



Date: March 15, 2011
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: March 22, 2011

Agenda Item No.: 9e

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 to provide probabilistic estimates of risk exposures in the market. In addition, Oliver Wyman reviewed ERCOT credit practices and conducted a comparison relative to best practice. The review results were 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 market credit risk in dollar terms.

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. Oliver Wyman recommended that



ERCOT develop a formal credit risk appetite statement which the organization could use to compare measured credit risk exposure relative to its risk tolerance with respect to one or more credit risk metrics. Appropriate mitigation plans should be implemented for situations in which risk metrics exceeded defined tolerance levels. 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.

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). The Standard, as approved in May 2009, was the result of this collaboration process.

At this time, the proposed Standard does not define credit risk tolerance limits 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 and assumptions used in the PFE model and the resultant estimated exposures.

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.

The Transition to Nodal

ERCOT generated analysis using the Potential Future Exposure (PFE) model through mid 2010. Given the changes as the market moved from Zonal to Nodal, ERCOT

1. Requested and obtained permission from the Board to discontinue running the zonal PFE Model and the corresponding summary analysis of results for the second and third quarters of 2010 since the results would not be available until at or near the conclusion of the zonal market and
2. Established a project to convert the PFE model for Nodal in the 2011 budget and plans to complete the conversion prior to year end 2011.

Current Request for Approval

In May 2010, the Board approved updates to 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 the March 22, 2011 Board meeting.

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

As noted 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 May 2010 and with the proposed modifications for which approval is currently sought, is therefore still a reporting standard as it will allow ERCOT time to adapt the PFE model for Nodal risk factors and provide time for the market and ERCOT to become familiar with the methodologies used for Nodal and the resultant estimated exposures.

ERCOT staff believes that implementation of the approved Standard, 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.

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.

Furthermore, ERCOT staff respectfully proposes to

1. waive running the zonal PFE Model for the first quarter, 2010 since the results are not relevant with the move to Nodal. ERCOT had originally expected to produce the first quarter 2010 results in mid 2010; however, staffing constraints and the focus on Nodal implementation precluded this activity.
2. Defer running of the PFE model for 2011 until the PFE model has been converted in late 2011.

Key Factors Influencing Issue:

Provide the Board a way to measure, monitor and potentially manage credit risk exposure in the ERCOT electricity market.

1. Formalize the objective to maintain the financial integrity of the ERCOT market.
2. Provide a mechanism to quantify potential credit risk, taking into consideration key risk factors.
3. Adherence to provisions of Board-approved Corporate Standards.
4. Improved clarity and consistency of ERCOT's policy documents.

Alternatives:

1. Approve modifications to the Standard, 1) waive running the zonal PFE Model for the first quarter, 2010 since the results are not relevant with the move to Nodal and 2) defer running



the PFE model for 2011 until the PFE model has been converted in late 2011; Remand the Standard to the F&A Committee with instructions; or

2. 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 March 21, 2011 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 waiver from running of the zonal PFE Model and corresponding summary analysis of results for the first quarter of 2010 or deferral from running the PFE model for 2011.



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

WHEREAS, after its meeting on March 21, 2011, the Finance and Audit (F&A) Committee of the Board of Directors (Board) of Electric Reliability Council of Texas, Inc. (ERCOT) has recommended that the Board approve revisions to the Market Credit Risk Standard (Standard) as set forth in Exhibit A and has recommended the waiver of the running of the zonal Potential Future Exposure (PFE) Model for the first quarter 2010 and the deferral of the running of the PFE model for 2011 until the PFE model has been converted in late 2011;

WHEREAS, pursuant to recommendation by the F&A Committee and after due consideration of the alternatives, the Board deems it desirable and in the best interest of ERCOT to approve the revised Standard, as set forth in Exhibit A and to waive running of the zonal PFE Model for the first quarter 2010 and the deferral of the running of the PFE model for 2011 until the PFE modal has been converted in late 2011; and

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

1. The revised Standard, as set forth in Exhibit A, which is attached hereto and incorporated herein for all purposes, in each and every respect to be effective immediately; and
2. The waiver of the running of the zonal PFE Model for the first quarter 2010 and the deferral of the running of the PFE model for 2011 until the PFE model has been converted in late 2011.

CORPORATE SECRETARY'S CERTIFICATE

I, Bill Magness, Corporate Secretary of ERCOT, do hereby certify that, at its March 22, 2011 meeting, the ERCOT Board passed a motion approving the above Resolution by _____.

IN WITNESS WHEREOF, I have hereunto set my hand this ____ day of March, 2011.

Bill Magness
Corporate Secretary