoopers (PwC) had performed additional testing.

Darrell Hayslip asked if any modifications to the 2005 financials were required after the additional testing by PwC. Mr. Petterson informed the Committee that no additional modifications were needed to the financials, and that he and his staff reviewed nearly 100% of the consulting expenses for the first four months of 2006 to confirm proper accounting treatment.

Clifton Karnei asked if the adjustment was due to the expense cut off date, and whether this was the only change to the draft financials. Mr. Petterson confirmed that the only adjustment was related to late invoices for the independent board member search, and that the only other modifications to the Audit Report since April 26, 2006 were for minor changes to the footnotes to the financial statements.

Sean Barry of PwC confirmed that, other than the additional \$40,000 expense accrual, there were no significant modifications in the final audited financials. Mr. Barry informed the Committee that PwC had tested outside services expenses, including 100% of legal expenses, and had cleaned up the wording of some of the disclosures. Mike Espinosa asked if the \$40,000 issue was the only item not treated expediently. Mr. Barry confirmed that this was the only issue. Mr. Barry also informed the Committee that \$40,000 was the only matter of consequence and that it normally may not have been brought back to the Committee, except that ERCOT had a practice of disclosing all items to the Committee.

Mr. Karnei asked if any issues had arisen with the lenders because of the short delay in the financials. Mr. Byone informed the Committee that the lenders and the Public Utility Commission had been notified that the audited financials had been delayed for a few weeks, and that none had indicated any concern. Mr. Byone also informed the Committee that he was working on getting additional improvement procedures into place. Mr. Karnei noted that it appeared that the late invoice issue was a normal issue at all companies and that the delay in the audited financials occurred because ERCOT went above and beyond the normal testing.

Darrell Hayslip made a motion that the Committee recommend that the Board accept the ERCOT financials; Mike Espinosa seconded the motion; the motion passed unanimously.

Adjournment

At approximately 8:30 A.M., the meeting was adjourned. The next meeting of the Committee is scheduled for the morning of May 16, 2006.

Susan Vincent, Secretary



Finance & Audit Committee

Credit Update

May 16, 2006

Morgan Davies
Chair, CWG

Goal

- ❑ Update F&A Committee re: actions taken by the market to improve the market credit profile
- ❑ Review current and expected level of credit exposure
- ❑ Gain an understanding of the target level of credit exposure from the F&A Committee

Update - April activity

- ❑ Since the April F&A meeting
 - ERCOT began planning for implementation of the Long Term solution proposed by RMS to reduce the timeline for the Mass Transition process (key dependency – definition of business requirements by Texas SET)
 - RMS and Texas SET met extensively to work on business requirements for the Long Term solution
 - Business requirements are well underway, but not yet finalized
 - The Long Term solution is expected to be implemented second quarter 2007
 - Long term solution will reduce the Mass Transition process from 9-11 business days to 3 business days

- ❑ Since the April F&A meeting (cont)
 - IMPORTANT: RMS and Texas SET, with ERCOT staff input, identified an interim way to reduce the Mass Transition timeline
 - Reduce time for initiating a switch by POLRs from 5 business days to 3 business days - based on POLR commitment to tighter timelines
 - Reduce “earliest available switch date” for TDSPs from 6 business days to 3 business days – based on reconfiguration of system data tables
 - Overall, reduce time line from 9-11 business days to 6 business days, a reduction of 3-5 business days
 - RMS and Texas SET expect that this can be fully implemented in the May / June timeframe

Update - April activity (cont.)

- ❑ Credit WG and ERCOT credit staff strongly support this effort and applaud TAC, RMS and Texas SET for finding a way to reduce credit exposure prior to completion of the long term solution.

Estimation of Credit Exposure with Interim and Long Term Solution

Revised timelines (in business days)

	<u>Curr</u>	<u>Inter</u>	<u>Long</u>
Identify problem / make collateral call	0	0	0
<u>Notice periods</u>			
❑ Collateral due	2	2	2
❑ Notice of default given	2	2	2
❑ 2 BDays to cure default	4	4	4
<u>Mass transition</u>			
❑ Conference call to begin Mass Transition	5	5	5
❑ POLRs initiate switches	8-10	7-8	6
❑ Time until switch complete by TDSP	14-16	10-11	8
Calendar days (approx)	<u>20-22</u>	<u>14-15</u>	<u>10-12</u>

Revised potential loss in exit scenario

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

	Curr	Interim	Long
Collateral held			
1,000 MWh/day x \$100/MWh = \$ 210	\$ 210	\$ 210	\$ 210
x 10% x 21 days			
At default			
1,000 MWh/day x \$100/MWh = <u>\$ 2,100</u>	<u>\$ 2,100</u>	<u>\$ 1,400</u>	<u>\$ 1,100</u>
x 100% x ? days			
Potential market loss	\$ 1,890	\$ 1,190	\$ 890
For 100 MWh/day	\$ 189	\$ 119	\$ 89
For 10,000 MWh/day	\$ 18,900	\$ 11,900	\$ 8,900
Reduction in exposure		37%	53%

Entity	Est MWh/day	Est ESIDs	Tot Est Exposure
LSE 1	350	3,000	\$ 410,000
QSE 1	50	500	\$ 30,000
QSE 2	65	550	\$ 200,000
LSE 2	3,500	12,250	\$ 5,160,000
LSE 3	1,500	10,000 (liab paid)	-0-
QSE 3	125	2,500 (liab paid)	-0-
Total			\$ 5,800,000

Estimates as of April 30, 2006

of LSEs by average daily MWh for March 2006

<u>MWh/day</u>	<u>CR</u>	<u>NOIE</u>	<u>Tot</u>	<u>%</u>	Potential <u>Loss by cat</u>
< 200	24	37	61	40%	\$ 119k ea
200-2,000	24	24	48	31%	\$ 1,190k ea
2,000-20,000	24	12	36	24%	\$11,900k ea
> 20,000	<u>5</u>	<u>3</u>	<u>8</u>	<u>5%</u>	
Total	77	76	153	100%	

Market Statistics

Average daily MWh for March 2006

<u>MWh</u>	<u>CR</u>	<u>NOIE</u>	<u>Total</u>	<u>%</u>
< 200	2,027	3,306	5,333	1%
200-2,000	19,573	16,484	36,057	5%
2,000-20,000	164,210	49,061	213,271	30%
> 20,000	352,726	96,314	449,040	64%
Total	538,536	165,165	703,701	100.0%
Total (Aug05)	779,002	254,984	1,033,986	100.0%

Target level of credit exposure?

Question for F&A

- ❑ How much residual credit exposure (that is not mitigated by collateral, insurance, etc) is acceptable?
 - CWG has discussed but has not reached consensus
 - Interim?
 - Long term?

- ❑ Financially stable and viable market
 - Some amount of residual credit exposure may exist
 - Amount of residual credit risk should not endanger the overall financial stability of the market

- ❑ All market participants understand the financial risks associated with residual credit exposure accepted in the market
 - If market risk is not mitigated, there will be losses whenever there is a Mass Transition. Losses may be of the order of magnitude described in this presentation.

Options considered

- ❑ Reduce timeline for Mass Transition
 - Most benefit has been obtained or will be obtained with combination of interim and long term solution (1-2 days may still be available)
- ❑ Increase collateral requirements
- ❑ Purchase credit insurance
- ❑ Accept some level of residual credit exposure

Considerations discussed

- ❑ Entities causing credit risk should mitigate credit risk (e.g. post collateral, pay for insurance premium, etc)
- ❑ Cost of collateral is high (see next slide). Collateralizing for some portion of remaining credit exposure could double or triple collateral requirements for QSEs that must post collateral.
 - May be a “barrier to entry” in the market
 - An appropriate level of demonstrated financial strength may be appropriate
- ❑ Desire to have a robust and vibrant market

Considerations discussed

- ❑ Collateralization may encourage market participants to buy energy out of the BES if scarce capital resources are tied up in collateral

Potential cost of collateral

		<u>Estimated Load (000's)</u>	<u># of days of add'l collateral?</u>	<u>Estimate d \$ / MWh</u>	<u>Estimated cost of capital</u>	<u>Add'l coll req'd market wide (000's)</u>	<u>Potential annual cost of req'd collateral (000's)</u>	<u>In cents / MWh</u>	
Load that meets credit standards	23%	230	7	\$ 100	none				
Load that posts Guaranty	41%	410	7	\$ 100	2%	\$ 287,000	\$ 5,740	0.038	paid by those posting collateral
Load that posts LC or cash	36%	360	7	\$ 100	12%	\$ 252,000	\$ 30,240	0.230	paid by those posting collateral
Total estimated MWhs / day in the market	100%	<u>1,000</u>				<u>\$ 539,000</u>	<u>\$ 35,980</u>		
Losses in 2002		1,000					\$ -	-	paid by entire market
Losses in 2003		1,000					\$ 15,000	0.041	paid by entire market
Losses in 2004		1,000					\$ -	-	paid by entire market
Losses in 2005		1,000					\$ 5,800	0.016	paid by entire market
Future? (0 - \$30,000 or more?)		1,000					\$ 30,000	0.082	paid by entire market

Sample cost of capital

	<u>Cap Struc</u>	<u>Cost</u>	<u>WAC</u>
Debt	65%	10%	6.5%
Equity	35%	15%	5.3%
Total	<u>100%</u>	<u>25%</u>	<u>11.8%</u>

Prime curr = 7.75%

F&A Discussion of Target Level of Credit Exposure

- ❑ Credit WG will
 - Follow up on F&A items from discussion
 - Follow the progress made by Texas SET and support implementation of the near term solution
 - Continue analysis of credit insurance as a mitigation tool
 - Expected losses (e.g. normal course)
 - Potential excess losses (e.g. due to non-routine occurrences)
 - Review and potentially revise credit standards



Finance & Audit Committee

Quarterly Investment Results

May 16, 2006

Cheryl Yager
Treasurer

- ❑ Request for surcharge filed on May 5, 2006
- ❑ Request for a surcharge beginning early June
 - \$0.0663 per MWH
 - Initially charged to existing QSEs
- ❑ Update with additional details filed two weeks prior to hearing
 - Program timeline
 - Program charter
 - Staffing plan
 - Cash flow projection
 - Quarterly update plan on costs & deliverables
 - Work packages listing
 - Description of cost estimate calculations
 - Debt balance projections
 - Pro forma financials 2007 - 2012

- ❑ Key elements of expected final order from PUCT
 - Approve System Administration Fee of \$0.4171
 - Reduce revenue requirements by approximately \$0.9 million with strong suggestion that reduction be achieved in the following areas
 - Relocation costs
 - Interns
 - Leadership development training
 - Employee events
 - Use funds collected for market monitoring (\$3.0 million) and incremental debt reduction (\$1.4 million), to the extent not used for the intended purpose, for incremental project work
- ❑ Management commitment to the recommendations contained in the expected final order was filed with the PUCT
- ❑ Limitations and implications

- ❑ Reforecast of expected 2006 revenue, operating expenses, and project expenditures is being developed and will be distributed in advance of the May 16, 2006 meeting of the Finance and Audit Committee.

□ General

- Lowest ERCOT System Administration Fee possible given ERCOT mission and responsibility
- Mission unchanged from 2006
- Performance goals and objectives unchanged from 2006
- Incorporate elements of reforecast of 2006 revenue requirements
- Consistent with conditions established in the final order issued by the PUCT in the 2006 fee filing case
- Allocate resources to address issues identified on the ERCOT risk map
- Remain a 501(c)(6) entity

- ❑ Wholesale Market Redesign
 - Costs fully recovered through the Texas Nodal Surcharge and are not presented in the 2007 budget proposal
- ❑ Market Monitoring
 - PUCT staff to provide details of and justification for market monitoring cost
 - Based on service level agreement for market monitoring support
- ❑ Regional Entity
 - ERCOT will maintain necessary compliance activities to satisfy the obligations of ERCOT, Inc.
 - Include ERO/RE assessments resulting from implementation of Energy Policy Act

□ Compensation and Staffing

- Maintain base operations staffing at 584 employees to provide support consistent with 2006
 - No significant, new compliance responsibility
 - No significant, new market monitoring support commitment
 - No significant, new federal regulation or requirements
 - No “SOX 404” internal control requirement
- Incorporate conclusions stemming from June 2006 workshop on ERCOT compensation practices
 - Compensation strategy
 - Merit increases
 - Portfolio of employee benefits
 - Variable compensation
 - Relocation
- Employee benefit load reflecting July 1, 2006 benefit changes

- ❑ Compensation and Staffing (continued)
 - Assumed “vacancy” savings
 - Contra-labor to capital project assumptions

□ Project Funding

- Identify and prioritize projects
- 2007 revenue requirement includes funding for only those projects that are expected to be through the planning phase by December 31, 2006
- Remaining projects are on a “candidate list” and will be considered for implementation after planning is complete
- 2007 revenue requirement includes debt facility charge necessary to arrange debt financing for projects on “candidate list” approved for implementation during the year
- Debt incurred to implement projects taken from the “candidate list” is assumed repaid in the following year(s) as detailed in future budgets

❑ Miscellaneous

- Insurance coverage consistent with 2006 levels
- Enhance credit loss protection through credit insurance
- Property tax expenses consistent with 2006 property assessment settlement and negotiated tax abatements
- No new building or leased space in 2007. New space needs are accommodated through the remodeling and reconfiguration of existing space or the finish out of unused space in existing facilities.
- No significant change in type and quantity of hardware and software used
- Enhance communication processes and tools
- Records management requirements
- Board and committee support unchanged from 2006



Finance & Audit Committee

Compliance Update

May 16, 2006




































Don Meek, Enterprise Risk Manager

- ❑ Each ERCOT officer has been asked to identify the compliance requirements within their respective organizations
- ❑ For each requirement, an assessment is made of whether the area is in compliance or not with any answer other than 'yes' requiring further explanation
- ❑ Formal management attestation will be required by all officers to being in compliance with all applicable laws, regulations, policies, protocols, contracts, or other requirements

An example can be found below:

<u>No.</u>	<u>Type</u>	Operations Area	Requirement / Description	In Compliance	Assigned Individual	Comments
1	Law	Human Resources	Immigration Forms (I-9)	Yes	VP HR	Collected within 3 days in all cases Quarterly, not yet for Q2 '06
2	Policy	Finance	Investment Policy Review	Substantially	CFO	

ELECTRIC RELIABILITY COUNCIL OF TEXAS, INC.
RISK MANAGEMENT EVENT PROFILE MATRIX (as of May 5th, 2006)

 Strategic Position 	 Operational Excellence	 Market Facilitation	 Grid Reliability	 Reporting 	 Compliance
 Strategy Development <i>Objective setting adequately incorporates informed stakeholder input, market realities and management expertise</i>	 Performance Monitoring <i>Clearly defined performance metrics linked to mission and goals; actively monitored, status communicated and corrective action taken</i>	 Customer Choice <i>Market design promotes efficient choice by customers of energy providers with effective mechanisms to change incumbent market participants as desired.</i>	 Grid Operations <i>Information required to operate the grid is efficiently gathered and appropriate tools are prudently configured to efficiently operate the system</i>	 Review Practices <i>Prudent measures are taken to insure that company disclosures are properly vetted and not misleading</i>	 Legal & Legislative  <i>Operations are conducted in compliance with all laws and regulations and current and proposed legislation is understood and communicated</i>
<p>ERCOT staff is generally not sufficiently aware of ERCOT's short or long-range strategic plan. Management is communicating ERCOT's vision and the employee's role to achieve the vision. Additionally, uncertainty surrounding the proposed ERO/RE and nature of a 'Quasi-state' entity environment increases risk.</p>	<p>Performance monitoring tools lack desired early warning indicators and may fail to highlight potential underperforming activities</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 and Test environment build out will have a major impact on Customer Choice operations.</p>	<p>Current tools utilized by the System Operator (including the State Estimator and the accuracy/availability of SCADA data) and the lack of an Operator Training Simulator exposes ERCOT to greater reliability risks.</p>	<p>Internal review standards to ensure accuracy and completeness of information prior to release are below desired levels. Board of Director's Review of management activities on an ongoing basis assists in ensuring proper review and disclosure practices.</p>	<p>Failure to properly comply with laws, regulations, and protocols may result in fines, penalties, reliability degradation or other impacts. Senate hearings relating to the Apr. '06 EECOP indicate that additional efforts are required to ensure proper understanding and communication of legislative and PUC directives.</p>
 Mission and Goals <i>Corporate objectives and performance standards are understood and followed</i>	 Business Practices <i>Business planning, processes and management standards are effective and efficient</i>	 Nodal Implementation  <i>Nodal Implementation is progressing in a timely fashion on budget and schedule within a defined scope.</i>	 Planning <i>Long-range planning methods enable efficient responses to necessary system changes to maintain reliability standards</i>	 Disclosure <i>Reporting and other disclosures to intended parties is timely, accurate and effective</i>	 Internal Control Compliance <i>Internal Control Compliance, processes and management standards are effective and efficient</i>
<p>Current management initiatives related to goal setting and 'Line of Sight' have increased awareness of goals, and objectives related to high-level corporate objectives and priorities for individual divisions, departments, and employees.</p>	<p>Business continuity and disaster recovery plans, record retention procedures, and safety practices are currently below desired expectations. Additional development activities required to implement and test these procedures.</p>	<p>Significant risks exist with respect to project budgeting, human resource staffing, project scope and management, and tracking completion of the project in an acceptable timeframe. The magnitude and scope of the initiative provides significant levels of risk to the organization which have not been fully addressed at this time</p>	<p>Lack of timely and accurate information necessary to build reasonable system models and forecasts, an insufficient ability to conduct long-range (6-10 years out) planning, demands on planning resulting from a transition to Nodal.</p>	<p>A Disclosure Committee is in the process of being institutionalized to discuss and report on issues related to external reporting and compliance.</p>	<p>Failure to comply with internal controls may lead to imprudent or unauthorized use of corporate assets and/or inaccurate reporting. Audit findings are actively monitored by management as well as Internal Audit. An internal control compliance effort will be largely completed by May 2006.</p>
 Reputation  <i>Positive perceptions by stakeholders typically lead to less cost and greater flexibility resulting in enhanced enterprise value</i>	 Human Resources  <i>Organization design, managerial and technical skills, bench strength and reward systems are aligned with corporate goals</i>	 Counterparty Credit <i>Bankruptcies and other capital deficiencies increase the cost for market participants and potentially impact Grid reliability through participant failure</i>	 Bulk System Resources <i>Market Participants have constructed and made available adequate bulk electric grid resources</i>	 Communication   <i>Internal and external communications are timely and effective</i>	 Industry Standards <i>Business practices provide stakeholders with required assurances of quality</i>
<p>Increased scrutiny resulting from the Fee Case filing, high visibility of initial Nodal implementation and impacts resulting from the Apr. '06 EECOP and Dec '05 Retail Transaction system failure events combine to negatively impact ERCOT reputation. Recent settlements relating to the 2004 scandal reflect favorably on ERCOT Inc.</p>	<p>PUCT inquiries regarding compensation programs, a mandated salary freeze and employee related cost cutting directives increase the risk of higher turnover and prolonged recruitment efforts. Hiring necessary to support the NODAL ramp-up further strains the situation. Previous mitigation actions including variable pay, relocation, tuition reimbursement and employee training are also in question.</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.</p>	<p>Uncertainty surrounding generation projects, installed and operational capacity, and the high dependency on natural gas in Texas' generation fleet may impact reliability.</p>	<p>Issues surrounding communications of April 17th EECOP event and notification of key stakeholders, governmental agencies, and the general public have heightened a significant need for improved resources and strategies in internal and external communications.</p>	<p>Failure to adhere to ERCOT adopted industry standards, and/or industry standards with which ERCOT is expected to adopt, may increase risks. Changes in NERC / FERC standards and policies require ERCOT action to ensure ongoing compliance. SAS 70 Audit Issues remain to be addressed.</p>
 Fiscal Management <i>ISO design requires competent, prudent and cost effective provision of services</i>	 Technology Infrastructure <i>Information systems and data are effectively managed and are reliable</i>	 Administration, Settlement & Billing <i>Market rules are fairly applied to all participants and accounting is timely and accurately reflects electricity production and delivery</i>	 Operational Responsibility  <i>Market participants conduct their operations in a manner which facilitates consistent grid reliability</i>	 Adequacy and Integrity <i>Robust processes exist to support management assertions embodied within financial reports</i>	 Regulatory Filings <i>Evidence, testimony and other supporting materials are compelling and successful</i>
<p>Current fiscal practices are effective in managing and controlling costs. Management has a focus on cost control having developed a key corporate goal to monitor on-going cost savings.</p>	<p>System development, testing, implementation, and data management environments are not at desired levels. The technology roadmap is not clearly defined and contributes to overall technology inefficiencies. Dec '05 Retail Transaction systems issues evidence of existing infrastructure concerns.</p>	<p>ERCOT's settlement/dispute processes has a small number of ADR's outstanding, however these are being addressed in a timely fashion. The recent SAS 70 audit has found no significant issues in the 13 Settlement & Billing control areas. No significant issues relating to administration of existing protocols have been identified.</p>	<p>Ineffective ERCOT enforcement ability relating to reliability standards may lead to gradual erosion of reliability. Response of generators to Apr. '06 EECOP event requires greater scrutiny in analyzing market participant operations.</p>	<p>Financial and Operations management information is being redesigned to enable management to effectively monitor and manage all aspects of the business. No significant items identified at this time. A fully functioning Compliance and Disclosure risk sub committee will further support this area.</p>	<p>Filings are completed timely and accurately. Ongoing management of competing priorities is necessary to avoid impacting the accuracy and timeliness of filings.</p>

Legend:  **Elevated Risk Level**  **Reduced Risk Level**  **Special Attention Required** **(New Risk Categories Indicated in Green)**

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Rationale for Category Risk Assessment Changes

Reputation	Downgrade
Human Resources	Flagged
Nodal Implementation	New Category - Downgrade
Operational Responsibility	Downgrade
Communication	Downgrade
Legal & Legislative	Downgrade

Fall out from Apr. '06 EECF event have impacted ERCOT's reputation amongst the public, regulators, and market participants
Additional impact from discontinuing payment for relocation, recruiter's fees, management training, tuition reimbursment
Significant risks exist with respect to Nodal budget, staffing, scope and deliverables, and project timeframe
Response of generators to Apr. '06 EECF event requires greater scrutiny in analyzing market participant operations.
Apr. '06 EECF event has indicated significant need for improved resources and strategies in internal and external communications.
Legislative and PUCT response to ERCOT handling of Apr. '06 EECF event has indicated additional required efforts



Finance & Audit Committee

Large Project Update

May 16, 2006

**David Troxtell,
Program Management**

ERCOT seeks approval for the following contract and project items (details and templates are contained in the Executive Session Board Packet):

- ❑ Enhancements to Areva Study Tools (MOMS) – PR 50003

Dashboard

- Progress on high priority projects from PPL
- Financial management and cost effectiveness

Department

- Review & streamline key policies, procedures and approval authorities
- Maintain integrity of financial records and reports
- Support Texas Nodal implementation
- Implement agreed changes incorporated in Projects improvement plan
- Deliver priority project phases in accordance with project schedules and budgets
- Enhance credit risk management
- Maintain cost controls and implement productivity improvements
- Improve budget development and fee filing processes
- Obtain Unqualified ("clean") audit opinions
- Obtain "Fully Meets" (or equivalent) rating from Agreed Upon Procedures review of Key internal controls
- Enhance compliance monitoring and reporting
- Achieve steady-state Internal Control Management Program
- Establish a standing Enterprise Risk Management (ERM) program
- Obtain zero qualifications from SAS 70 Audit
- Create an exciting and rewarding place to work (Attract, Motivate & Develop Top Talent)

Department	Authorized FTE	Actual FTE	Contractor
Controller	17	15	6
Treasurer	5	4	1
Procurement	11	8	0
Project Management	11	10	3
ICMP	2	1	2
ERM	1	1	0
Totals	47	39	12