



To: Human Resources and Governance Committee
 From: Susie Westbrook, Assistant General Counsel
 Date: May 9, 2011
 Re: Proposed Modifications of the Conflict of Interest Corporate Standard (CS5.18)

Issues

1. ERCOT employees inadvertently violate CS5.18 Conflict of Interest Corporate Standard, when their family and household members own stock of market participants. Such ownership may not be within the employee’s control.
2. ERCOT employees inadvertently violate CS5.18 Conflict of Interest Corporate Standard, when they own stock in companies that are or become affiliates of market participants, even if the affiliate’s primary business is not energy-related. Although this problem occurs primarily with respect to financial services companies, it sometimes occurs with industrial and retail companies that create QSEs to serve their own facilities.

Discussion

Background

The Public Utility Commission of Texas promulgated a rule requiring that ERCOT adopt policies to ensure that its operations are not affected by conflicts of interests involving employees and contractors:

(f) Conflicts of interest. ERCOT shall adopt policies to ensure that its operations are not affected by conflicts of interests relating to its employees’ outside employment and financial interests and its contractors’ relationships with other businesses. These policies shall include an obligation to protect confidential information obtained by virtue of employment or a business relationship with ERCOT. 16 TAC §25.362(f).

ERCOT adopted CS5.1 Conflict of Interests Corporate Standard, which provides, in pertinent part, as follows:

5.18.2 Conflicting Interests: The following situations are examples in which an employee might show undue favoritism to any one party (market participant or supplier) or where a conflict between personal financial interests and the interests of the Company would exist. Such situations could result in discipline.

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- Interest in Market Participant: Any involvement or interest in a member or market participant by any employee or his/her spouse, dependent, or a member of his/her household or immediate family. . .

In the ERCOT market, as in other power markets, increasing numbers of businesses whose principal line of business is not energy are becoming involved as market participants, either directly or through affiliates. These include large industrial companies serving only their own facilities, large consumer product retailers and financial institutions.

Historically, ERCOT management has interpreted CS5.18.2 expansively and required divestiture of investments in all affiliates of market participants. As the financial services industry continues

to consolidate and acquire non-traditional businesses, and as large industrial and retail businesses become more experienced in self-management of their energy acquisitions, the occurrence of employee conflicts arising from investments in such businesses is becoming more frequent, and employees have been required to sell such investments at a loss.

Industry Practices

All RTOs under the jurisdiction of the Federal Energy Regulatory Agency (FERC) are required to adopt a conflict of interest policy that meets the requirements of 18 CFR §35.34(j)(i), which states that, “The Regional Transmission Organization, its employees, and any non-stakeholder directors must not have financial interests in any market participant.” This rule further defines “market participant” as:

- i) Any entity that, either directly *or through an affiliate*, sells or brokers electric energy, or provides ancillary services to the Regional Transmission Organization, unless the Commission finds that the entity does not have economic or commercial interests that would be significantly affected by the Regional Transmission Organization's actions or decisions; and
- ii) Any other entity that the Commission finds has economic or commercial interests that would be significantly affected by the Regional Transmission Organization’s actions or decisions.

The FERC-regulated ISOs and RTOs have all filed tariffs which prohibit employees and unaffiliated directors from acquiring financial interests in market participants to the extent prohibited by 18 CFR §35.34(j)(i). Many have also adopted codes of conduct or conflict of interest policies that provide further definition of prohibited transactions. These clarifications are summarized as follows:

Entity Name	Prohibited Investment	Exceptions	Covered Parties
CAISO	Code of Conduct § 3.1 – Prohibits direct or indirect financial interest in any market participant to the extent prohibited by 18 CFR 35.34(j)(1)(i)	None listed	Employees
ISO New England	Code of Conduct §2.1 – prohibits (i) direct ownership of financial interests in market participants; (ii) ownership via mutual fund if interest carries voting power; and (iii) ownership via mutual fund concentrating in investments in market	Interest held in a mutual fund that is not principally comprised of utility investments and investor has no control over fund investments; qualifying shares owned by spouse as a condition of employment by a market participant; participation in 401(k) sponsored by market participant so long as funds are not invested directly in the	Board members, officers, employees and their spouses and minor children

Entity Name	Prohibited Investment	Exceptions	Covered Parties
	participants	sponsor's stock	
Midwest ISO	Standards of Conduct (Appendix A to Electric Tariff) §1 prohibits direct financial interest in any Owner, Member, or User of the transmission system or any of their affiliates	Interest held in a mutual fund that is not principally comprised of utility investments and investor has no control over fund investments; right to receive benefits under a defined benefits pension plan that doesn't involve ownership of the sponsor's securities; blind trust	Board members, agents, officers and employees
NYISO	FERC Electric Tariff Attachment F (Orig. Sheet 367)§7 prohibits ownership, control, or power to vote securities of any market participant or their affiliates whose primary business purpose is to buy, sell, or schedule Energy, Capacity, Ancillary Services or Transmission Services	Qualifying shares owned by spouse as a condition of employment by a market participant; Interest held in a publicly-traded mutual fund that is not principally comprised of utility investments and investor has no control over fund investments	Board members, officers, employees and their spouses and minor children
PJM	Code of Conduct prohibits financial interests in any PJM member or market participant	Interest held in a mutual fund that is not principally comprised of utility investments and investor has no control over fund investments; ownership as a part of participation in a PJM member's pension plan or fund; qualifying shares owned by spouse as a condition of employment by PJM member	Board members, officers, employees and their spouses and dependent children
SPP	Standards of Conduct §7.2 prohibits ownership of securities issued by any owner, operator or user of the bulk power system	Interest held in a mutual fund that is not principally comprised of utility investments and investor has no control over fund investments	Employees, spouses, minor children or any person for whom the employee has a power of attorney or guardianship

Entity Name	Prohibited Investment	Exceptions	Covered Parties
			rights

The scope of ERCOT’s investment prohibition is somewhat broader than that mandated by FERC because there is no explicit provision for exceptions. The ERCOT standard is also broader than policies adopted by the other ISOs and RTOs because ERCOT’s extends to more family members and household members.

Proposal #1 – Revise ERCOT’s Conflict of Interest Corporate Standard to eliminate investment prohibitions that are not reasonably within the employee’s control.

ERCOT employees are unlikely to have knowledge of the investments made by their parents, adult children and adult household members. Even if an ERCOT employee makes appropriate inquiries, adult family and household members have no obligation to disclose that information or to restrict their investment choices based on ERCOT policy. ERCOT’s best interest is not served by terminating or restricting the roles of capable employees as a result investment choices they cannot control and which provide them no benefit.

- Option 1 – Limit the financial interest prohibitions to ERCOT employees.
- Option 2 – Limit the financial interest prohibitions of CS5.18.2 to ERCOT employees, their spouses or domestic partners, and their minor children. If a spouse or domestic partner is employed by a market participant and ERCOT has determined that this relationship does not create an actual conflict of interest, allow ownership of the minimum number qualifying shares required by that employer.

Proposal #2 – Revise the Conflict of Interest Corporate Standard to expressly permit investments in affiliates of market participants.

If ERCOT decisions will not have a material effect on the bottom line of a market participant’s affiliate, prohibiting ownership in that company serves no purpose.

- Option 1 – Permit limited investments in publicly traded affiliates.
- Option 2 – Permit limited investments in affiliates, so long as ERCOT decisions will not have a material financial impact on their operations.
- Option 3 – Provide for management exceptions to permit limited investments in publicly traded affiliates whose primary business is not generating, buying, selling, or scheduling energy or ancillary services in the ERCOT market.