Electric Reliability Council of Texas

2010 financial statement audit results

Ernst & Young
Quality In Everything We Do

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The Finance and Audit Committee
Electric Reliability Council of Texas, Inc.

April 12, 2011

Dear Members of the Finance and Audit Committee,

We are pleased to present the results of our audit of the 2010 financial statements of the Electric Reliability Council of Texas, Inc. (ERCOT) and the status of our final procedures.

The audit is designed to express an opinion on the 2010 financial statements as of December 31, 2010. In accordance with professional standards, we obtained a sufficient understanding of internal control to plan the audit and to determine the nature, timing and extent of tests to be performed. However, we were not engaged to and we did not perform an audit of internal control over financial reporting.

This report is intended solely for the information and use of the Finance and Audit Committee and management, and is not intended to be and should not be used by anyone other than these specified parties.

We appreciate this opportunity to meet with you to discuss the contents of this report and answer any questions you may have about these or any other audit-related matters.

Very truly yours,

Philip J. Gunn
Partner

Agenda

- Deliverables
- Required communications
- Critical policies, estimates and areas of emphasis
- Summary of Audit Differences
- Appendix
  - Accounting Changes – FASB’s Modified Convergence Work Plan

Deliverables

	Finance and Audit deliverables	Status update
Opinion	► Express an opinion on the financial statements of ERCOT	► Obtain a letter of representations from management ► Perform final quality review procedures ► Complete subsequent events to date of report issuance ► Obtain external legal letters

Timing of required communications

	Communicate when event occurs	Communicate on a timely basis, at least annually
Our responsibility under generally accepted auditing standards, including discussion of the type of opinion we are issuing		X
Overview of planned scope and timing		X
Other information in documents containing audited financial statements		X (NA)
Our views about the qualitative aspects of the Company's significant accounting practices, including:		
‣ The appropriateness of accounting policies to the particular circumstances of the Company including, the adoption of, or a change in, an accounting policy	X	
‣ The effect of significant accounting policies in controversial or emerging areas	X (NA)	
‣ Significant accounting estimates		X
‣ Financial statement disclosures and related matters		X
Significant difficulties encountered in dealing with management when performing the audit	X (NA)	
Uncorrected misstatements		X
Material corrected misstatements		X
Disagreements with management	X (NA)	
Representations we are requesting from management		X

NA-Not applicable related to this audit

Timing of required communications

	Communicate when event occurs	Communicate on a timely basis, at least annually
Management's consultations with other accountants	X (NA)	
Significant issues, if any, arising from the audit that were discussed, or the subject of correspondence, with management	X (NA)	
Communication of independence matters	X	
Fraud and illegal acts involving senior management and fraud and illegal acts that cause a material misstatement of the financial statements	X	
Significant deficiencies and material weaknesses in internal control		X
AICPA ethics ruling regarding third-party service providers		X
Other findings or issues regarding the oversight of the financial reporting process	X (NA)	

NA-Not applicable related to this audit

Required communications

Area	Comments
Auditor's responsibilities under generally accepted auditing standards The financial statements are the responsibility of management. Our audit was designed in accordance with auditing standards generally accepted in the United States, as established by the American Institute of Certified Public Accountants, to obtain reasonable, rather than absolute assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we will express no such opinion.	Upon completion of our remaining audit procedures, we currently expect to issue an unqualified opinion on the Company's financial statements for the year ended December 31, 2010.
Our views about the qualitative aspects of the Company's significant accounting practices	Refer to Note 2 to the financial statements for detailed descriptions of the significant accounting policies. Refer to the section titled, "Critical policies, estimates and areas of emphasis" for our qualitative comments. Required adoption of accounting changes in 2010 did not significantly affect accounting or disclosures in the financial statements. We are not aware of any significant transactions recorded by the Company based on significant accounting policies used by the Company in controversial or emerging areas for which there is a lack of authoritative guidance.

Required communications

Area	Comments
Overview of planned scope and timing	We have planned a substantive audit similar to 2009.
Unrecorded misstatements	In 2010, ERCOT determined it had overaccrued for medical liabilities in prior years. The effect was net income was increased by approximately $660 thousand, which was deemed to be not material to the entity's 2010 operations, or for any prior individual year impacted.
Material corrected misstatements	There were no recorded audit misstatements in the current year.
Representations we are requesting from management	Representations to be received from management are standard. We will provide to you a copy of the signed representations letter.
Communication of independence matters	There are no matters that, in our professional judgment, may reasonably be thought to bear on our independence or that we gave significant consideration to in reaching the conclusion that independence has not been impaired.
Fraud and illegal acts involving senior management and fraud and illegal acts that cause a material misstatement of the financial statements	We are not aware of any matters that require communication.
Significant deficiencies and material weaknesses in internal control over financial reporting	No material weaknesses were identified.
AICPA ethics ruling regarding third-party service providers	From time to time, and depending on the circumstances, (1) we may subcontract portions of the Audit Services to other EY Firms, who may deal with the Company or its affiliates directly, although EY alone will remain responsible to you for the Audit Services, and (2) personnel (including non-certified public accountants) from an affiliate of EY or another EY Firm or any of their respective affiliates, or from independent third-party service providers (including independent contractors), may participate in providing the Audit Services. In addition, third-party service providers may perform services for EY in connection with the Audit Services.

Critical policies, estimates and areas of emphasis
Executive summary

Area	Ernst & Young comments on quality of accounting policy and application
Systems under Development	The Company's approach and methodology for capitalizing both internal/external costs to Nodal and Zonal appear reasonable and were consistently applied. EY tested amounts capitalized in the current year. Additionally, we tested the transfer into fixed assets as the Nodal system was placed into service during December 2010.
The Reserve Fund	For the year ended December 31, 2008, the Company recorded a charge of approximately $3.8 million related to investments at The Reserve. In January 2010, ERCOT received partial recovery of the amount previously recorded as a loss. Accounting literature suggests that gain contingencies be recorded when collected. Accordingly, the Company has properly recorded the recovered $3.4 million as a gain in 2010.
Impairment of long-lived assets	There were no indicators of impairments during 2010. Management's policy for assessing the Association's assets for impairment is consistent with the prior year and is considered to be reasonable.
Regulatory assets and liabilities	The Company's approach and methodology for deferring revenues and costs under FAS No. 71 is reasonable and supportable based on specific decisions made by regulators that have provided evidence that it is probable that the cost or obligation will be included in amounts allowable for recovery or refund in future rates.
Derivatives activities	The Company's accounting for interest rate swap transactions is in conformity with GAAP and was applied consistently. Changes in the valuation of the interest rate swap resulted in $2.9 million gain in 2010.
Notes payable	EY confirmed notes payable outstanding as of December 31, 2010. Amounts are appropriately stated.
Texas RE Divestiture	On July 1, 2010, ERCOT transferred all assets and liabilities of Texas RE to the new Texas RE entity. EY tested the calculation, noting divestiture appears properly recorded.

Appendix

Accounting Changes – FASB's Modified Convergence Work Plan

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Accounting changes – FASB's modified convergence work plan

Numerous accounting changes

While the SEC is still deciding on whether and how IFRS will be adopted in the US, the FASB and IASB continue to aggressively work on a number of accounting convergence projects that could significantly affect US GAAP. In November 2010, the FASB issued a progress report on the convergence standards. As part of this progress report, the FASB and the IASB presented changes to their initial project plan. [1] Although some projects have been slowed down, many of the proposals are expected to be finalized by the end of 2011. Because the FASB intends to finalize new standards irrespective of what happens with IFRS, the effects on US companies may be significant. These changes could cause stress to accounting and operations personnel. In addition, the Boards are currently considering whether to require adoption of the various standards at a single date (in a "big bang" approach) or over some staggered time period.

There are nine projects remaining within the convergence activities and several will have significant effects on reported results and require changes to internal operating systems and processes for many entities. The following four projects have the potential to have greatest effects:

- Financial instruments – Consideration of fair value measurement with potential limits to use of amortized cost, impairment and hedging having significant implications.
- Revenue recognition – Proposed changes would require the unwinding of sector-specific standards in favor of a singular principles-based model and effects could affect timing of revenue and costs recognized.
- Leases – Current proposals would require all leases to be brought onto the balance sheet for both lessees and lessors. Lease periods, options and residual value guarantees would all be measured differently. The changes expected would require significant lead time to collect all necessary data for compliance.
- Financial statement presentation – Proposed direct cash flow approach and increased classification in the balance sheet and income statement may require significant adjustments to current financial statement preparation process.

Other convergence projects being considered at the FASB that may have lesser effects include derecognition, financial Instruments with characteristics of equity and refinements to fair value measurement guidance.

[1] **Our Hot Topic, *FASB and IASB joint projects update*, (issued 22 December 2010), provides a summary joint projects and their current status.**

Accounting changes – FASB's modified convergence work plan (cont.)

Business implications

These changes may require additional investments in systems and personnel to analyze and implement the proposed change and establish new processes and related internal controls. The proposed changes may also affect the company's business. For example, the proposed leasing changes may prompt more lessees to buy assets instead of leasing them.

EY observations

We support the Boards' recent commitment to conducting additional outreach during the re-deliberations period "to ensure the quality and effective implementation of the final standards." However, in our recent letter to the FASB and IASB (9 December 2010) we expressed our concern that the Boards' continued plan to issue final standards on certain major projects by June 2011 may, in our view, result in the issuance of standards that do not adequately meet the needs of users and preparers.

We believe that more time than is available under the current time line, even as recently amended, needs to be devoted to the development of major projects that will likely affect financial reporting for many years to come.

Regardless of the timing of the issuance of these final standards, the scope and breadth of the changes will be unprecedented, and we encourage all stakeholders, including audit committees, to monitor the Boards' progress closely and to participate in the standard-setting process.

Accounting changes – FASB's modified convergence work plan (cont.)

	2010			2011				2012	2013	2014	2015
	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
Convergence projects											
▸ Financial instruments	ED		RT		Final			Implementation		Effective *	
▸ Leases		ED	RT		Final			Implementation		Effective *	
▸ Revenue recognition	ED		RT		Final			Implementation		Effective *	
▸ Financial statement presentation				To Be Determined				Implementation		Effective *	
▸ Presentation of OCI	ED			Final				Implementation		Effective *	
▸ Fair value measurement	ED			Final				Implementation		Effective *	
▸ Other **					Various			Implementation		Effective *	

* Assumes three year implementation window
** Includes Discontinued operations, Liabilities and equity, Consolidation, Insurance, Energy trading schemes, and Balance sheet-offsetting

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