



Date: May 11, 2010
To: Board of Directors
From: Clifton Karnei, Chair, Finance and Audit (F&A) Committee
Subject: Market Credit Risk Standard Approval

Issue for the ERCOT Board of Directors

ERCOT Board of Directors Meeting Date: May 18, 2010

Agenda Item No.: 16b

Issue:

Whether the ERCOT Board of Directors (Board) should accept the expected recommendation of the F&A Committee of the Board to authorize and approve any or all of the ERCOT staff-proposed modifications to the Market Credit Risk Standard (Standard), reflected in *Attachment A*, or any other changes to the Standard.

Background/History:

Development and Approval of the Standard

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 Standard was developed by ERCOT staff and was reviewed and endorsed by both the Credit Work Group (CWG) and the Technical Advisory Committee (TAC). The Board approved the Standard in May 2009.

The Standard was considered to be 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 it was understood that the Standard would need to be further developed as outlined below to function as a credit risk management tool.

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 at that time.

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 combined the impact of key market credit risk factors and used 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 the Standard in conjunction with various market groups, including the Retail Market Subcommittee (RMS), Wholesale Market Subcommittee (WMS) and Market Credit Working Group (MCWG), who sought endorsement of the Standard. The Standard, as approved in May 2009, is the result of this collaboration process.

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 Standard, as approved in May 2009, is therefore a *reporting* standard 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 Standard, as approved in May 2009, represented a positive step forward in credit risk assessment and monitoring for the ERCOT electricity market, ERCOT staff believes that the Standard will likely not be fully effective until the missing elements described above are incorporated.

The Standard has provided a framework by which the ERCOT Board can advance the desire to maintain the long-term financial integrity of the ERCOT electricity market and help ensure that overall market credit risk exposure is monitored and understood.

Current Request for Approval

In May 2009, the Board approved the Standard, which is expected to be reviewed annually and updated as needed. The Board must approve any modifications to the Standard.

This Standard establishes an objective to maintain the financial integrity of the ERCOT electricity market, defines the manner in which credit risk is measured, and assigns responsibility for measuring, reporting and monitoring of credit risk in the ERCOT electricity market. As a result of this Standard, the ERCOT PFE Model was developed, which combines the impact of key market credit risk factors and uses these factors to quantify in dollar terms the overall level of credit risk in the ERCOT market.

ERCOT staff has reviewed the Standard and respectfully proposes several minor changes, as reflected in *Attachment A*. The F&A Committee is expected to recommend that the Board adopt, reject, or amend the revisions at its May 18, 2010 meeting.



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

As noted previously when the Standard was originally approved, 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 Standard, as approved in May 2009 and with the proposed modifications for which approval is currently sought, is therefore a *reporting* standard 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 Standard, as approved in May 2009 even with the proposed modifications for which approval is currently sought, represents a positive step forward in credit risk assessment and monitoring for the ERCOT electricity market, ERCOT staff believes that the Standard will likely not be fully effective until the missing elements described above are incorporated.

The Standard, since its approval in May 2009, has provided a framework by which the ERCOT Board can advance the desire to maintain the long-term financial integrity of the ERCOT electricity market and help ensure that overall market credit risk exposure is monitored and understood.

Furthermore, ERCOT staff respectfully proposes to discontinue running the zonal Potential Credit Risk (PCR) Model and the corresponding summary analysis of results for the following quarterly periods since the results will not be available until at or near the conclusion of the zonal market:

- a. Second quarter, 2010; and
- b. Third quarter, 2010.

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.
4. Adherence to provisions of Board-approved Corporate Standards.
5. Improved clarity and consistency of ERCOT's policy documents.

Alternatives:

1. Approve modifications to the Standard and the discontinuation of the running of the zonal PCR Model and the corresponding summary analysis of results for the second and third quarters of 2010 as recommended by ERCOT staff and accepted by the F&A Committee;



2. Leave the Standard in its current form;
3. Remand the Standard to the F&A Committee with instructions; or
4. Direct ERCOT staff to make adjustments to the proposed modifications to the Standard or seek additional input from other sources.

Conclusion/Recommendation:

The F&A Committee will review these changes at their meeting on May 18, 2010 and is expected to recommend to the Board whether the Board should authorize and approve any or all of the ERCOT staff-proposed modifications to the Standard, reflected in *Attachment A*, or any other changes to the Standard as well as any discontinuation of the running of the zonal PCR Model and corresponding summary analysis of results for the second and third quarters of 2010.



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, the Board approved the Market Credit Risk Standard (Standard) in May 2009, and ERCOT staff has now recommended modifications to the Standard as reflected in Attachment A, and recommended the discontinuation of the running of the zonal Potential Credit Risk (PCR) Model and the corresponding summary analysis of results for the second and third quarters of 2010, which recommendations the F&A Committee has accepted and recommended to the Board for its approval;

WHEREAS, after due consideration of the alternatives, the Board deems it desirable and in the best interest of ERCOT, to approve the modifications to the Standard as reflected in Attachment A and the discontinuation of the running of the zonal PCR Model and the corresponding summary analysis of results for the second and third quarters of 2010 as recommended by the F&A Committee;

THEREFORE, BE IT RESOLVED, the Board hereby accepts the recommendation of the F&A Committee and authorizes and approves the following:

- (1) The revised Market Credit Risk Standard, as set forth in Attachment A, in each and every respect which is attached hereto and incorporated herein for all purposes; and,
- (2) The discontinuation of the running of the zonal PCR Model and the corresponding summary analysis of results for the second and third quarters of 2010.

CORPORATE SECRETARY'S CERTIFICATE

I, Bill Magness, Interim Corporate Secretary of ERCOT, do hereby certify that, at its May 18, 2010 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 May, 2010.

Bill Magness
Interim Corporate Secretary