

**ELECTRIC RELIABILITY COUNCIL OF TEXAS, INC.
MINUTES OF THE FINANCE & AUDIT COMMITTEE – GENERAL SESSION**

7620 Metro Center Drive (Room 206) – Austin, Texas 78744
October 18, 2010

Pursuant to notice duly given, the Finance & Audit Committee (Committee) of Electric Reliability Council of Texas, Inc. (ERCOT) convened on the above-referenced date. Committee Chairman Clifton Karnei confirmed that a quorum was present and called the meeting to order at approximately **12:30 p.m.** The Committee immediately went into Executive Session, where it remained until it recessed and reconvened in General Session at **1:45 p.m.**

General Session Attendance

Committee members:

Bermudez, Jorge	Unaffiliated Board Member	Unaffiliated Board Member	Present
Crowder, Calvin	American Electric Power Service Corporation	Investor Owned Utility	Present
Dreyfus, Mark	Austin Energy	Municipal	Present
Espinosa, Miguel (Vice Chair)	Unaffiliated Board Member	Unaffiliated Board Member	Present
Fehrenbach, Nick	City of Dallas	Commercial Consumers	Present
Karnei, Clifton (Chair)	Brazos Electric Power Cooperative	Cooperative	Present
Zlotnik, Marcie	StarTex Power	Independent REP	Present

Other Board Members and Segment Alternates:

Doggett, Trip	ERCOT	Chief Executive Officer	Present
Doll, Laura	Unaffiliated Board Member	Unaffiliated Board Member	Present
Gent, Michehl	Unaffiliated, Acting Board Chairman	Unaffiliated, Acting Board Chairman	Present
Givens, Sheri	Office of Public Utility Counsel	Consumer/Residential	Present
Helton, Bob	International Power America Services	Independent Generator	Present
Ryall, Jean	Constellation Energy	Independent Power Marketer	Present
Smitherman, Barry	Public Utility Commission of Texas	PUCT Chairman	Present
Walker, Mark	NRG Texas	Independent Generator	Present

Whittle, Brandon	DB Energy Trading	Independent Power Market Representative	Present
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ERCOT Staff and Guests:

Anderson, Kenneth	Public Utility Commission of Texas - Commissioner
Cleary, Mike	ERCOT – Senior Vice President and Chief Operating Officer
Magness, Bill	ERCOT – Vice President and General Counsel
Manning, Chuck	ERCOT – Vice President and Chief Compliance Officer
Moseley, Cheryl	ERCOT – Manager, ICMP
Morehead, Juliana	ERCOT – Associate Corporate Counsel
Morgan, Richard	ERCOT – Vice President and Chief Information Officer
Nikazm, Tamila	Austin Energy
Petterson, Mike	ERCOT – Controller
Wullenjohn, Bill	ERCOT – Director, Internal Audit
Yager, Cheryl	ERCOT - Treasurer

Approval of General Session Minutes – September 21, 2010 (Agenda Item 4)

Mr. Karnei entertained a motion to approve the September 21, 2010 General Session F&A Committee meeting minutes (Minutes).

Jorge Bermudez made a motion to approve the Minutes. Marcie Zlotnik seconded the motion. The motion passed unanimously by voice vote.

Review Assumptions for Preliminary Schedules for the 2011 Annual Operating Budget (2011 Budget) (Agenda Item 5)

Mike Petterson and the Committee discussed assumptions and preliminary schedules for the 2011 annual Operating Budget (2011 Budget or Budget). Mr. Petterson gave the Committee a review of prior budget discussions, summarized 2011 Budget preparations, and fielded questions concerning detailed Budget information. He emphasized that the proposed 2011 Budget assumed no change to the System Administration Fee (Admin Fee) or the Nodal surcharge. Mr. Petterson explained ERCOT could hold the Admin Fee and Nodal surcharge fees flat at current levels by using \$25.2M of the \$113M Board Discretionary Fund to pay for post go-live charges on the Nodal program. He added that \$11.9M of the funds would be used to pay recurring annual charges incurred as an ERCOT base operating cost starting in 2012, and the remaining \$13.3M would be used to pay non-recurring project charges incurred in 2011.

Mr. Espinosa asked for a more detailed description of these charges. Mr. Petterson described the recurring expenses (i.e., hardware and software systems licensing and maintenance costs) and non-recurring expenses (i.e. nodal market stabilization costs) that ERCOT would incur resulting from the transition into a Nodal market. Mr. Doggett emphasized that the proposed treatment of recurring expenses is consistent with ERCOT's standard project accounting practices.

Commissioner Anderson asked for more details on the classification of reoccurring charges. Messrs. Petterson and Cleary enumerated the charges as licensing and maintenance fees for hardware and software systems, and dedicated vendor resources to help manage and maintain

such applications in the future. Mr. Cleary defined the planning component associated with "Parking Deck" items as the prioritization, requirements definition, and design development that would be undertaken during the course of 2011, in preparation for implementation in 2012. Mr. Cleary further informed the Committee that at present, ERCOT had 700 outstanding deferred defects, one-half of which are assumed to be resolved in 2011 using the \$2.55M as designated on page 14 of the meeting materials.

Mr. Espinosa and Mr. Petterson briefly discussed a change that Mr. Morgan brought to the Board in September 2010, which resulted in a change to the carryover amount from 2010.

Mr. Petterson then discussed the use of a portion of the Board Discretionary Fund to pay for post Nodal go-live charges. He noted that not using the Fund for post-go-live charges, as enumerated above, would cause approximately a 5.5 percent increase in the Admin Fee, which would raise the fee to \$0.4725 per MWh. Mr. Petterson then discussed the Admin Fee, should the Fund be used for such charges. Chairman Smitherman inquired as to whether the potential increase in the Admin Fee, should the Fund not be used for post-go-live charges, would be \$17M due to the 40/60 funding formula. Mr. Petterson replied in the affirmative. Mr. Petterson addressed the period of 2012–2016, and mentioned that the key drivers (hardware and software licenses and maintenance, incremental vendor services, nonrecurring items, and sales tax refund receipts) during that time would likely cause the fee to remain around \$0.46 per MWh.

Mr. Fehrenbach asked whether the money ERCOT would receive for the Nodal surcharge, if the Board Discretionary Fund was not used for post-go-live costs, would go to pay off the debt ERCOT incurred in building the Nodal program. Mr. Petterson answered in the affirmative. Mr. Fehrenbach noted that ERCOT would then be essentially using 100% debt to fund current year operations. Mr. Cleary noted that Mr. Fehrenbach's analysis was correct, and commented that his position could also be viewed as using the money ERCOT has saved to fund Nodal-related items in 2011. Mr. Karnei commented that the use of the Board Discretionary Fund for post-go-live costs was in the interest of keeping the Admin Fee flat.

Mr. Gent revisited the \$14.4M favorable financial variance currently forecasted for year-end 2010, and inquired as to whether such would go against the total expenses for 2010. Mr. Petterson said that it would, and that ERCOT assumed that the \$14.4M favorable variance (i.e., the money collected, but not used in 2010), would be carried forward and used to cover revenue requirements in 2011. Mr. Gent further asked what the total expenses were expected to be, regardless of where the revenue was derived. Mr. Petterson replied that the total ERCOT spending authorization for the 2011 Budget was expected to be \$215,194,000.00 without regard to the funding source, and the 2010 carry forward would be approximately \$14,420,000.00.

Mr. Dalton inquired as to the impact of using the Board Discretionary Fund for post-go-live purposes on ERCOT's debt/equity structure in 2011 and 2012. Ms. Yager replied that when the Nodal Surcharge was set at \$0.375 per MWh, it was presumed that ERCOT would be spending all of the Board Discretionary Fund, and that since the Board Discretionary Fund was not being fully expended on Nodal Program implementation costs the current Nodal Surcharge afforded equity contribution in excess of 40 percent.

Mr. Petterson confirmed that in November, management would present a recommended budget for 2011 and seek concurring recommendation from the Committee and subsequent approval of the recommended 2011 budget from the Board. Mr. Karnei specified that ERCOT management presented a plan to keep the Admin Fee flat, and asked that any Committee member in

disagreement with management's plan make his/her opinion known sooner than later. Mr. Bermudez asked what the ultimate budgetary goal was. Mr. Karnei responded that the cheapest way to fund ERCOT's operations was by having zero debt and funding everything with cash, which tends to make the Admin Fee extremely volatile. Historically, he noted, ERCOT has used debt financing to normalize the Admin Fee. From a political perspective, Mr. Karnei noted the ability to avoid an Admin Fee increase in 2011 by using the Board Discretionary Fund, albeit not the cheapest means of funding ERCOT's operations.

Messrs. Petterson and Magness clarified that ERCOT would be asking the Board to authorize its plan to use some of the Board Discretionary Fund at the meeting on October 19, 2010, as to allow ERCOT staff to prepare the 2011 Budget for Committee recommendation and Board approval at the November 2010 meeting. Mr. Fehrenbach noted that he was not opposed to using some of the Board Discretionary Fund for non-recurring charges, deferred defects, and Nodal stabilization, but that he had issue with using the Board Discretionary fund to pay for expenses that will reoccur such as hardware and software licenses and maintenance charges.

Mr. Smitherman referred to the chart on page 22 of the meeting materials and asked Mr. Petterson to prepare additional budget scenarios by varying forecasted load growth and expected project expenditures for the years 2012-2016., Mr. Petterson agreed to do so.

Mr. Helton asked whether the budgeted load growth was the same as the load growth in the latest Current Day Report (CDR). Mr. Doggett replied that the figures should be very close, but noted that the CDR data was calculated in May 2010, whereas the Budget data was calculated more recently. Thus, he said, there could be some slight timing difference in the load forecasts.

Concerning a modification to the Admin Fee, Ms. Zlotnik expressed significant concern that any change thereto would have to pass through to consumers. Mr. Crowder commented that ERCOT had an aggressive debt repayment schedule built into its budget, and that such should be kept in mind, to which Mr. Karnei agreed. Mr. Cleary followed-up on Ms. Zlotnik's concern and explained that ERCOT's executive team undertook a rigorous process to ensure that the figures making up the \$25.2M were adequately linked to real Nodal issues. Mr. Magness further noted that ERCOT was filing for approval to use the Board Discretionary Fund for post Nodal go-live charges, and as such, the public would be aware of ERCOT's proposal for use of the Fund. Mr. Karnei noted that ERCOT would be facing a future uptick in the Admin Fee, albeit not in 2011. He further elaborated that the Nodal fee would run its course, and if ERCOT could defer an Admin Fee increase for an additional year, it would be a positive move. Mr. Espinosa noted that in determining whether to increase the Admin Fee, ERCOT must consider political and market implications.

Nodal Credit (Agenda Item 6)

Oliver Wyman Report on Nodal Credit Policy and Practices

Michael Denton of Oliver Wyman reviewed Oliver Wyman's report on ERCOT's credit practices, provided the Committee with a benchmark analysis of key elements comparing ERCOT to other Independent System Operators (ISOs), as well as recommendations to further ERCOT's goals (see also Credit Risk Management Review and Benchmarking Study dated October 1, 2010 in meeting materials).

Mr. Dalton inquired about Market Participants that have access to unsecured credit, and those that were eligible for it. Ms. Yager clarified that as of September 30, 2010, 19 entities received unsecured credit directly, and 30 entities received it using guarantees. They discussed the breakdown of figures, which demonstrated how much, on average, entities had in outstanding and unsecured credit.

Mr. Karnei commented that the presentation was very helpful.

Nodal Credit Risk Profile and Status

Ms. Yager reviewed the timeline for Nodal credit readiness, and noted that ERCOT successfully completed all of the various readiness tasks concerning systems, processes, and people. Ms. Yager then provided the Committee with an update on Nodal-related open credit items.

Concerning Congestion Revenue Rights (CRR) auction credit constraints, she noted that the Technical Advisory Committee (TAC) proposed that the Multiplier be changed from one (1) to zero (0), and the Adder from \$1.50 to \$0.75 per MWh. Ms. Yager further noted that ERCOT informed TAC that it preferred the Adder to be \$1.00 per MWh, but was satisfied with the move to \$0.75 per MWh.

Ms. Yager identified an issue involving Day-Ahead Market (DAM) credit constraints, and said that ERCOT planned to resolve this issue by November 5, 2010, in time for Nodal go-live. She also noted that ERCOT was working with Market Participants to determine how credit was consumed in the DAM, and would continue to address questions and resolve issues as they arose.

Ms. Yager informed the Committee that there were some credit constraints in the DAM that used a 95th percentile; (1) Real Time (RT) – Day Ahead (DA) spread used to collateralize Energy Only Offers; and (2) Point-to-Point (PTP) Obligation Bids. She noted that if one or two data points were high, then the values of the constraints could rise dramatically, which could affect credit for thirty-days forward. Ms. Yager noted that should such an event occur, ERCOT would not have the ability to respond quickly, since it does not have the discretion to modify these percentiles. However, she noted that ERCOT asked the market to consider changing the percentiles to provide for additional outliers, and defining a contingency and/or providing flexibility to address issues should they arise. She concluded by informing the Committee that the Board of Director may see something on this topic in November 2010.

Ms. Yager noted that ERCOT developed a "benchmark" tool, which would help ERCOT evaluate the reasonableness of the calculated Total Potential Exposure (TPE) in the new market. She noted that the tool would define low-end and high-end risks and identify outliers. Ms. Yager explained that the tool was still a work in progress and will evolve over time to meet ERCOT's needs.

Ms. Yager revisited ERCOT's maximum unsecured credit limit, noting that ERCOT reviewed it with the Credit Work Group (CWG) a couple years ago. Ms. Yager indicated that ERCOT would maintain its current internal limit on unsecured credit (\$75M) until CWG reviewed and reevaluated the cap following Nodal go-live. Mr. Crowder asked Ms. Yager for her opinion as to whether ERCOT's method of granting unsecured credit was too stringent, given that ERCOT grants credit more conservatively than other ISOs. Ms. Yager replied that it was her opinion that the percentiles should not be increased at this time. Mr. Karnei inquired as to whether Ms.

Yager felt comfortable continuing to use guarantees as unsecured credit. Ms. Yager responded that she was reasonably comfortable with the use of guarantees for the time being, given that the language in the guarantee form had been strengthened (revised in 2009). Mr. Crowder asked what percent of the market was being granted unsecured credit (i.e., the percent of total financial transactions). Ms. Yager noted that, at September 30, 2010, 55% of the Estimated Aggregate Liability (EAL) was unsecured either directly or through guarantees, and forty-five percent (45%) was secured by cash or letters of credits.

Ms. Yager then noted that TAC certified full Nodal systems for Go-Live for December 2, 2010 based on the October 1, 2010 ERCOT Management Readiness Certification and the Nodal Advisory Task Force (NATF) recommendation. After reviewing the language in the draft Recommendation, Ms. Yager asked the F&A Committee for their recommendation that the Board vote to certify that all Market Readiness Criteria have been met for Nodal Market Go-Live for Operating Day, December 1, 2010 (based on recommendations from TAC, CWG, NATF, and ERCOT Management). Chairman Karnei asked to hear from the CWG before voting on this issue.

Credit Work Group's Status and Recommendation

Tamila Nikazm provided an overview of the CWG's recommendation concerning ERCOT's credit readiness in preparation for Nodal go-live. Ms. Nikazm stated that CWG's recommendation was to verify that (a) credit calculations were functioning per Nodal protocols based on the data available to CWG from market trials, and (b) credit risks in a Nodal market had been adequately addressed.

Ms. Nikazm noted an issue in the DAM credit constraint concerning the calculation for PTP obligation bids, as discovered on October 5, 2010. However, because ERCOT had a plan to resolve it by November 5, 2010, Ms. Nikazm stated that CWG confirmed that with the fix, DAM credit consumption is expected to adequately address the credit risk. CWG, with six segments voting, unanimously voted to make the above recommendation, she said. Also included in the recommendation, Ms. Nikazm said, was that CWG would like to see status updates regarding outstanding issues at future ERCOT Board meetings.

Ms. Nikazm then discussed CWG's review of the CRR Multiplier and Adder. She noted that the CWG voted to concur with the TAC modifications to the Adder and Multiplier, but that the vote was 3.5 to 1.5 by the segments. Ms. Nikazm stated that she believed the municipality and cooperative segments voted not to concur with TAC's changes. Mr. Karnei inquired as to the pro and con arguments concerning the \$0.75 Adder. Ms. Nikazm responded that the segment that voted for the \$0.75 Adder believed it could be reduced to a lower number. The segments voting against the \$0.75 Adder, she said, believed that it should not be reduced below \$1.00 since many CRRs would be collateralized at \$1.00 after the auction and should hold that amount during the auction. However, Ms. Nikazm informed the Committee that all parties agreed that there was not yet adequate data from the Nodal market for a full analysis.

Several Board members expressed their opinions concerning the CRR auction credit constraints Adder and Multiplier. Mr. Dreyfus stated that it was his opinion, as a member of the municipal community, that the Adder should be set closer to \$1.00, but noted that he was prepared to vote in support of the \$0.75. Ms. Zlotnik stated that the exposure was pretty limited for the market, and gave an advantage to the largest players, while discouraging participation, but noted that she was prepared to vote in support of the \$0.75. Ms. Yager clarified that at this time, ERCOT

had only one mechanism to address low risk, low cost items, and high-risk, low cost items, but would like to find a way to better segregate out the risk items in the future. Ms. Zlotnik expressed that she would rather ERCOT be more lenient for the first 90 days, and then reevaluate to see if it needed to increase the Adder. Mr. Bermudez expressed caution at lowering the Adder much below \$1.00 due to the inability to build a proper risk model for it. Mr. Helton agreed with Mr. Bermudez but noted the importance of considering that if collateral was too high and priced participants out of the market, there could be defaults. Mr. Karnei stated that he was concerned about lowering the Adder below \$1.00 due to the uncertainties of the market. He expressed the idea of tightening credit upfront, and thereafter reviewing it monthly to relax credit where needed. Mr. Karnei noted that reducing credit at the beginning of the market and thereafter tightening it is more difficult than starting tight and backing off later. Mr. Helton responded that Mr. Karnei's analysis was an example of why he was agreeing to vote for the \$0.75. Mr. Fehrenbach expressed his opinion that the greatest risk lies in the first 180 days following go-live (i.e., market and system problems, rather than individual defaults), and was concerned about credit pricing out small or undercapitalized Market Participants. Thus, albeit a risk, he supposed, in the initial period, he would favor being a little more lax on the credit. Mr. Bermudez commented that bringing the Adder down from \$1.50 to \$1.00 would accept and loosen some of the standards to an appropriate level, and that further adjustment could occur after the market has had experience in a Nodal market.

The credit parameters were then voted on, as set forth below.

Ms. Nikazm then briefly discussed other items the CWG was working on. She noted that the CWG voted to reduce ERCOT's 95th percentile to the 85th percentile, and clarify language such that ERCOT would have the authority to utilize each factor and moderate collateral requirement as needed, and that this issue would likely be up for Committee discussion at the November 2010 meeting. Ms. Nikazm told the Committee of concerns the CWG had about the Oliver Wyman Report. Specifically, the CWG wanted Oliver Wyman to: (1) review ERCOT's CRR credit readiness and evaluate its credit model for the CRR; (2) provide more clarification on ERCOT's standing with unsecured credit compared to other ISOs; and (3) provide a more in-depth review of ERCOT's credit exposure, albeit outside the scope of the Review concerning short-term life. Ms. Yager noted that Oliver Wyman agreed to address the first two points in their Report.

Mr. Karnei reintroduced the issue of ERCOT's credit readiness in preparation for Nodal go-live. Mr. Crowder inquired as to whether CWG believed the systems, processes, and people in place were available to support Nodal go-live. Ms. Nikazm replied that CWG only looked into the accuracy of the calculations in the systems based on Nodal protocols. As far as systems readiness was concerned, she said, CWG had sufficient evidence to confirm that systems were ready for Nodal go-live, but noted that CWG did not look into staffing independently of what the Nodal protocols directed for confirming systems readiness. Mr. Crowder asked Ms. Nikazm whether ERCOT's Market Participants seemed to have a good understanding of the credit requirements. Ms. Nikazm replied that it appeared to CWG that the Market Participants had a good grasp on credit requirements, but as far as readiness of their systems were concerned, the entities are working diligently to prepare for go-live. Mr. Crowder then asked Ms. Yager whether the November 5, 2010 deadline for fixing the issue regarding calculations for PTP obligation bids was reasonable. Ms. Yager responded in the affirmative, and noted that the fix was not a difficult undertaking. Mr. Cleary clarified that the patch (or fix) would be arriving on October 23, 2010 and ERCOT would have it tested and in production by November 5, 2010. He further noted that ERCOT was not concerned about fixing the problem by the November 5, 2010

deadline. Further, he said, should that not be the case, ERCOT would be certain to notify the Board.

Miguel Espinosa made a motion to recommend to the Board of Directors the change of the credit parameter Multiplier from "1" (one) to "0" (zero). Calvin Crowder seconded the motion. The motion passed by unanimous voice vote.

Calvin Crowder made a motion to recommend to the Board of Directors the change of the credit parameter Adder from \$1.50 to \$0.75. Nick Fehrenbach seconded the motion. The motion passed by majority vote, with two opposed (Messrs. Espinosa and Bermudez).

Mark Dreyfus made a motion to recommend that the Board vote to certify that all Market Readiness Criteria had been met for Nodal market go-live for Operating Day, December 1, 2010. Calvin Crowder seconded the motion and the motion passed by unanimous voice vote.

Discussion of SAS 70 Transition to Nodal (Agenda Item 7)

Cheryl Moseley provided a brief presentation on the SAS 70 transition to Nodal and fielded questions from Committee members. She noted that ERCOT staff recommended that ERCOT:

- (a) In 2010, issue a management letter concerning Zonal controls for October 1, 2010 through November 30, 2010, with exceptions due to network model and CRR controls going live before December 1, 2010; this letter would include a listing of controls that did not change, as well as the controls which changed in December 2010, resulting from Nodal go-live and the network model and CRR controls running prior to December 1, 2010; and
- (b) In January 2011, undertake a Type I audit, which would give ERCOT an opinion at a point in time concerning the design of the new controls (not operating effectiveness).

Mr. Karnei recalled that ERCOT had previously completed SAS 70 Type I audits, and then moved to Type II. Ms. Mosely agreed, and noted that undertaking another Type I audit was necessary due to the new set of controls.

Nick Fehrenbach made a motion that ERCOT: (1) In 2010, issue a management letter concerning Zonal controls for October 1, 2010 through November 30, 2010, inclusive of a list of controls that did not change, as well as controls which changed in December 2010; and (2) In January 2011, undertake a Type I audit. Marcie Zlotnik seconded the motion and the motion passed by unanimous voice vote.

Committee Briefs (Agenda Item 8)

No Committee Briefs were discussed.

Future Agenda Items (Agenda Item 9)

Mike Petterson noted that the Ernst & Young item would be on the November 2010 agenda.

The following items were identified as Future Agenda Items:

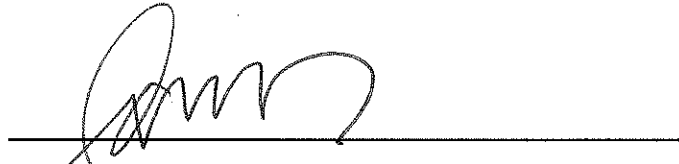
1. Standing approval of prior month's minutes
2. Standing Internal Audit agenda items
3. Standing EthicsPoint update
4. Standing Contracts, Personnel, Litigation and Security
5. Update on the 2010 SAS70 Audit
6. Appointment of independent financial auditors/fees
7. Review of independent financial auditor's procedures and independence
8. Review of scope of annual financial audit
9. Recommendation of the 2011 Base Operating Budget
10. Review of Investment and Financial Corporate Standards
11. Annual review of Committee Charter and structure
12. Standing Nodal Credit Status
13. Standing Review of investment strategy
14. Standing Committee briefs
15. Standing Future Agenda Items

Other Business (Agenda Item 10)

None.

Adjournment

Mr. Karnei adjourned the meeting at approximately **3:40 p.m.**



Juliana Morehead
Associate Corporate Counsel