Item 5.3: Review of Audited Financial Statements

Sean Taylor
Controller

Finance & Audit Committee Meeting
ERCOT Public
May 13, 2013

Financial Statements

Electric Reliability Council of Texas, Inc.
Years Ended December 31, 2012 and 2011
With Report of Independent Auditors

Electric Reliability Council of Texas, Inc.

Financial Statements

December 31, 2012 and 2011

Contents

Report of Independent Auditors

The Finance and Audit Committee

Electric Reliability Council of Texas

Report on the Financial Statements

We have audited the accompanying financial statements of the Electric Reliability Council of Texas, Inc. (ERCOT), which comprise the statements of financial position as of December 31, 2012 and 2011, and the related statements of activities and net assets and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in conformity with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement, whether due to fraud or error.

Auditor's Responsibility

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.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

________________May 17, 2013

PRELIMINARY AND TENTATIVE FOR DISCUSSION ONLY

Electric Reliability Council of Texas, Inc.

Statements of Financial Position

	December 31 2012	December 31 2011
	(In Thousands)	
Assets		
Current assets:		
Cash and cash equivalents	**$ 319,262**	$ 246,803
Accounts receivable	**3,865**	9,498
Unbilled revenue	**6,368**	10,111
Restricted cash	**471,876**	413,884
Prepaid expenses and other current assets	**14,970**	18,265
Total current assets	**816,341**	698,561
Property and equipment, net	**288,213**	376,601
Systems under development	**10,025**	9,859
Debt issuance costs	**560**	327
Total assets	**$ 1,115,139**	$ 1,085,348
Liabilities and unrestricted net assets		
Current liabilities:		
Accounts payable	**$ 2,177**	$ 8,529
Accrued liabilities	**8,247**	10,253
Deferred revenue	**3,282**	3,649
Market settlement liabilities	**330,151**	296,762
Security deposits	**471,876**	413,884
Notes payable, current portion	**17,637**	164,970
Total current liabilities	**833,370**	898,047
Notes payable, less current portion	**88,630**	27,267
Derivative liability	–	3,236
Regulatory liabilities	**166,724**	115,967
Other long term liabilities	**399**	360
Total liabilities	**1,089,123**	1,044,877
Unrestricted net assets	**26,016**	40,471
Total liabilities and unrestricted net assets	**$ 1,115,139**	$ 1,085,348

See accompanying notes.

Electric Reliability Council of Texas, Inc.

Statements of Activities and Net Assets

	Year Ended December 31	
	2012	**2011**
	(In Thousands)	
Operating revenues:		
System administration fees	**$ 136,273**	$ 139,540
Nodal implementation surcharge	**122,645**	125,669
Reliability organization pass-through	**13,062**	11,975
Membership fees and other	**5,275**	3,429
Total operating revenues	**277,255**	280,613
Operating expenses:		
Salaries and related benefits	**72,535**	69,341
Depreciation	**33,656**	33,087
Facility and equipment costs	**12,483**	12,519
Outside services	**12,220**	8,367
Hardware and software maintenance and licensing	**19,241**	11,339
Reliability organization assessment	**13,062**	11,975
Other	**6,152**	5,568
Amortization of regulatory asset	**122,645**	125,669
Total operating expenses	**291,994**	277,865
(Loss) income from operations	**(14,739)**	2,748
Other income (expense):		
Interest income	**3**	7
Interest expense	**(3,382)**	(3,978)
Change in valuation of interest rate swap	**3,236**	6,596
Non-operating income (expense)	**427**	(775)
Change in unrestricted net assets	**(14,455)**	4,598
Unrestricted net assets, beginning of year	**40,471**	35,873
Unrestricted net assets, end of year	**$ 26,016**	$ 40,471

See accompanying notes.

PRELIMINARY AND TENTATIVE FOR DISCUSSION ONLY

Electric Reliability Council of Texas, Inc.

Statements of Cash Flows

	Year Ended December 31	
	2012	**2011**
	(In Thousands)	
Cash flows from operating activities		
Change in unrestricted net assets	**$ (14,455)**	$ 4,598
Adjustments to reconcile change in unrestricted net assets to net cash provided by operating activities:		
Depreciation	**33,656**	33,087
Amortization of debt issuance costs	**140**	140
Change in valuation of interest rate swap	**(3,236)**	(6,596)
Net (gains) losses on capital assets	**(58)**	805
Changes in operating assets and liabilities:		
Accounts receivable	**5,633**	(154)
Unbilled revenue	**3,743**	(996)
Prepaid expenses and other assets	**3,295**	(4,283)
Other long-term liabilities	**39**	37
Accounts payable	**(6,224)**	4,159
Accrued liabilities	**(459)**	(4,568)
Deferred revenue	**(367)**	347
Regulatory liabilities	**119,832**	99,623
Net cash provided by operating activities	**141,539**	126,199
Cash flows from investing activities		
Capital expenditures for property and equipment and systems under development	**(16,224)**	(35,930)
Proceeds from sale of property and equipment	**98**	13
Net cash used in investing activities	**(16,126)**	(35,917)

Continued on following page

Electric Reliability Council of Texas, Inc.

Statements of Cash Flows (continued)

	Year Ended December 31	
	2012	**2011**
	(In Thousands)	
Cash flows from financing activities		
Proceeds from issuance of notes payable	**$ 80,000**	$ –
Repayment of notes payable	**(165,970)**	(143,970)
Payment of debt issuance costs	**(373)**	–
Increase in restricted cash	**(57,992)**	(158,286)
Increase in market settlement liabilities	**33,389**	230,935
Increase in security deposits	**57,992**	158,286
Net cash (used in) provided by financing activities	**(52,954)**	86,965
Net increase in cash and cash equivalents	**72,459**	177,247
Cash and cash equivalents, beginning of year	**246,803**	69,556
Cash and cash equivalents, end of year	**$ 319,262**	$ 246,803
Supplemental information		
Cash paid for interest	**$ 6,968**	$ 12,078
Supplemental disclosure of non-cash investing and financing activities		
Change in accrued capital expenditures	**$ (1,676)**	$ (4,626)
Capitalized interest	**$ 3,105**	$ 7,912

See accompanying notes.

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% 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.

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 and money market investment accounts.

Cash and cash equivalents consist 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

2. Summary of Significant Accounting Policies (continued)

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.

System administration fee – This fee was 41.71 cents per megawatt hour of adjusted metered load in both 2012 and 2011 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. On January 1, 2013, ERCOT achieved full recovery of the Nodal implementation surcharge. The surcharge was discontinued on January 2, 2013.

Reliability organization pass-through – The North American Electric Reliability Corporation (NERC) invoices ERCOT for reliability functions performed primarily by Texas Regional Entity, Inc. In turn, ERCOT collects revenue from Market Participants for this Electric Reliability Organization (ERO) billing. The ERO billing is based on actual NERC funding, and ERCOT collects this revenue and remits 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, training for market participants, 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.

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 non-operating income (expense) in the statement of activities for the period. The Company recognized a gain of $259 and a loss of $805 in 2012 and 2011, respectively, related to such retirements and disposals. Repairs and maintenance costs are expensed when incurred.

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

Asset Category	**Depreciable Life**
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.

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 2012 or 2011.

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 2012 and 2011, capitalized interest costs were $292 and $429, respectively.

In connection with the TNMIP (see Note 10), interest is allocated as an operating expense to all projects no longer in progress. As discussed in Note 10, the interest is recorded as part of the TNMIP expenditures and is recognized through the regulatory liabilities. During 2012 and 2011, TNMIP allocated interest costs were $2,813 and $7,483, respectively.

During 2012 and 2011, total capitalized interest costs were $3,105 and $7,912, 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.

ERCOT manages a congestion revenue rights (CRR) program which includes monthly auctions and auctions for longer than one month. ERCOT collects and holds the proceeds from the auctions until the proceeds are distributed according to provisions of the ERCOT Protocols.

(Dollars in Thousands)

2. Summary of Significant Accounting Policies (continued)

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.

Market settlement liabilities consist of the following at December 31:

	2012	2011
CRR auction funds	**$ 299,074**	$ 257,737
Prepayments of settlement obligations	**31,077**	39,025
Total market settlement liabilities	**$ 330,151**	$ 296,762

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.

2. Summary of Significant Accounting Policies (continued)

Financial Instruments

The carrying values reported on the balance sheet for current assets and liabilities and for the revolving lines of credit, 3.00% senior notes payable and term loan approximate their fair values. The fair value of the Company's 6.17% senior notes payable is $28,389 and $43,448 as of December 31, 2012 and 2011. The fair value is estimated based on net present value calculations and quoted market prices for similar issues.

ERCOT used 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. All of the interest rate swaps expired in 2012.

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.

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.

(Dollars in Thousands)

3. Fair Value Measurement (continued)

- 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.

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, 2012 and 2011.

As of December 31, 2012	Total	Level 1	Level 2	Level 3
Assets				
Cash equivalents[(a)]	**$ 319,262**	**$ 319,262**	**$ –**	**$ –**
Restricted cash[(a)]	**471,876**	**471,876**		
Total assets	**$ 791,138**	**$ 791,138**	**$ –**	**$ –**

(Dollars in Thousands)

3. Fair Value Measurement (continued)

As of December 31, 2011	Total	Level 1	Level 2	Level 3
Assets				
Cash equivalents[a]	$ 246,803	$ 246,803	$ –	$ –
Restricted cash[a]	413,884	413,884	–	–
Total assets	$ 660,687	$ 660,687	$ –	$ –
Liabilities				
Interest rate derivatives[b]	$ 3,236	$ –	$ 3,236	$ –
Total liabilities	$ 3,236	$ –	$ 3,236	$ –

(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.

(Dollars in Thousands)

4. Property and Equipment

Property and equipment consists of the following at December 31:

	2012	2011
Computer hardware and equipment	**$ 75,551**	$ 83,273
Software	**584,123**	578,243
Building and leasehold improvements	**88,404**	92,055
Furniture and fixtures	**31,381**	30,990
Land	**947**	947
Vehicles	**119**	124
Construction in progress	**–**	597
	780,525	786,229
Accumulated depreciation	**(492,312)**	(409,628)
	288,213	376,601
Systems under development	**10,025**	9,859
Total property and equipment, net	**$ 298,238**	$ 386,460

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:

	2012	2011
3.00% senior notes	**$ 79,000**	$ –
6.17% senior notes	**27,267**	40,904
Revolving lines of credit	**–**	80,500
Term loan	**–**	70,833
	$ 106,267	$ 192,237

5. Notes Payable (continued)

Debt Restructuring

In 2012, ERCOT restructured its debt to create a simpler debt structure with reduced interest costs consistent with its more stable operating profile. The new debt structure consists of a single revolving line of credit facility and fixed rate long-term senior notes.

Revolving Line of Credit

ERCOT has one revolving line of credit with JPMorgan Chase Bank which was entered into in June 2012. This facility is primarily used for short term working capital needs, has a maximum amount of available credit of $125,000 and expires on June 29, 2014. As of December 31, 2012, there was no debt outstanding under this line of credit.

The interest rate on this facility is based on prime rate, a Eurodollar based rate, or other rate as described in the debt agreements. The contractual rate of interest on the revolving line of credit's outstanding balance was 0.81% at December 31, 2012. Additionally, at December 31, 2012, ERCOT pays a commitment fee of 0.12% on the unused portion of the $125,000 revolving credit facility. During 2012 and 2011, ERCOT incurred commitment fees totaling $155 and $208, respectively, in connection with its debt facilities. The revolving line of credit has several debt covenants, the most restrictive of which limits ERCOT's indebtedness. At December 31, 2012, the revolving line of credit had $124 of unamortized debt issuance costs and ERCOT was in compliance with its debt covenants for this facility.

3.00% Senior Notes

On October 31, 2012, ERCOT issued $80,000 in senior notes through a private placement. These notes bear interest at 3.00% and are due in equal quarterly principal payments beginning in December 2012 through September 2032. The private placement has several covenants, the most restrictive of which limits ERCOT's indebtedness. At December 31, 2012, $79,000 of these senior notes were outstanding, there was $249 of unamortized debt issuance costs and ERCOT was in compliance with its covenants for these notes.

(Dollars in Thousands)

5. Notes Payable (continued)

6.17% Senior Notes

ERCOT had $27,267 outstanding in senior notes at December 31, 2012. These senior notes bear interest at 6.17% 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 the revolving line of credit. At December 31, 2012, the senior notes had $187 of unamortized debt issuance costs and ERCOT was in compliance with its covenants for these notes.

Future Maturities

Future maturities of the senior notes and private placement debt are as follows:

	6.17% Senior Notes	3.00% Senior Notes	Total
Year Ending December 31:			
2013	$ 13,637	$ 4,000	$ 17,637
2014	13,630	4,000	17,630
2015	–	4,000	4,000
2016	–	4,000	4,000
2017	–	4,000	4,000
Thereafter through 2032	–	59,000	59,000
	$ 27,267	$ 79,000	$ 106,267

6. Derivatives

Interest Rate Derivatives

The Company had variable to fixed rate swap agreements (Swaps) with two financial institutions which expired in 2012. The notional amounts of the Swaps were 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 matured prior to or concurrent with the respective borrowings' due dates. Under the terms of the Swaps, the Company paid the counterparties a fixed rate. In

(Dollars in Thousands)

6. Derivatives (continued)

return, the counterparties paid the Company variable interest at LIBOR, which approximates, but does not precisely equal, the rate of interest on the related borrowing.

Derivative Financial Statement Presentation and Fair Values

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

	Liability Derivatives	
	Statements of Financial Position Location	**2011**
Derivatives not designated as hedging instruments		
Interest rate derivatives	Derivative liabilities	$ 3,236
Total		$ 3,236

For the years ended December 31, 2012 and 2011, the unrealized derivative gains arising from interest rate derivatives were as follows:

	Location of Gain recognized in Income	**2012**	**2011**
Derivatives not designated as hedging instruments			
Interest rate derivatives	Change in valuation of interest rate swap	**$ 3,236**	$ 6,596
Total		**$ 3,236**	$ 6,596

(Dollars in Thousands)

7. Employee Benefit Plans

Defined Contribution Plan

ERCOT sponsors the ERCOT Defined Contribution 401(k) Savings 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.

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

	2012	**2011**
75% of the employee's contribution up to 6%	**$ 1,711**	$ 1,806
10% of the employee's compensation	**6,032**	6,302
Total employer contributions	**$ 7,743**	$ 8,108

8. Lease and Contract Commitments

The Company has non-cancellable 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. In April 2012, ERCOT entered into an amendment to reduce the leased space to approximately 30,000 square feet and extend the lease term to March 31, 2022.

(Dollars in Thousands)

8. Lease and Contract Commitments (continued)

Minimum payments due under these commitments are:

2013	$	389
2014		383
2015		385
2016		371
2017		335
Thereafter		1,480
Total minimum lease payments	$	3,343

ERCOT recognized $637 and $849 of office rent expense in 2012 and 2011, 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.

(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:

	2012	2011
Nodal surcharge fees	**$ 122,645**	$ 125,669
Nodal costs not included in systems under development	**71,888**	97,362
Over collections	**(50,757)**	(28,307)
Regulatory liabilities, beginning of year	**(115,967)**	(87,660)
Regulatory liabilities, end of year	**$ (166,724)**	$ (115,967)

This regulatory liability will be amortized over the next two and a half years, consistent with the depreciation to be recorded on TNMIP development costs.

(Dollars in Thousands)

10. Accounting for the Effects of Regulation (continued)

The following is a summary of TNMIP development costs incurred:

	2012	2011
Salaries and related benefits	**$ –**	$ 2,966
Depreciation	**69,075**	71,302
Facility and equipment costs	**–**	4
Outside services	**–**	9,596
Hardware and software maintenance and licensing	**–**	5,965
Other	**–**	46
Interest expense	**2,813**	7,483
Total TNMIP development costs	**$ 71,888**	$ 97,362

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 May 17, 2013, the date the Company's financial statements were available to be issued.