



HR&G Agenda Item 7.2.2

ERCOT Legal Memorandum Regarding Endorsement of Proposed Amendments to ERCOT Articles of Incorporation and Bylaws

Dated March 15, 2018

Presented by ERCOT Legal to the
Technical Advisory Committee on
March 22, 2018

To: Technical Advisory Committee (TAC)
From: Chad V. Seely, Vice-President, General Counsel & Corporate Secretary
Vickie Leady, Asst. General Counsel & Asst. Corporate Secretary
Jonathan Levine, Senior Corporate Counsel
Date: March 15, 2018
Re: TAC Agenda Item 10 – ERCOT Reports: Endorsement of Proposed Amendments to ERCOT Articles of Incorporation and Bylaws

ERCOT Legal is proposing amendments to its governing documents, namely its Articles of Incorporation (which will be amended to be known as Certificate of Formation) and Bylaws. This memorandum sets forth a summary of those changes as well as responses to stakeholder comments.

Articles of Incorporation (to be known as Certificate of Formation)

ERCOT Legal proposes changes to the ERCOT Articles of Incorporation as follows:

- Update legal references and nomenclature to reflect changes to Texas corporate statutes after review with ERCOT’s outside corporate counsel
 - Change statutory references from the Texas Nonprofit Corporation Act to the Texas Business Organizations Code (TBOC)
 - Update nomenclature from “Articles of Incorporation” to “Certificate of Formation” as used in TBOC
 - Removal of membership approval step in relation to limitation of liability of directors to allow for any statutory changes to take effect immediately
- Update legal references and language as needed after review with ERCOT’s outside tax-exempt organization counsel
 - Update language to support ERCOT’s Section 501(c)(4) tax-exempt purposes and related restrictions on operations [as ERCOT was a Section 501(c)(6) organization at the time of the original filing]
 - Update restrictions and requirements language as recommended by counsel to reflect statutory requirements for disposition of assets and distributions upon dissolution of ERCOT

- Update of factual references
 - Current list of Directors
 - Current Chief Executive Officer
 - Current registered agent and registered office address
- New references to applicable provisions of the Public Utility Regulatory Act (*i.e.*, mandatory composition of the Board of Directors) and Public Utility Commission of Texas Substantive Rules (*i.e.*, distribution of assets and winding up if and upon decertification) to clarify requirements related to ERCOT governance

Bylaws

ERCOT Legal proposed amendments to the Bylaws as follows:

- Update definition of **Cooperative**
- Update definition of one or more **Membership Segments**
- Update definition of **Affiliate**
- Update definition of **Officer**
- Updates to legal code references
- Corrections to scrivener's errors

ERCOT Legal will address the comments received on the Affiliate and Segment definitions in this memorandum.

The basic premise for inclusion of the definition of Affiliate in the ERCOT Bylaws is to avoid a concentration of influence or control over ERCOT by multiple Members controlled by the same person. Where Members are considered Affiliates of one another, ERCOT's Bylaws limit such Members' ability to hold memberships in more than one segment, to elect directors and to vote. The current definition essentially creates a presumption of influence or control if an Investing Company owns five percent or more of an ERCOT Member, which must be rebutted in each case.

You may recall that, beginning in September 2017, several ERCOT Corporate Members submitted requests for the Board to make a determination of non-affiliation among Members after learning of various holdings above five percent of several Members by passive institutional investors such as Vanguard, Fidelity and BlackRock. While these issues may have potentially arisen for one or two

Members in the past, changes and consolidation in the industry, as well as overlapping investments by many of the nation's largest investment companies and institutional investors, have led to many more recent issues or potential issues with the Affiliate definition.

After benchmarking against other Independent System Operators (ISOs)/Regional Transmission Organizations (RTOs) for the proposed amended definition of Affiliate, ERCOT Legal proposed an increase in the threshold from five to ten percent for passive investors before the Board would be required to make a determination of non-affiliation. When considering the Member submissions before the ERCOT Board of Directors (Board) in October 2017, there were several instances of passive institutional investors holding more than ten percent of Members' stock. After further review, to address this, ERCOT Legal plans to propose that the threshold be increased from the originally proposed 10 percent to 20 percent since it would be in line with the other aspects of the Affiliate definition (particularly, the current definition that allows the Board to make a determination of non-affiliation of any holdings between five and 20 percent) and would be well within standard corporate benchmark definitions for affiliates. Delaware General Corporation Law defines an "associate" as any entity of which a person is a director, officer or owner of 20 percent or more of the entity's stock, and in its definition of "control" states that a person who owns 20 percent or more of the voting stock of any entity is presumed to have control of such entity. 8 DEL. C. § 203(c). The definition of affiliate in the context of the United States Bankruptcy Code presumes affiliate status based on ownership, control or the power to vote 20 percent or more of an entity's securities. 11 U.S.C. § 101. A change to a 20 percent threshold would accomplish the goal of bringing only issues of material concern before the Board because true passive investments would not be routinely before the Board. The proposed definition maintains the discretion of the Board to dispute the level of control or influence, even where the ownership level is 20 percent or less.

ERCOT's stakeholders have raised several concerns with the proposed amended definition of Affiliate.

1. The amended definition of Affiliate includes a definition of "person" as any individual, corporation, limited liability company, partnership, firm, joint venture, association, joint stock company, trust, unincorporated organization, or other entity. This essentially tracks the definition used by other ISOs/RTOs, the Texas Business Organizations Code and the Delaware General Corporation Law. The comment suggested that the definition of person exclude all of the entities listed in Section 11.0042(a)(1)-(5) of the Public Utility Regulatory Act ("PURA"). ERCOT Legal did not include a reference to the exclusions in Section 11.0042 because it was believed they were too narrow to pick up all of the different types of passive investors in the ERCOT Members. However, coupled with the more simplistic and standard definitions of affiliate, person and control, and combined with the presumption of affiliation at 20%, this suggestion could be accepted.

The comment also suggested making the 10 percent (now proposed to be 20 percent) threshold an independent variable for evaluating control, and went on to propose that even if a person owned greater than 10 percent of the equity securities of another person, such ownership would not result in affiliation if the other prongs of our proposed test were met. If we use the 20 percent threshold, we do not believe this change would be necessary as changing to 20 percent would most likely eliminate much of the commenters' concerns.

The comment suggested adding clarification that in cases where non-affiliation arises because of the common ownership of an upstream investor, non-control of one ERCOT Member would result in no affiliation with respect to the other. This suggestion could also be accepted.

The commenter also suggested a more specific process for rebutting the presumption of control. Assuming that this is the process followed now and procedurally would work for the ERCOT Board, this suggestion could also be accepted.

2. A second comment noted that the amended definition of "person" could have more closely tracked the PURA definition of person by excluding electric cooperatives from the definition of person. We are open to this suggestion.

Regarding Segment definitions, as discussed in ERCOT Legal's February 15, 2018 memorandum to TAC, ERCOT has been directed by the Public Utility Commission of Texas (PUC) "to determine the appropriate [Segment] for Southern Cross Transmission (SCT) and any other entity[.]"¹ which will require an amendment to the definition of that Segment in the Bylaws. In that memorandum, ERCOT Legal initially recommended that the Investor Owned Utility (IOU) and Independent Power Marketer Segments be considered as appropriate Segments for SCT and solicited comments from stakeholders regarding the PUC's directive. ERCOT Legal received three sets of comments, two of which recommended revising the Independent Power Marketer Segment definition to accommodate SCT's membership, and one of which recommended revising the IOU Segment. ERCOT Legal continues to believe that these two Segments represent the two most appropriate options for consideration.

¹ See Revised Order dated May 23, 2017 in PUC Project No. 46304, Oversight Proceeding Regarding ERCOT Matters Arising out of Docket No. 45624 (Application of the City of Garland to Amend a Certificate of Convenience and Necessity for the Rusk to Panola Double-Circuit 345-Kv Transmission Line in Rusk and Panola Counties), Directive #1.