



Date: May 13, 2009
To: Board of Directors
From: Clifton Karnei, Chair, Finance and Audit Committee
Subject: Market Credit Risk Standard Approval

Issue for the ERCOT Board of Directors

ERCOT Board of Directors Meeting Date: May 20, 2009

Agenda Item No.: 12a

Issue:

Whether the ERCOT Board of Directors (Board) should accept the expected recommendation of the Finance and Audit (F&A) Committee of the Board to authorize and approve the proposed Market Credit Risk Standard (Standard), which is attached as Exhibit A.

Background/History:

The F&A Committee, in its oversight role as it seeks to maintain the long-term financial integrity of the ERCOT market, asked ERCOT staff to develop a standard by which the Board could monitor and evaluate the credit risk in the ERCOT electricity market. The proposed Standard was developed by ERCOT staff and has been reviewed and endorsed by both the Credit Work Group (CWG) and the Technical Advisory Committee (TAC). Please see Exhibit A. The proposed Standard is a significant step forward in the implementation of a more comprehensive program to assess and monitor ERCOT credit risk; however, it should be noted that the proposed Standard will need to be further developed as outlined below to function as a credit risk management tool. The proposed Standard requires Board approval for implementation.

In March 2007, the F&A Committee of the Board held a credit workshop to gain a better understanding of credit risk in the ERCOT electricity market. As a result of that workshop, ERCOT staff received authorization to contract with Oliver Wyman, Inc. (Oliver Wyman) to develop a potential future exposure model that considers key market risks, in combination and to provide estimates of risk exposures in the market together with the probability of occurrence of such risk events. In addition, Oliver Wyman reviewed ERCOT credit practices and conducted a comparison relative to best practice. The review results were also presented to the Board.

The modeling effort led by Oliver Wyman began in August 2007 and continued through January 2008. Over that timeframe there were several open sessions with the CWG and other market participants to gather input and discuss options. The resulting potential future exposure (PFE) model combines the impact of key market credit risk factors and uses these factors to quantify in dollar terms market credit risk.

In February 2008, Oliver Wyman presented the model results and the results of their best practice review to the F&A Committee and to the Board.



- A key Oliver Wyman recommendation was that ERCOT develop a formal credit risk appetite statement which the organization would then use to compare measured credit risk exposure relative to its risk tolerance. Appropriate mitigation plans should be implemented for any situations beyond the defined tolerance level.
- The F&A Committee asked ERCOT staff to develop a proposed Standard consistent with the recommendation and to obtain input from the CWG and TAC.

Since that time, ERCOT staff developed a proposed standard and has been working with various market groups, including the Retail Market Subcommittee (RMS), Wholesale Market Subcommittee (WMS) and Market Credit Working Group (MCWG), seeking endorsement of the proposed Standard.

The proposed Standard is the result of this collaboration process.

The proposed Standard establishes an objective to maintain the financial integrity of the ERCOT market, defines how credit risk will be measured, and assigns responsibility for measuring, reporting and monitoring ERCOT electricity market credit risk.

At this time, the proposed Standard *does not* define a credit risk tolerance limit or the actions to be taken as levels of credit risk approach or exceed predefined levels.

The proposed Standard is therefore a *reporting* standard at this time as it will allow market participants and ERCOT more time to become familiar with the methodologies used and the resultant exposures generated.

While ERCOT staff believes that implementation of the proposed Standard represents a positive step forward in credit risk assessment and monitoring for the ERCOT electricity market, it believes that the proposed Standard will likely not be fully effective until the missing elements described above are incorporated.

This proposed Standard provides a framework by which the ERCOT Board of Directors can advance the desire to maintain the long-term financial integrity of the ERCOT electricity market and it helps ensure that overall market credit risk exposure is monitored and understood.

Key Factors Influencing Issue:

- 1) Provide the Board a way to measure, monitor and potentially manage credit risk exposure in the ERCOT electricity market.
- 2) Formalize the objective to maintain the financial integrity of the ERCOT market.
- 3) Provide a mechanism to quantify credit risk, taking into consideration key risk factors.

Alternatives:

- 1) Accept the F&A Committee's recommendation to authorize and approve the Standard as



recommended.

- 2) Direct ERCOT staff to make adjustments to the proposed Standard or seek additional input from other sources.

Conclusion/Recommendation:

The F&A Committee is expected to recommend that the Board authorize and approve the attached proposed Standard.



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

WHEREAS, the Finance and Audit (F&A) Committee of the Board of Directors (Board) of Electric Reliability Council of Texas, Inc. (ERCOT), in its oversight role as it seeks to maintain the long-term financial integrity of the ERCOT market, asked ERCOT staff to develop a standard by which the Board could monitor and evaluate the credit risk in the ERCOT electricity market;

WHEREAS, in response to the F&A Committee's direction, ERCOT staff developed the Market Credit Risk Standard (Standard) attached as Exhibit A and the Standard has been reviewed and endorsed by both the Credit Work Group (CWG) and the Technical Advisory Committee (TAC);

WHEREAS, the proposed Standard is a significant step forward in the implementation of a more comprehensive program to assess and monitor ERCOT credit risk; and

WHEREAS, pursuant to recommendation by the F&A Committee, the Board deems it desirable and in the best interest of ERCOT to approve the Standard, as set forth in Exhibit A;

THEREFORE BE IT RESOLVED, that the Standard, as set forth in Exhibit A, which is attached hereto and incorporated herein for all purposes, is hereby authorized and approved by the Board in each and every respect.

CORPORATE SECRETARY'S CERTIFICATE

I, Michael G. Grable, Corporate Secretary of ERCOT, do hereby certify that, at its May 20, 2009 meeting, the ERCOT Board of Directors passed a motion approving the above Resolution by _____.

IN WITNESS WHEREOF, I have hereunto set my hand this ____ day of _____, 2009.

Michael G. Grable
Corporate Secretary