

Articles

"Certain Steps to Setting Up a Retail Electric Provider ("REP") to Self-Provide Electricity in the Electric Reliability Council of Texas ("ERCOT")"

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A retail electricity customer in ERCOT may choose to establish its own Retail Electric Provider ("REP") and directly access the wholesale electricity market in ERCOT. By doing so, the customer gains greater flexibility and control over its electricity purchases and has the opportunity to reduce its electricity costs. There are a variety of legal and regulatory issues to consider if a customer decides to establish a "self-serve" REP. This outline highlights those issues and presents a roadmap of the steps to setting up a self-serve REP.

1. Choice and Formation of Entity

(a) Choice of Entity. The retail customer (otherwise referred to as the "REP sponsor") will wish to conduct the REP's business in a limited liability vehicle, which ordinarily would be a limited liability company ("LLC"). LLCs are subject to franchise tax in Texas, however, so if the REP for some reason is to have substantial income or net assets, consideration should be given to using a limited partnership ("LP") as an alternate form, so long as LPs continue to be exempt from Texas franchise tax.

(b) State of Formation. An LLC that conducts REP operations only in Texas would usually be formed as a Texas LLC, but the sponsor will wish to review its overall group policies, including franchise tax planning, to determine whether LLC formation in Delaware or some other state such as Nevada would be optimal.

(c) Capitalization. LLCs in Texas are not subject to a statutory capitalization requirement (as is the case, for example, for Texas corporations), but they are subject to court-developed piercing-the-veil doctrines that currently are the same as those for corporations. Veil piercing will ordinarily be unlikely if (a) the LLC is adequately capitalized, taking into account the risks that may reasonably be expected to be encountered and the LLC's general liability insurance coverages, and (b) the LLC is operated as if it were a stand alone entity, with proper documentation of entity activities, maintenance of books and records and no commingling of funds with those of the parent or other group members. In order to obtain cost effective entity administration services, such as performance of accounting, billing, insurance, and benefits functions, and cash management services, however, the REP could contract to receive them from the parent or other group members under an administrative services agreement on appropriate arm's length terms.

(d) Tax. The REP sponsor can structure the REP so that it is treated as a disregarded entity for federal income tax purposes using either the LLC or LP form. However, Texas franchise tax considerations may favor the use of one form over the other in certain circumstances. In any event, the additional tax burden to the REP sponsor caused by the creation and operation of the REP should be minimal to nonexistent.

(e) Location. To serve as a REP, the entity must maintain a physical office in Texas for the purpose of providing customer service, accepting service of process and making available its books and records showing compliance with applicable law.

2. Organizational Documents

(a) Organizational Documents. Formation of a Texas LLC requires (i) execution of articles of organization for the LLC, and filing of the articles with the Texas Secretary of State, and (ii) adoption and execution of regulations (corresponding to the limited liability company agreement, or operating agreement, used in Delaware and other states) by either the board of managers and the members, if the LLC is to be managed by managers, or by the members alone, if the LLC is to be managed by its members.

(b) Management. A wholly-owned LLC would ordinarily be managed by its sole member, without a board of managers. The member then typically will appoint officers of the LLC to conduct the LLC's day-to-day business. Such officers would include at least a President and Secretary, and should usually also include one or more Vice Presidents and a Treasurer. In addition, important services of even a managerial nature may be obtained from third parties pursuant to service

Articles

agreements.

3. Registrations

(a) Formation Filings. Formation of a Texas LLC requires the filing of articles of organization with the Secretary of State of Texas, together with the required filing fee of \$200. If the REP is organized as a foreign LLC (e.g., Delaware), but transacts business in Texas, in addition to the filing of the LLC's certificate of formation in Delaware and a filing fee of \$120, the REP would also need to file with the Secretary of State of Texas an application for a certificate of authority to transact business in Texas as a foreign LLC and pay a filing fee of \$500.

(b) Tax Filings. The organization of the REP will require the filing of a limited number of tax forms, including an application for a federal Employer Identification Number and an application for a Texas sales tax permit.

(c) Regulatory Filings.

(i) Certification as a REP. The Public Utility Commission of Texas (the "Commission") must certify the entity as a REP.

A. Application. The entity will need to fill out and submit an application to the Commission. The application requires information about, among other things, the entity's (or its employees' or principals') experience in the retail electric industry and any complaint history of the entity (or its affiliates or principals) with applicable regulatory agencies. Following submission of the application for certification, the Commission has 90 days to approve or reject the application.

B. Customer Affidavit. The entity will need to provide affidavits from the customers that will receive the retail power, each of whom must receive at least 1MW of capacity. The affidavit must state that the customer is satisfied that the REP can meet various financial, technical, managerial and customer protection requirements set out by the Commission. If any of the retail customers of the REP will receive less than 1MW of capacity, then certain other requirements will need to be met by the REP to qualify on a geographic or transmission or distribution utility basis.

C. ISO Affidavit. The entity will need to provide to the Commission an affidavit stating that it will become certified with the ERCOT independent system operator.

D. Customer Service Plan. The entity will need to provide a customer service plan that describes how the REP complies with the Commission's customer protection and anti-discrimination rules.

E. Customer Protection Affidavit. The entity will need to provide to the Commission an affidavit stating that it will comply with the Commission's customer protection and anti-discrimination rules.

(ii) Load Serving Entity Registration. ERCOT must approve the entity as a load serving entity ("LSE"). To obtain this approval, the entity will need to fill out and submit an application to ERCOT, pay a \$500 processing fee, and execute the ERCOT LSE Agreement. The application requires information about, among other things, the entity's structure, address, affiliates, officers and authorized representatives. The entity must also provide information concerning its Qualified Scheduling Entity ("QSE"). The entity must demonstrate that it has the communications equipment required by ERCOT and must undergo testing by ERCOT to demonstrate that the REP can meet the performance requirements set forth in the ERCOT Protocols and Operating Guides.

iii) Municipal Registration. Some municipalities require a REP to register with the municipality before it may provide service to customers residing within the boundaries of the municipality. Municipalities that require such registration may also charge the REP an administrative fee.

(iv) DUNS Registration. The entity may need to register with Dun & Bradstreet to obtain a DUNS number.

4. Contracts

Articles

(a) REP Certification Parent Guaranty. As required for REP certification, the entity must obtain an irrevocable guaranty (or other type of acceptable credit support, including a loan from the parent, or a bond or letter of credit) from its parent company (or otherwise possess sufficient creditworthiness itself), which parent company must meet a minimum standard of creditworthiness. Such standard includes having an investment grade rating, assets in excess of liabilities of at least \$50 million, or unused cash resources in an amount equal to \$100,000 for the first \$250,000 in total monthly billings from transmission and distribution utilities ("TDUs") (and if there are greater than \$250,000 in total monthly billings from TDUs, a greater amount equal to such \$100,000 to \$250,000 ratio based on the actual total monthly billings from TDUs).

(b) Transition Charges Parent Guaranty. If required by the applicable TDU, the entity must obtain a guaranty (or other type of acceptable credit support, including a cash deposit, surety bond or letter of credit) from its parent company (or otherwise possess sufficient creditworthiness itself), which parent company must have an investment grade rating. Such guaranty or other form of credit support must provide for two months of the maximum expected transition charges that the REP is required to collect from its customers.

(c) ERCOT LSE Agreement. The REP must execute a standard LSE agreement with ERCOT.

(d) Back-Office Services and Systems. The REP will need to enter into contracts with service providers ("Back-Office Service Providers") for the provision of certain backoffice services and systems, including the systems for compliance with the independent system operator's scheduling, reliability, settlement and other requirements.

(e) QSE Agreement. If the Back-Office Service Provider contracts do not include QSE services, then the REP will need to execute an agreement with a separate QSE to provide scheduling and settlement with ERCOT.

(f) Wholesale Contract. The REP will need to enter into contracts with the wholesale generators and marketers from which it is purchasing electricity. Many of these entities use the standardized wholesale electricity sale and purchase agreements promulgated by the Edison Electric Institute ("EEI").

(g) Customers. The REP will need to enter into power purchase agreements with the customers that will receive the retail electricity.

(h) TDU Agreement. The REP will need to enter into a standard transmission service agreement with the applicable TDU that will deliver the wholesale power purchased to the REP's customers.

(i) Lease. The REP may need to enter into a sublease with its parent or other person providing it office space.

(j) Administrative Services Agreement. The REP will need to enter into an administrative services agreement with an affiliate to provide any necessary services not provided by the Back-Office Service Provider contracts.

5. Operations

(a) Organizational Formalities. The REP will need to perform annual organizational formalities, such as the holding of a members meeting, electing officers and updating minute books and company records.

(b) Tax Considerations.

(i) Income Tax. The REP sponsor will calculate the price paid to the REP for electricity purchased by the customers by adding an expense adjustment factor to the wholesale price paid by the REP. Therefore, the REP should generate very little (if any) taxable income.

(ii) Franchise Tax. A REP formed as an LLC will itself be subject to Texas franchise tax, and a REP formed as an LP will subject its partners to Texas franchise tax, unless the limited partners have no other contacts with Texas. The amount of Texas franchise tax that the REP will pay each year will be the greater of the tax computed on the REP's "earned surplus," which is essentially the REP's taxable income for federal income tax purposes, and the tax computed on the REP's "taxable

Articles

capital," which is essentially the net value of the REP's assets for GAAP purposes. However, the franchise tax imposed on the REP or the limited partners of the REP for each year should be marginal because the REP will earn little income and possess few assets.

(iii) Sales Tax. The use of a REP to purchase electricity will not increase the existing sales tax burden on the REP sponsor's purchases of electricity. In fact, the use of a REP should actually decrease the REP sponsor's total sales tax burden on its purchases of electricity because the sales tax will be applied to a lower sales price.

(iv) Utility Gross Receipts Tax; Assessment Report. A REP is assessed a state tax equal to 1/6 of one percent of its gross receipts from prices charged to its customers. The tax is collected by the state comptroller on an annual basis, although the REP may choose to remit the tax on a quarterly basis. In this regard, the REP will need to file a report with the state comptroller stating the amount of gross receipts collected and remitted to the comptroller from customers. This report is filed quarterly or annually depending upon how often the REP remits the tax to the comptroller.

(c) Commission Reports.

(i) Commission Quarterly Reports. The Commission requires REPs to file a quarterly performance measures report detailing the REP's performance of its technical systems used to bill its customers.

(ii) Commission Annual Reports. The REP must also file an annual report with the Commission, which is due each year following the year of certification on June 1. The annual report requires updated information as to the REP's address and contact information, demonstration that the REP has complied with Commission and ERCOT rules and an affidavit that the REP is not in material violation of the requirements of its REP certificate.

(d) Creditworthiness. The entity must continue to maintain its creditworthiness as required for its certification as a REP and to secure its transition charges collection obligations (i.e., maintain the parent guaranty or other applicable credit support in place).

(e) Renewable Energy Purchases. A portion of the electricity purchased by a REP at wholesale must be from renewable energy generation. A REP can meet this obligation by purchasing renewable energy or renewable energy credits ("RECs"). The amount of RECs required from REPs is determined annually by the REC Program Administrator appointed by the Commission and is based upon the retail energy sales of the REP.

(f) Notices to Commission; New Customers. Should the REP change its address or other contact information, or should there be any material change to the financial requirements or technical conditions that formed the basis of the REP's application for certification, or other changes to the material facts contained in the application, the REP must notify the Commission. If the REP wishes to add new customers, the REP will need to notify the Commission and amend its certificate.

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Articles

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