

FINANCIAL STATEMENTS

Electric Reliability Council of Texas, Inc.  
December 31, 2011 and 2010  
With Report of Independent Auditors

Electric Reliability Council of Texas, Inc.

Financial Statements

December 31, 2011 and 2010

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**PRELIMINARY AND TENTATIVE FOR DISCUSSION ONLY**

## Report of Independent Auditors

We have audited the accompanying statements of financial position of the Electric Reliability Council of Texas, Inc. (ERCOT) as of December 31, 2011 and 2010, and the related statements of activities and net assets, and cash flows for the years then ended. These financial statements are the responsibility of ERCOT's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of ERCOT's internal control over financial reporting. Our audits included 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 ERCOT's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Electric Reliability Council of Texas at December 31, 2011 and 2010, and the results of its activities and net assets and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

\_\_\_\_\_, 2012

Electric Reliability Council of Texas, Inc.

Statements of Financial Position

	<b>December 31</b>	
	<b>2011</b>	<b>2010</b>
	<i>(In Thousands)</i>	
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 246,803	\$ 69,556
Accounts receivable	9,498	9,344
Unbilled revenue	10,111	9,115
Restricted cash	413,884	255,598
Prepaid expenses and other current assets	18,265	13,982
Total current assets	698,561	357,595
Property and equipment, net	376,601	452,996
Systems under development	9,859	7,381
Debt issuance costs	327	467
Total assets	<u>\$ 1,085,348</u>	<u>\$ 818,439</u>
<b>Liabilities and unrestricted net assets</b>		
Current liabilities:		
Accounts payable	\$ 8,529	\$ 4,265
Accrued liabilities	10,253	19,552
Deferred revenue	3,649	3,302
Market settlement liabilities	296,762	65,827
Security deposits	413,884	255,598
Notes payable, current portion	164,970	224,470
Total current liabilities	898,047	573,014
Notes payable	27,267	111,737
Derivative liability	3,236	9,832
Regulatory liabilities	115,967	87,660
Other long term liabilities	360	323
Total liabilities	1,044,877	782,566
Commitments and contingencies <i>(Notes 8 and 11)</i>		
Unrestricted net assets	40,471	35,873
Total liabilities and unrestricted net assets	<u>\$ 1,085,348</u>	<u>\$ 818,439</u>

*The accompanying notes are an integral part of these financial statements.*

**PRELIMINARY AND TENTATIVE FOR DISCUSSION ONLY**

Electric Reliability Council of Texas, Inc.

Statements of Activities and Net Assets

	<b>Year Ended December 31</b>	
	<b>2011</b>	<b>2010</b>
	<i>(In Thousands)</i>	
Operating revenues:		
System administration fees	\$ 139,540	\$ 132,951
Nodal implementation surcharge	125,669	119,718
Reliability organization pass-through	11,975	12,169
Membership fees and other	3,429	4,018
Total operating revenues	280,613	268,856
Operating expenses:		
Salaries and related benefits	69,317	54,450
Depreciation	33,087	29,645
Facility and equipment costs	10,347	9,123
Outside services	8,367	13,892
Hardware and software maintenance and licensing	11,339	9,251
Reliability organization assessment	11,975	8,296
Other	7,740	6,309
Amortization of regulatory asset	125,669	119,718
Total operating expenses	277,841	250,684
Income from operations	2,772	18,172
Other income (expense):		
Interest income	7	7
Interest expense	(3,978)	(2,733)
Change in valuation of interest rate swap	6,596	2,901
Non-operating income	(775)	3,613
Change in unrestricted net assets before deferred pension costs and distribution of net assets	4,622	21,960
Deferred pension costs	(24)	(43)
Distribution of net assets – Texas RE	–	(1,034)
Change in unrestricted net assets	4,598	20,883
Unrestricted net assets, beginning of year	35,873	14,990
Unrestricted net assets, end of year	\$ 40,471	\$ 35,873

*The accompanying notes are an integral part of these financial statements.*

Electric Reliability Council of Texas, Inc.

Statements of Cash Flows

	<b>Year Ended December 31</b>	
	<b>2011</b>	<b>2010</b>
	<i>(In Thousands)</i>	
<b>Cash flows from operating activities</b>		
Change in unrestricted net assets	\$ 4,598	\$ 20,883
Adjustments to reconcile change in unrestricted net assets to net cash provided by operating activities:		
Depreciation	33,087	29,645
Amortization of debt issuance costs	140	184
Change in valuation of interest rate swap	(6,596)	(2,901)
Net losses (gains) on disposition or impairment of capital assets	805	(44)
Changes in operating assets and liabilities:		
Accounts receivable	(154)	(535)
Unbilled revenue	(996)	(2,525)
Prepaid expenses and other assets	(4,283)	(942)
Other long-term liabilities	37	(1,403)
Accounts payable	4,159	(1,172)
Accrued liabilities	(4,568)	2,972
Deferred revenue	347	(968)
Regulatory liabilities	99,623	91,909
Net cash provided by operating activities	126,199	135,103
<b>Cash flows from investing activities</b>		
Capital expenditures for property and equipment and systems under development	(35,930)	(102,527)
Proceeds from sale of property and equipment	13	13
Net cash used in investing activities	(35,917)	(102,514)

*Continued on following page*

Electric Reliability Council of Texas, Inc.

Statements of Cash Flows (continued)

	<b>Year Ended December 31</b>	
	<b>2011</b>	<b>2010</b>
	<i>(In Thousands)</i>	
<b>Cash flows from financing activities</b>		
Proceeds from issuance of notes payable	\$ –	\$ 56,000
Repayment of notes payable	(143,970)	(84,471)
Increase in restricted cash	(158,286)	(123,267)
Increase (decrease) in market settlement liabilities	230,935	(13,377)
Increase in security deposits	158,286	123,267
Net cash provided by (used in) financing activities	<u>86,965</u>	<u>(41,848)</u>
Net increase (decrease) in cash and cash equivalents	177,247	(9,259)
Cash and cash equivalents, beginning of year	69,556	78,815
Cash and cash equivalents, end of year	<u>\$ 246,803</u>	<u>\$ 69,556</u>
<b>Supplemental information</b>		
Cash paid for interest	<u>\$ 12,078</u>	<u>\$ 15,034</u>
<b>Supplemental disclosure of non-cash investing and financing activities</b>		
Change in accrued capital expenditures	<u>\$ (4,626)</u>	<u>\$ 2,542</u>
Capitalized interest	<u>\$ 7,912</u>	<u>\$ 12,206</u>

*The accompanying notes are an integral part of these financial statements.*

# Electric Reliability Council of Texas, Inc.

## Notes to Financial Statements (Dollars in Thousands)

December 31, 2011 and 2010

### **1. Organization and Operations**

The Electric Reliability Council of Texas, Inc. (ERCOT or the Company) is an independent, not-for-profit corporation. Since July 31, 2001, ERCOT has also functioned as the independent system operator for its reliability region which comprises about 85 percent of the electrical load in Texas. The ERCOT region has approximately 84,000 Megawatts of installed generating capacity, including approximately 73,600 Megawatts of available capacity.

The Public Utility Commission of Texas (PUCT) has primary jurisdictional authority over ERCOT which is responsible for ensuring the adequacy and reliability of electricity across the state's main interconnected power grid and for operating and settling the electricity markets it administers. ERCOT's market rules and operations are carried out in accordance with its Protocols filed with the PUCT. The ERCOT electric service region is contained completely within the borders of Texas, and it has only a few direct current ties across state lines to import or export power with neighboring reliability regions. ERCOT has no synchronous connections (alternating current) across state lines. As a result, ERCOT is considered "intrastate" and does not fall under the jurisdiction of the Federal Energy Regulatory Commission (FERC) except for reliability issues under the provisions of the Federal Energy Policy Act of 2005.

ERCOT is governed by a Board of Directors composed of 16 members. One board member is selected from each of the following market participant groups: retail electric providers, independent generators, independent power marketers, investor-owned utilities, municipal-owned utilities, and electric cooperatives. The remaining ten seats on the Board are filled by three consumer representatives, five unaffiliated Board members, the Chair of the PUCT and ERCOT's Chief Executive Officer.

### **2. Summary of Significant Accounting Policies**

#### **Method of Accounting**

The accompanying financial statements have been prepared on an accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America.

#### **Unrestricted Net Assets**

Unrestricted net assets are those that are not subject to restrictions or stipulations and that may be expendable for any purpose in performing ERCOT's objectives. Accordingly, net assets of ERCOT and changes therein are classified and reported as unrestricted net assets.

**PRELIMINARY AND TENTATIVE FOR DISCUSSION ONLY**



# Electric Reliability Council of Texas, Inc.

## Notes to Financial Statements (Dollars in Thousands)

### **2. Summary of Significant Accounting Policies (continued)**

#### **Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities of the financial statements and reported amounts of revenues, expenses, and capital expenditures during the reporting period. Actual results could differ from those estimates.

#### **Reclassifications**

Certain reclassifications have been made to prior year amounts to conform to current year classifications.

#### **Cash and Cash Equivalents**

Cash and cash equivalents consist of deposits in banks, money market investment accounts, and overnight deposits in treasury-backed securities with an original maturity date of 90 days or less.

Cash and cash equivalents consists primarily of amounts held by ERCOT on behalf of market participants for congestion management funds and prepayments of settlement obligations (as described in Note 2 – Market Settlement Liabilities).

#### **Restricted Cash**

Restricted cash primarily represents amounts received for security deposits from ERCOT's market participants.

#### **Accounts Receivable and Revenue Recognition**

ERCOT funds its operations primarily through transaction fees collected from electric service providers operating within the Texas grid. Two volume related fees are charged pursuant to the ERCOT protocols and as approved by both the ERCOT board of directors and the PUCT, each of which is based on actual volume consumption. Revenues from these fees are recognized in the period that the underlying energy transaction occurs. Amounts not yet billed are accrued and presented as unbilled revenue on the statement of financial position.

# Electric Reliability Council of Texas, Inc.

## Notes to Financial Statements (Dollars in Thousands)

### 2. Summary of Significant Accounting Policies (continued)

*System administration fee* – This fee was 41.71 cents per megawatt hour of adjusted metered load in both 2011 and 2010 and is structured to provide funding for ERCOT's core operations and related services.

*Nodal implementation surcharge* – In 2006, ERCOT began collecting an additional rate of 6.63 cents per megawatt hour (real time net metered generation) in connection with the Texas Nodal Market Implementation Project (TNMIP) described in Note 10. Effective June 2007, ERCOT increased the project surcharge to 12.7 cents per megawatt hour, and, effective June 2008, ERCOT increased the project surcharge to 16.9 cents per megawatt hour. Effective January 2010, ERCOT increased the project surcharge to 37.5 cents per megawatt hour. Revenue recognition for this fee is impacted by regulatory requirements established by the PUCT as described in Note 10.

*Reliability organization pass-through* – In 2008, the system administration fee included 1.69 cents to fund the North American Electric Reliability Corporation (NERC) reliability functions performed primarily by Texas Regional Entity, Inc. (Texas RE), a division of ERCOT through June 30, 2010 (as described further in Note 10). The system administration fees associated with expenses incurred by Texas RE were reported as reliability pass-through revenues. Effective January 2009, ERCOT replaced this portion of the fee with a fixed quarterly Electric Reliability Organization (ERO) billing. The ERO billing is based on actual NERC funding. Although Texas RE is a separate non-profit entity as of July 1, 2010, ERCOT continues to collect this revenue and remit it to NERC on a quarterly basis.

ERCOT's other revenue relates to services offered to its participants including connectivity to ERCOT's grid, wide-area network usage, and membership dues. Revenue related to these services is recognized either as the services are performed or at the completion of the project, assuming ERCOT has no significant continuing obligation and collection is reasonably assured. The Company does not maintain an allowance for doubtful accounts as it does not believe it has a material risk of loss associated with lack of collection. Membership dues are recognized over the membership period.

# Electric Reliability Council of Texas, Inc.

## Notes to Financial Statements (Dollars in Thousands)

### 2. Summary of Significant Accounting Policies (continued)

#### Property and Equipment

Property and equipment consists primarily of computer equipment, software, and buildings for operations and are recorded at cost. Depreciation is computed on the straight-line method using the half year convention over the estimated life of the asset. The cost of betterments to, or replacement of, property and equipment is capitalized. When assets are retired or otherwise disposed of, the cost and related depreciation are removed from the accounts and any resulting gain or loss is reflected in the statement of activities for the period. Included in non-operating income, the Company recognized a loss of \$805 and a gain of \$44 in 2011 and 2010 respectively. This represents the net book value of property and equipment that was disposed of or no longer in service. Repairs and maintenance costs are expensed when incurred.

ERCOT's depreciable lives (in years) for property and equipment are:

<u>Asset Category</u>	<u>Depreciable Life</u>
Computer Hardware	3
Software	5
Vehicles	5
Furniture and Equipment	7
Mechanical Building Components	10
Buildings	30
Leasehold Improvements	Life of the lease

#### Systems Under Development

ERCOT continues to develop the information systems and grid operating systems that are being used in its operations. ERCOT capitalizes direct costs and related indirect and interest costs incurred to develop or obtain these software systems, most of which are developed in connection with system development contracts with external firms. Internal costs and contract expenditures not related directly to the development of systems, and related testing activities, are expensed as incurred. Costs from completed projects are transferred to property and equipment when the systems are placed in service.

# Electric Reliability Council of Texas, Inc.

## Notes to Financial Statements (Dollars in Thousands)

### **2. Summary of Significant Accounting Policies (continued)**

#### **Impairment**

ERCOT evaluates long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If impairment exists, it is measured as the difference between the net book value of the asset and its estimated fair value. Impairment is computed by comparing the expected future cash flows, undiscounted and before interest, to the carrying value of the asset. No impairments requiring write-offs were identified in 2011 or 2010.

#### **Interest Capitalization**

Interest is capitalized in connection with the construction of major software systems and buildings and improvements. The capitalized interest is recorded as part of the asset to which it relates and is amortized or depreciated over the asset's estimated useful life. During 2011 and 2010, capitalized interest costs were \$7,912 and \$12,206, respectively.

#### **Market Settlement Liabilities**

Market settlement liabilities primarily represent two types of funds held on behalf of the ERCOT market: congestion management funds and prepayments of settlement obligations. Market participant settlement amounts are collected and redistributed by ERCOT in the normal course of managing the settlement of ERCOT's markets. Such settlement obligations are generally held for less than fifteen days before distribution to the market in accordance with timetables set forth in ERCOT's Protocols.

Effective November 1, 2010, ERCOT manages a congestion revenue rights (CRR) program which includes monthly auctions and auctions for longer than one month. Prior to this date, ERCOT managed a transmission congestion rights (TCR) program which included annual and monthly auctions. The change in congestion management programs occurred in connection with the implementation of the Nodal market as discussed further in Note 10. Under both programs, ERCOT collects and holds the proceeds from the auctions until the proceeds are distributed according to provisions of the ERCOT Protocols. ERCOT's Financial Corporate Standard, adopted by the Board of Directors, includes a provision that funds held as a result of CRR auctions may be used to fund ERCOT working capital and capital expenditure needs within certain guidelines.

# Electric Reliability Council of Texas, Inc.

## Notes to Financial Statements (Dollars in Thousands)

### 2. Summary of Significant Accounting Policies (continued)

Market settlement liabilities consist of the following at December 31:

	<u>2011</u>	<u>2010</u>
CRR/TCR auction funds	\$ 257,737	\$ 29,861
Prepayments of settlement obligations	39,025	35,966
Total market settlement liabilities	<u>\$ 296,762</u>	<u>\$ 65,827</u>

### Security Deposits

Market participants not meeting certain creditworthiness standards referenced in ERCOT Protocols may maintain a cash security deposit with ERCOT in order to mitigate credit risk in lieu of providing alternative means of security such as corporate guaranties, letters of credit, or surety bonds. Cash security deposits are classified as restricted cash.

### Income Taxes

ERCOT is exempt from Federal income tax under Section 501(a) of the Internal Revenue Code as an organization described in Section 501(c)(4). The Company is also exempt from state income taxes. Accordingly, no provision for income taxes or uncertain tax positions has been reflected in the financial statements.

### Debt Issuance Costs

ERCOT capitalizes issuance costs related to debt. The amounts are classified in non-current assets and amortized over the life of the debt.

### Financial Instruments

The carrying values reported on the balance sheet for current assets and liabilities and for the revolving lines of credit and term loan approximate their fair values. The fair value of the Company's senior notes payable is \$43,448 and \$59,465 as of December 31, 2011 and 2010. The fair value is estimated based on net present value calculations and quoted market prices for similar issues.

# Electric Reliability Council of Texas, Inc.

## Notes to Financial Statements (Dollars in Thousands)

### **2. Summary of Significant Accounting Policies (continued)**

ERCOT uses interest rate swap agreements, which are derivative instruments, to reduce interest rate risk. ERCOT presents these interest rate swaps at fair value in the statement of financial position and recognizes changes in fair value in the statement of activities and net assets.

#### **Accounting for the Effects of Regulation**

ERCOT is subject to the provisions of the Financial Accounting Standards Board in accounting for the effects of rate regulation. These provisions require regulated entities, in appropriate circumstances, to establish regulatory assets and/or liabilities, and thereby defer the income statement impact of certain revenues and charges because it is probable they will be recovered or repaid in future periods.

#### **Investment Gains/Losses**

Based on market events in 2008 related to The Reserve's Primary Fund, ERCOT recorded a valuation reserve of \$3,961 on its money market investments as of December 31, 2008. These unrealized losses were included in non-operating expense and represented the decrease in fair market value of ERCOT's investments in the Primary Fund. In addition, The Reserve imposed redemption restrictions on all investments in the Primary Fund and established a plan for the liquidation and distribution of fund assets.

In 2010, ERCOT received total distributions of \$47,451 of its original investment of \$47,842. Based on these distributions received from The Reserve, ERCOT recognized a gain of \$3,410 in 2010. The gain is included in non-operating income in the statement of activities and net assets and is a component of the unrestricted net assets at December 31, 2010.

## Electric Reliability Council of Texas, Inc.

### Notes to Financial Statements (Dollars in Thousands)

#### 3. Fair Value Measurement

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value measurements are based on inputs of observable and unobservable market data that a market participant would use in pricing the asset or liability. The use of observable inputs is maximized where available and the use of unobservable inputs is minimized for fair value measurement. In a three-tier fair value hierarchy, that prioritizes inputs to valuation techniques used for fair value measurement, the following levels were established for each input:

- Level 1 valuations use quoted prices in active markets for identical assets or liabilities that are accessible at the measurement date. An active market is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis.
- Level 2 valuations use inputs, other than those included in Level 1, that are observable for the asset or liability, either directly or indirectly.
- Level 3 valuations use unobservable inputs for the asset or liability. Unobservable inputs are used to the extent observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. The input may reflect the assumptions of the reporting entity of what a market participant would use in pricing an asset or liability.

In the case of multiple inputs being used in a fair value measurement, the lowest level input that is significant to the fair value measurement represents the level in the fair value hierarchy in which the fair value measurement is reported.

Electric Reliability Council of Texas, Inc.

Notes to Financial Statements  
(Dollars in Thousands)

**3. Fair Value Measurement (continued)**

The following tables set forth by level within the fair value hierarchy ERCOT's financial assets and liabilities that were accounted for at fair value on a recurring basis as of December 31, 2011 and 2010.

<b>As of December 31, 2011</b>	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
<b>Assets</b>				
Cash equivalents (a)	\$ 246,803	\$ 246,803	\$ —	\$ —
Restricted cash (a)	413,884	413,884	—	—
Total assets	<u>\$ 660,687</u>	<u>\$ 660,687</u>	<u>\$ —</u>	<u>\$ —</u>

<b>Liabilities</b>				
Interest rate derivatives (b)	\$ 3,236	\$ —	\$ 3,236	\$ —
Total liabilities	<u>\$ 3,236</u>	<u>\$ —</u>	<u>\$ 3,236</u>	<u>\$ —</u>

<b>As of December 31, 2010</b>	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
<b>Assets</b>				
Cash equivalents (a)	\$ 69,556	\$ 69,556	\$ —	\$ —
Restricted cash (a)	255,598	255,598	—	—
Total assets	<u>\$ 325,154</u>	<u>\$ 325,154</u>	<u>\$ —</u>	<u>\$ —</u>

<b>Liabilities</b>				
Interest rate derivatives (b)	\$ 9,832	\$ —	\$ 9,832	\$ —
Total liabilities	<u>\$ 9,832</u>	<u>\$ —</u>	<u>\$ 9,832</u>	<u>\$ —</u>

(a) Amounts consist of deposits in banks and money market investments with an average maturity of 90 days or less. The Company calculates fair value using the market approach.

(b) Amounts consist of interest rate swaps with pricing information generated from observable market data and adjusted for credit-risk.



# Electric Reliability Council of Texas, Inc.

## Notes to Financial Statements (Dollars in Thousands)

### 4. Property and Equipment

Property and equipment consists of the following at December 31:

	<b>2011</b>	<b>2010</b>
Computer hardware and equipment	\$ 83,273	\$ 87,044
Software	578,243	588,308
Building and leasehold improvements	92,055	92,041
Furniture and fixtures	30,990	30,610
Land	947	947
Vehicles	124	124
Construction in progress	597	—
	<b>786,229</b>	799,074
Accumulated depreciation	<b>(409,628)</b>	(346,078)
	<b>376,601</b>	452,996
Systems under development	9,859	7,381
Total property and equipment, net	<b>\$ 386,460</b>	<b>\$ 460,377</b>

Systems under development consist primarily of costs incurred for ongoing upgrades and improvements to the ERCOT systems.

### 5. Notes Payable

ERCOT's notes payable consist of the following:

	<b>2011</b>	<b>2010</b>
Revolving lines of credit	\$ 80,500	\$ 140,000
Term loan	70,833	141,666
Senior notes	40,904	54,541
	<b>\$ 192,237</b>	<b>\$ 336,207</b>

## Electric Reliability Council of Texas, Inc.

### Notes to Financial Statements (Dollars in Thousands)

#### **5. Notes Payable (continued)**

##### **Revolving Lines of Credit**

ERCOT has two revolving lines of credit with JPMorgan Chase Bank, as lead agent, and a separate line of credit under a loan agreement with Bank of America, NA. These facilities are primarily used for short term working capital needs, and individual borrowings under these facilities are structured to mature within one year. The first revolving line of credit with JPMorgan Chase Bank has a maximum amount of available credit of \$75,000 and expires on June 15, 2012. As of December 31, 2011, the total debt outstanding under this line of credit is \$75,000. The second revolving line of credit with JPMorgan Chase Bank has a maximum amount of available credit of \$100,000 and expires on August 13, 2013. As of December 31, 2011, the total debt outstanding under this line of credit is \$5,500. The revolving line of credit with Bank of America, NA has a maximum amount of available credit of \$50,000 and expires on August 24, 2012. As of December 31, 2011, there are no outstanding borrowings under this line of credit.

The interest rates on these facilities are based on prime rate, a Eurodollar based rate, or other rate as described in the debt agreements. The effective rate of interest at December 31, 2011 was 2.68 percent for the revolving lines of credit, including amounts fixed by interest rate swaps. Additionally, at December 31, 2011, ERCOT pays a commitment fee of 0.10 percent on the unused portion of the \$75,000 revolving credit facility and 0.15 percent on the unused portion of the \$100,000 and \$50,000 revolving credit facilities. During 2011 and 2010, ERCOT incurred commitment fees totaling \$208 and \$268, respectively, in connection with its debt facilities. The revolving lines of credit have several debt covenants, the most restrictive of which limits ERCOT's indebtedness. At December 31, 2011, ERCOT was in compliance with its debt covenants for these facilities.

##### **Term Loan**

ERCOT also has a term loan with JPMorgan Chase Bank, as lead agent. The term loan has a maximum amount of available credit of \$70,833 and expires on December 15, 2012. At December 31, 2011, the term loan is fully drawn with outstanding borrowings of \$70,833. As such, there is no commitment fee due on the facility. The interest rates on the term loan are based on prime rate, a Eurodollar based rate, or other rate as described in the debt agreement. The

# Electric Reliability Council of Texas, Inc.

## Notes to Financial Statements (Dollars in Thousands)

### 5. Notes Payable (continued)

effective rate of interest at December 31, 2011 was 4.64 percent, including amounts fixed by interest rate swaps. The term loan has several covenants, the most restrictive of which limits ERCOT's indebtedness. At December 31, 2011, ERCOT was in compliance with its debt covenants for the term loan.

#### Senior Notes

ERCOT has \$40,904 outstanding in senior notes at December 31, 2011. These senior notes bear interest at 6.17 percent and are due in equal annual principal payments through May 2014. The senior notes have several covenants, the most restrictive of which limits ERCOT's indebtedness and requires the maintenance of an interest reserve equal to the amount of the next installment of interest. The reserve is currently satisfied by available capacity under revolving lines of credit. At December 31, 2011, ERCOT was in compliance with its covenants for the senior notes.

#### Future Maturities

Future maturities of the senior notes and term loan are as follows:

	<u>Senior Notes</u>	<u>Term Loan</u>	<u>Total</u>
Year Ending December 31:			
2012	\$ 13,637	\$ 70,833	\$ 84,470
2013	13,637	—	13,637
2014	13,630	—	13,630
	<u>\$ 40,904</u>	<u>\$ 70,833</u>	<u>\$ 111,737</u>

ERCOT expects to collect Nodal Surcharge revenue totaling approximately \$120 million in 2012. The entire \$120 million is dedicated to principal and interest payments on outstanding debt. Outstanding debt, not repaid by Nodal Surcharge revenue collected in 2012, will be refinanced.

# Electric Reliability Council of Texas, Inc.

## Notes to Financial Statements (Dollars in Thousands)

### 6. Derivatives

#### Interest Rate Derivatives

The Company has variable to fixed rate swap agreements (Swaps) with two financial institutions. The notional amounts of the Swaps are primarily related to the term loan, with two Swaps related to a portion of the \$75,000 revolving line of credit with JPMorgan Chase Bank. The Swaps generally mature prior to or concurrent with the respective borrowings' due dates. Under the terms of the Swaps, the Company pays the counterparties a fixed rate. In return, the counterparties pay the Company variable interest at LIBOR, which approximates, but does not precisely equal, the rate of interest on the related borrowing. The fixed rate terms of the Swaps and their notional values at December 31, 2011 are summarized in the following table.

<b>Transaction Date</b>	<b>From</b>	<b>To</b>	<b>Fixed Rate Due to Counterparty</b>	<b>Notional Values at December 31, 2011</b>
2007	Nov-08	Nov-12	5.6550%	30,000
2008	Nov-08	Nov-12	3.2130%	30,000
2009	Nov-09	Jun-12	2.4225%	40,000
2009	Nov-09	Jun-12	2.5225%	40,000

The Company is exposed to the risk of nonperformance if the counterparties default or if the swap agreements are terminated.

# Electric Reliability Council of Texas, Inc.

## Notes to Financial Statements (Dollars in Thousands)

### 6. Derivatives (continued)

#### Derivative Financial Statement Presentation and Fair Values

At December 31, 2011 and 2010, the fair value of interest rate derivatives was reflected in the statements of financial position as follows:

		<b>Liability Derivatives</b>	
		<b>Statements of Financial</b>	
		<b>Position Location</b>	
		<b>2011</b>	<b>2010</b>
<b>Derivatives not designated as hedging instruments</b>			
Interest rate derivatives	Derivative liabilities	\$ 3,236	\$ 9,832
Total		<u>\$ 3,236</u>	<u>\$ 9,832</u>

For the years ended December 31, 2011 and 2010, the unrealized derivative gains arising from interest rate derivatives were as follows:

		<b>Location of Gain</b>	
		<b>recognized in Income</b>	
		<b>2011</b>	<b>2010</b>
<b>Derivatives not designated as hedging instruments</b>			
Interest rate derivatives	Change in valuation of interest rate swap	\$ 6,596	\$ 2,901
Total		<u>\$ 6,596</u>	<u>\$ 2,901</u>

### 7. Employee Benefit Plans

#### Defined Contribution Plan

ERCOT sponsors the ERCOT Defined Contribution 401(k) Plan (the 401(k) Plan) which is subject to the provisions of the Employee Retirement Income Security Act of 1974. The 401(k) Plan utilizes a third-party administrator. Employees participating in the 401(k) Plan are fully vested after five years. Employees must be 21 years of age to be eligible to participate.

# Electric Reliability Council of Texas, Inc.

## Notes to Financial Statements (Dollars in Thousands)

### 7. Employee Benefit Plans (continued)

ERCOT matches 75 percent of the employee's contribution up to 6 percent of eligible compensation as defined in the 401(k) Plan document. Employees are fully vested for the ERCOT match of 75 percent after five years. In addition, ERCOT contributes 10 percent of a participant's eligible compensation as defined in the 401(k) Plan document. Employees are fully vested for the ERCOT contributions of 10 percent after three years. Employer contributions to the 401(k) are summarized in the table below:

	2011	2010
75 percent of the employee's contribution up to 6 percent	\$ 1,806	\$ 1,851
10 percent of the employee's compensation	6,302	6,373
Total employer contributions	<u>\$ 8,108</u>	<u>\$ 8,224</u>

### Defined Benefit Plan

During 2011 and 2010, ERCOT offered post-retirement health benefits to employees hired in 1997 or earlier and who retire between age 55 and 65 with 10 years or more of service. This plan allows retirees to participate in the medical and prescription drug coverage available to employees, subject to certain annual and lifetime benefit limits.

Related to this plan, in 2011 ERCOT recognized an increase in the post-retirement liability of \$66, operating expenses of \$42 and an increase to deferred pension costs of \$24. In 2010, ERCOT recognized an increase in the post-retirement liability of \$85, operating expenses of \$42 and an increase to deferred pension costs of \$43.

### 8. Lease and Contract Commitments

The Company has noncancellable operating leases and service contracts providing telecommunication services, system infrastructure and office facilities. Through March 2012, ERCOT leased approximately 45,000 square feet of office space in Austin, Texas. The initial facility lease began in the second quarter of 2001 and covered a 120 month period, with two optional renewal periods available. Effective in early 2011, ERCOT exercised a 36 month renewal to extend the facility lease to March 2014. However, in April 2012, ERCOT entered into an amendment to reduce the leased space to approximately 15,000 square feet and extend the lease term to March 31, 2022.

## Electric Reliability Council of Texas, Inc.

### Notes to Financial Statements (Dollars in Thousands)

#### 8. Lease and Contract Commitments (continued)

Minimum payments due under these commitments are:

2012	\$	461
2013		389
2014		383
2015		385
2016		371
Thereafter		1,815
Total minimum lease payments	\$	<u>3,804</u>

ERCOT recognized \$849 and \$1,003 of office rent expense in 2011 and 2010, respectively.

#### 9. Concentrations

ERCOT provides reliability and market services to market participants. ERCOT settles the costs of these services by passing through the costs of such services from the providers to the users of such services. In the event that a market participant is unable to make payment on its market obligations, ERCOT's Protocols stipulate that the amount of the default is to be allocated to other market participants based on their market activity and define the allocation mechanism. In order to limit the risks associated with such occurrences, ERCOT requires a cash security deposit, letter of credit, corporate guaranty, or surety bond from market participants that do not meet certain credit standards. Credit risk related to trade receivables associated with ERCOT's fees are substantially mitigated by the fact that, by Protocol, ERCOT's fees are paid from market receipts as a first priority before any market obligations are paid.

ERCOT's fee revenue is driven by the demand for electricity rather than the number of market participants. In the event that any market participant representing load ceased to operate, another market participant representing load would assume the role in response to the demand for electricity. As such, ERCOT believes its exposure to a material reduction in revenues associated with the loss of any market participant is limited.

# Electric Reliability Council of Texas, Inc.

## Notes to Financial Statements (Dollars in Thousands)

### 10. Accounting for the Effects of Regulation

#### Texas Nodal Market Implementation Project (TNMIP)

During 2006, ERCOT began incurring significant costs associated with the TNMIP. This project represents a market redesign and systems upgrade to improve grid reliability, increase market efficiency, and enable transparency of wholesale energy prices.

On December 1, 2010 ERCOT launched the Nodal market, which features locational marginal pricing for generation at more than 8,000 nodes, a day-ahead energy and ancillary services co-optimized market, day-ahead and hourly reliability-unit commitment, and congestion revenue rights. Based on this implementation date, TNMIP software assets of \$353,534 previously classified as systems under development on the statement of financial position were reclassified to fixed assets with an in-service date of December 1, 2010.

The PUCT set forth the framework of the TNMIP rates, which provides for explicit recovery of all allowable development costs and all debt service costs over the financing period of the project. Some of the development costs encompassed in the rate order would otherwise be treated as period costs under generally accepted accounting principles. Amounts earned under the rate order are presented as Nodal surcharge fees in the accompanying statement of activities and net assets. TNMIP development costs related to the systems under development are capitalized as discussed in Note 2. All other TNMIP development costs are subject to the provisions of regulatory accounting, which provides for deferral of the income statement impact.

The following is a reconciliation of TNMIP's long term regulatory liabilities at December 31:

	<b>2011</b>	<b>2010</b>
Nodal surcharge fees	\$ <b>125,669</b>	\$ 119,718
Nodal costs not included in systems under development	<b>97,362</b>	68,547
Over collections	<b>(28,307)</b>	(51,171)
Regulatory liabilities, beginning of year	<b>(87,660)</b>	(36,489)
Regulatory liabilities, end of year	<b>\$ (115,967)</b>	\$ (87,660)



# Electric Reliability Council of Texas, Inc.

## Notes to Financial Statements (Dollars in Thousands)

### 10. Accounting for the Effects of Regulation (continued)

The following is a summary of TNMIP development costs incurred:

	2011	2010
Salaries and related benefits	\$ 2,966	\$ 9,903
Depreciation	71,302	42,312
Facility and equipment costs	4	901
Outside services	9,596	8,602
Hardware and software maintenance and licensing	5,965	5,573
Other	46	405
Interest expense	7,483	851
Total TNMIP development costs	<u>\$ 97,362</u>	<u>\$ 68,547</u>

### Texas Regional Entity

By order of the FERC, NERC has been designated as the ERO. During 2007, Texas RE, an independent division of ERCOT through June 30, 2010, was approved by FERC to contract with and perform certain activities for NERC. NERC has delegated authority to Texas RE to propose, monitor, and enforce federal electric reliability standards within the designated geographic area within Texas known as the ERCOT region.

On January 1, 2010, a new nonprofit Texas corporation called Texas Reliability Entity, Inc. (New Texas RE) was formed to assume the business, rights, and obligations of Texas RE. On February 19, 2010, NERC filed a petition with FERC requesting: (1) approval of an Amended and Restated Delegation Agreement between NERC and the New Texas RE to develop, and to monitor and enforce compliance with, reliability standards in the ERCOT Region; (2) termination of the existing Amended and Restated Delegation Agreement between NERC and Texas RE; and (3) approval of an Amended 2010 Business Plan and Budget for the New Texas RE. This petition was accepted and approved by FERC on May 6, 2010.

In connection with this approved order, Texas RE divested from ERCOT as of July 1, 2010. The New Texas RE assumed the activities and responsibilities of Texas RE as well as its assets and liabilities, and as of July 1, 2010 ERCOT transferred all assets and liabilities of Texas RE to the New Texas RE. The impact of the divestiture is recognized in 2010 on the statement of activities and net assets as a distribution of net assets for \$1,034.

Electric Reliability Council of Texas, Inc.

Notes to Financial Statements

*(Dollars in Thousands)*

**11. Contingencies**

The Company is party to regulatory and legal proceedings that management considers to be normal actions to which an enterprise of its size and nature might be subject. Such proceedings are not anticipated to have a material impact on ERCOT's financial condition, results of operations or cash flow.

**12. Subsequent Events**

ERCOT has evaluated material subsequent events through \_\_\_\_\_, 2012, the date the Company's financial statements were available to be issued.