

ERCOT FINANCE & AUDIT COMMITTEE MEETING

MINUTES OF THE ERCOT FINANCE & AUDIT COMMITTEE MEETING

Austin Met Center

7:30 A.M.

November 14, 2006

Pursuant to notice duly given, the meeting of the Electric Reliability Council of Texas, Inc. Finance & Audit Committee convened at 7:30 A.M. on **November 14, 2006**. The Meeting was called to order by **Clifton Karnei** who ascertained that a quorum was present.

Meeting Attendance

Committee members:

Clifton Karnei, Chair	Brazos Electric Cooperative	Cooperative	Present
Miguel Espinosa, Vice Chair	Independent Board Member	Independent Board Member	Present
Robert Manning	H-E-B Grocery Co.	Consumer	Present
R. Scott Gahn	Just Energy	Ind. Retail Electric Provider	Present
Tom Standish	Centerpoint Energy	Investor-Owned Utility	Not Present
William Taylor	Calpine Corporation	Ind. Generator	Present

ERCOT staff and guests present:

Barry, Sean	PriceWaterhouseCoopers (PwC)
Brenton, Jim	ERCOT
Byone, Steve	ERCOT (CFO)
Campbell, Cassandra	ERCOT
Davies, Morgan	Calpine
Doolin, Estrellita	ERCOT
Gresham, Kevin	Reliant Energy
Hancock, Misti	ERCOT
Jones, Sam	ERCOT (CEO)
Meek, Don	ERCOT
Moseley, Cheryl	ERCOT
Mueller, Paula	PUCT
Petterson, Mike	ERCOT
Greer, Clayton	Constellation
Ruebsahm, Jammie	Deloitte & Touche (D&T)
Saathoff, Kent	ERCOT
Schwerdtfeger, Kathie	Deloitte & Touche (D&T) via telephone
Troxell, David	ERCOT
Vance, Cathy	ERCOT
Vincent, Susan	ERCOT
Walker, Mark	NRG
West, James	PriceWaterhouseCoopers (PwC)
Wullenjohn, William	ERCOT
Yager, Cheryl	ERCOT

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Executive Session

At 7:30 AM, the Committee meeting was adjourned and the Committee went into Executive Session until approximately 8:11 AM. The Committee returned to Open Session at 8:17 AM.

Commendation

Mike Espinosa moved to commend Bob Manning for his dedicated service on the Finance & Audit Committee; William Taylor seconded the motion. The motion passed unanimously.

Approval of Previous Minutes

Bob Manning moved to approve the minutes for the previous meetings held on October 17, 2006, with one amendment as attached hereto; William Taylor seconded the motion. The motion passed unanimously.

Approval of 2007 Audit Plan

Miguel Espinosa moved to approve the 2007 Internal Audit Plan, as presented in Executive Session; Bob Manning seconded the motion. The motion passed unanimously.

Contract / Conflicts Issue

Cheryl Yager explained that, over the past year or two, a large number of financial institution affiliates have become ERCOT market participants, both as Qualified Scheduling Entities and as Transmission Congestion Rights (TCR) holders. Ms. Yager noted that, as the number of financial institutions with market participant affiliates has increased, the group of qualified financial institutions that are not related to a market participant and from which ERCOT can obtain debt financing has dramatically decreased, causing concern about ERCOT's ability to obtain needed debt financing on a competitive basis. In addition, the number of financial institutions with which ERCOT can temporarily invest excess funds and which it can use for other administrative services has decreased, although this is not as problematic.

The Committee stated that it deemed it desirable to permit ERCOT to use financial institutions that are affiliates of market participants for ERCOT financing, banking, and other administrative services (for example, benefits administration and transfer agent services) and ERCOT and market participant fund investments, so long as the market participant and its financial institution affiliate agree to acceptable confidentiality provisions, in order to provide ERCOT with competitive options

William Taylor moved to recommend to the Board that ERCOT be permitted to use financial institutions that are affiliates of market participants for ERCOT debt financing, banking, other administrative services, and investments, so long as the financial institution and the market participant execute an acceptable confidentiality agreement with ERCOT; Scott Gahn seconded the motion. The motion passed unanimously.

2007 Strategic Financial Plan and Budget

Steve Byone provided an overview of ERCOT's 2007 Strategic Financial Plan and Budget and explained that he was seeking the Committee's recommendation for approval. Mr. Byone

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reviewed the Budget, explaining that the system administrative fee would remain stable at 41.71 cents per MWh, not including the Nodal Surcharge or the new Electric Reliability Organization ("ERO") fee that had been approved by FERC, and answered questions from the Committee. Mr. Byone informed the Committee that the 2007 ERO fee was estimated to be approximately 1.5 to 2.1 cents per MWh. Mr. Byone answered the Committee's questions regarding the proposed \$37 million for Zonal projects that were being managed as a component of the Texas Nodal Market Implementation Program ("TNMIP"), and outlined the two alternatives that staff proposed regarding the funding of the \$37 million. The Committee discussed the 2007 Strategic Financial Plan and Budget and the pros and cons of each of the funding alternatives in detail. Mr. Byone confirmed to the Committee that the PUCT had indicated its acceptance of the Budget and either of the alternatives. In response to the Committee's concern regarding the modification to the debt to equity ratio cap, Mr. Byone informed the Committee that the PUCT had indicated that, if the first Alternative (proposing a temporary increase in debt funding of projects from 60 percent to near 73 percent) was selected, the PUCT would consider issuing an order that the 60/40 debt to equity ratio be restored by the end of 2008.

After extensive discussion, William Taylor moved to recommend to the Board that the proposed 2007 Strategic Plan and Budget, with Alternative #1, be approved; Bob Manning seconded the motion. The motion passed unanimously.

Third Party Audits

A. Deloitte & Touche ("D&T") Agreed Upon Procedures Internal Controls Assessment

Kathie Schwerdtfeger of D&T provided an update of the Agreed Upon Procedures Internal Controls Assessment. After a brief review of D&T's history with ERCOT's internal controls, Ms. Schwerdtfeger informed the Committee that D&T had concluded its fieldwork and that the final report would be completed soon. She noted that the key controls were adequately designed and documented for all areas reviewed and the ICMP program design was 100% appropriate. Ms. Schwerdtfeger noted that the report would identify some opportunities for key controls to operate more effectively. She reported that out of 152 controls tested, 145 were found to be operating effectively, which provided a pass rate of greater than 95%. When Mr. Karnei asked for examples of areas that were not operating effectively, Jamille Ruebsahm explained that the primary issues were caused by lack of proper documentation to evidence compliance. Mr. Karnei asked if remediation had begun on all areas with issues, and Mr. Byone responded that remediation was absolutely underway, which Ms. Schwerdtfeger confirmed. Ms. Schwerdtfeger commended ERCOT on the significant progress to date and encouraged continued focus and support of the ICMP to ensure the sustainability and operating effectiveness of the newly designed control environment. Mr. Karnei requested that D&T make a presentation of the results to the full Board in January.

B. 2006 SAS 70 Audit

Sean Barry of PricewaterhouseCoopers ("PwC") confirmed that the 2006 SAS 70 audit was on schedule and that no exceptions had been noted in 17 of 18 of the Control Areas. Mr. Barry noted that this was a significant achievement for ERCOT because for 95% of the areas tested, there were not only no qualifications but also no exceptions, including the Physical Security area, which had significant exceptions in 2005. Mr. Barry also noted that it was significant that mid-period changes in Information Technology staff (departure of the director and several managers) were handled with sustained effective controls and no exceptions.

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Mr. Barry informed the Committee that the only area that he believed would be qualified in the audit report was the Logical Security area, which included a number of exceptions. Most of the Logical Security findings were in the same areas as 2005, including the recertification process, certain terminations of access that did not occur for all systems, and policies that were written differently than the actual activities being carried out by the company. Jim Brenton noted that the areas with deficiencies were the same areas that had been identified by Security as having issues, and that these areas were being addressed. Mr. Barry noted that there had been improvements from 2005 and that Logical Security was the area in which most ISOs traditionally experienced difficulty. William Taylor asked whether all processes were correct and only documentation was lacking, and Mr. Barry noted that this was primarily the case, but that one area did need better procedures, which were being remedied by Mr. Brenton's team.

Mr. Barry told the Committee that PwC had reviewed the findings with management and management had developed an action plan to correct the problems. Mr. Brenton confirmed that action teams had already been formed and were in the process of addressing all issues. Mr. Brenton informed the Committee that he believed that all Logical Security issues would be resolved by January. Mr. Espinosa requested that Mr. Brenton provide a report by January on the progress of the remediation plans. Mr. Karnei requested that this update be put on the December or January Committee agenda.

C. 2006 Financial Audit

James West and Mr. Barry reviewed the audit plan for the 2006 financial audit for the Committee, noting that the plan, which would begin in earnest in January 2007 and complete in April 2007, was similar to the 2005 audit plan. Mr. Karnei confirmed that PwC would review the capitalizable life of software and hardware, in response to concern previously expressed by Commissioner Smitherman. Mr. Barry noted that, because past internal control issues had been resolved, the 2006 audit would only include a "normal" internal control review.

FAS 71 – Regulatory Accounting

Mike Petterson explained that, because it is good internal control practice, staff would continue to notify the Committee of important accounting assumptions, estimations, practices, and issues. To that end, he wanted to discuss applicability and specific accounting requirements of Statement of Financial Accounting Standards No. 71 ("FAS 71") Accounting for the Effects of Certain Types of Regulation.

Mr. Petterson explained that FAS 71 is a fact-based accounting standard rather than a managerial choice and he summarized the main accounting concepts and requirements of the Standard. Mr. Petterson noted that three key facts: (1) a prescriptive regulatory order, (2) an explicit balancing of expenditures and cost recovery mechanism, and (3) the creation of a discrete surcharge had led management to the conclusion that FAS 71 accounting must be employed by ERCOT commencing in 2006 for transactions relating to TNMIP. The Committee discussed and Mr. Karnei confirmed that this was an informational update and no Committee action was needed.

Annual Financial and Investment Standard and Charter Review

Cheryl Yager noted that staff had performed its annual review of the Financial Standard and Investment Standard and reviewed the proposed updates to the Standards with the Committee. The Committee discussed the proposed changes to the Standards.

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Ms. Yager and Morgan Davies also updated the Committee regarding the intended modifications to the Credit Work Group Charter, noting that there were remaining issues regarding qualification of members and alternative members. Mr. Davies told the Committee that he expected to be able to bring the proposed Charter to the December meeting.

Bob Manning made a motion to recommend to the Board the approval of the revisions of the Financial Standard and the Investment Standard; William Taylor seconded the motion. The motion passed unanimously.

Interest Rate Risk Management and Derivatives


Ms. Yager and Mr. Byone updated the Committee on the interest rate swap the Board approved last year, noting that the swap was currently "in the money". Staff also reminded the Committee that a review of interest rates and ERCOT debt would be needed in early 2007 so that ERCOT could remain compliant with its Financial Standard requirement to limit un-hedged variable rate debt to not more than 40% of total debt outstanding.

Outage Scheduler Project Cancellation Q&A

Kent Saathoff, project sponsor of the Outage Scheduler Project, presented information on the project including circumstances that led the project team to cancel the outage scheduler development effort. In response to questions posed by members of the Committee, Mr. Saathoff provided clarifying comments to the satisfaction of the Committee.

Adjournment

At 9:58 A.M., the meeting was adjourned. The next Committee meeting will be held on the morning of December 12, 2006.



Susan Vincent, Secretary