Control Number: 40000

Item Number: 145

Addendum StartPage: 0

40000

PROJECT NO. ~~37897~~

PUC PROCEEDING RELATING TO RESOURCE AND RESERVE ADEQUACY AND SHORTAGE PRICING	§ § § §	**PUBLIC UTILITY COMMISSION OF TEXAS**

12 MAY 29 PM 2:27

FILING CLERK

TEXAS INDUSTRIAL ENERGY CONSUMERS' COMMENTS

I. INTRODUCTION

Texas Industrial Energy Consumers (TIEC) opposes implementing the proposed 50% increase in the System Wide Offer Cap (SWOC) by August 1, 2012. Less than three months' notice is simply not enough time for the market to effectively respond to this increase. Raising the SWOC to $4,500 without giving the market sufficient time to adjust will create significant uncertainty about how pricing under existing retail contracts will be impacted. This unanticipated financial risk could also increase the risk of REP defaults during the summer months, which could have adverse consequences for the entire market.

For the reasons discussed below, the Commission should reject the proposed August 1, 2012 implementation date. Instead, the Commission should allow sufficient time between the adoption and implementation of any SWOC increase to allow the market to adjust. At a minimum, given the high percentage of retail contracts that are one year or less, the Commission should provide at least one year's notice before increasing the SWOC. The same principle holds true for any additional SWOC changes that may be considered in the "long-term" rulemaking in Project No. 40268.

II. RESPONSE TO COMMISSION QUESTION

Question: *The direct effect of the new section will be to allow resources to offer services in the ERCOT ancillary service auctions at higher prices. In turn, this direct effect is expected to increase revenues to resources, which will be paid for by LSEs, including retail electric providers. Will the new section implicate the provisions of §25.475 that allow retail electric providers to change rates in fixed-rate products for retail customers due to "changes resulting from federal, state or local laws that impose new or modified fees or costs on a REP that are beyond the REP's control"?*

The direct effect of this rule will be to increase the SWOC by 50% for all purposes in the ERCOT market This change will increase both energy and ancillary service costs for participants in the wholesale market, creating additional costs that were not considered when

AUS:654160.4

145

Load Serving Entities (LSEs) negotiated their current supply arrangements, developed and implemented their current hedging strategies, or drafted their current retail contracts. Accordingly, this change would appear to implicate the "change in law" language quoted above because it "imposes new or modified fees or costs on a REP that are beyond the REP's control" and are the result of a Commission rule change, which is arguably a change in law. Whether the terms of a specific retail contract allow the REP to pass through increased wholesale costs resulting from this rulemaking will depend upon how the specific retail contract defines terms like "law" and "cost." Based on experience, however, TIEC would expect many retail contracts to define a "change in law" to include a new Commission rule, and REPs with these contract terms would likely seek to pass through any additional costs they incur as a result of the new $4,500 cap. TIEC also notes that the product categories and the specific "change in law" language in P.U.C. Subst. R. 25.475 applies to only residential and small commercial customers.[1] The terms of retail contracts for large commercial and industrial customers may treat PUC rule changes and the associated costs in any number of ways, and those customers will now have an insufficient opportunity to examine and re-negotiate their existing agreements before this change would become effective. Ultimately, any disputes over how a particular retail contract treats this issue will be decided by the courts on a contract-by-contract basis.

TIEC also notes that the way this question is framed significantly understates the actual market impact of increasing the SWOC to $4,500. The question refers to the impact of the proposed rule as "allowing resources to offer services into the ancillary services auctions at higher prices." However, QSEs are not just "allowed" but are *required* to offer their energy at the SWOC when offering certain ancillary services in the market. Numerous other market conditions also require prices to be administratively set at the SWOC—whether that is $3,000 or $4,500. For example, as a result of other market changes recently requested by the Commission, the proposed SWOC increase would come into play anytime RUC for Capacity or Responsive Reserves are deployed, anytime Regulation-Up is deployed through SCED.[2] The new SWOC would also be implicated when ERCOT creates a proxy offer to extend a generation resource's offer curve to its HSL, and when the Power Balance Penalty Curve is triggered. Therefore, the

[1] P.U.C. Subst. R. 25.475(a).

[2] *See* NPRRs 427 and 435.

AUS:654160.4

proposed rule is not just a matter of "allowing" resources to submit higher ancillary service offers. The additional costs that both LSEs and customers may be exposed to as a result of this increase could be significant and should not be understated.[3]

III. COMMENTS ON THE PROPOSED RULE

A. The market should be given time to adjust before an SWOC change is implemented.

Without weighing in on whether $4,500/MWh is an appropriate level for the SWOC at this time, TIEC opposes implementing an SWOC increase on a timeline that does not give the market adequate opportunity to enter into transactions and contracts that account for the new risks being created. Given that most retail contracts are executed for one year or less, the market should be given at least a year to allow most existing contracts to expire and to allow LSEs and customers to adjust their hedging strategies and contract language before a change like this takes effect. Failing to provide the market with a sufficient opportunity to adjust to this change will (1) increase financial risk for all market participants without providing sufficient time to manage that risk, (2) create uncertainty about pricing under current retail contracts, and (3) increase the risk of REP defaults, which could cause significant market uplifts and POLR transitions during the volatile summer months.

REPs and other LSEs have already negotiated their wholesale supply arrangements and developed and implemented hedging strategies for this summer. Implementing a 50% increase in the SWOC on August 1, 2012 may dramatically change the costs and benefits associated with pre-existing wholesale contract positions and hedging strategies. Because REPs and other LSEs have not been given an adequate opportunity to adjust their wholesale supply arrangements and hedging strategies, these entities may either incur additional costs in an attempt to modify or supplement their pre-existing arrangements at such a late date, or be exposed to potentially significant financial risk if there are market events that cause prices to hit the cap and the REPs are not fully hedged, or if pre-existing hedges are not effective due to this change.

In the face of this financial risk and any increased costs of managing that risk, REPs will look to their retail contracts to determine what avenues are available for passing on additional costs or shifting this increased risk to retail customers. This will implicate "change in law"

[3] *See* ERCOT's Revised 2011 Backcast Analysis (May 11, 2012).

provisions and other pass-through features of retail contracts, as discussed above. In turn, this will create significant pricing uncertainty and financial risk for retail customers—even those under fixed price or indexed products as defined in P.U.C. Subst. R. 25.475. The price uncertainty associated with variable or non-standard retail contracts will be even more extreme. Without sufficient notice of the SWOC increase, many retail customers will have no meaningful opportunity to re-negotiate their existing retail agreements. This could result in significant unexpected costs for retail customers for retail customers in the ERCOT market. For industrial customers in particular—whose energy costs can comprise up to 70% of production cost—renegotiating a retail supply agreement is a time-consuming and resource-intensive process that typically takes many months or longer. Without additional time, these customers cannot contract for the risk protection they need.

While retail customers would undoubtedly be harmed if the additional costs associated with this change are passed through under pre-existing retail contracts, forcing REPs to absorb significant new costs or take on additional financial risk under a timeframe that does not allow them to adjust their supply and hedging arrangements is also an undesirable outcome, and could have adverse consequences for the entire market. The unanticipated additional cost and financial risk associated with this SWOC increase could greatly increase the likelihood of default for certain REPs during the summer months. The Commission and the ERCOT market have prior experience with the adverse consequences of REP defaults from the summer of 2008, during which multiple REP defaults caused market uplifts and significant retail customer transition issues. These types of risks could be minimized by postponing implementation of an SWOC for a time period that is sufficient to allow REPs and retail customers to prepare for the change.

For these reasons, TIEC opposes implementing an SWOC increase to $4,500 effective August 1, 2012 and urges the Commission to provide the market with sufficient time to react to this change before it becomes effective.

B. The Power Balance Penalty Curve should be adjusted to account for the SWOC increase.

If the Commission moves forward with any SWOC increase, the Power Balance Penalty Curve (PBPC) should also be modified.

It has been widely assumed that the upper limit of the PBPC will be increased to correspond with the new $4,500 SWOC to avoid a mismatch between certain ancillary service offer requirements and the PBPC. Because of the additional increase in the SWOC, the slope of the PBPC should be softened to allow generation resources and loads to respond at the various points on the PBPC prior to reaching the SWOC. Maintaining the current shape of the PBPC while moving the upper limit to $4,500/MWh will result in prices escalating too quickly and will deprive loads and generators of adequate opportunity to respond. A PBPC that is too steep will cause SCED to deploy more expensive units based purely on ramp rate constraints when those units are not actually needed, which will create price spikes and reversals. Allowing SCED to borrow from Regulation based on a smooth, gradual curve will facilitate proper price formation and limit price reversal. For these reasons, a PBPC that gradually escalates from $200 to $4,500 over 500 MW is appropriate, similar to the original CPS Energy Proposal.[4]

However, TIEC is aware that there is some concern that Regulation will be exhausted if the PBPC slope extends beyond 200 MW. The 200 MW PBPC proposed in Commissioner Anderson's May 16, 2012 memo would resolve this concern, and is preferable to other curve proposals that would either start at $500 or ramp too quickly over 50 MW.

C. Effective Date

TIEC also notes that the proposed $4,500 SWOC cap would be effective from August 1, 2012, to May 31, 2013 under the proposed new P.U.C. Subst. R. 25.508. These dates may not match up with the implementation of any longer-term SWOC changes that the Commission ultimately makes to P.U.C. Subst. R. 25.505 in Project No. 40268. This synchronization issue should be addressed in the final rule to avoid uncertainty in the market.

IV. CONCLUSION

TIEC opposes with the proposed August 1, 2012 implementation date of the new $4,500/MWh SWOC. For the reasons discussed herein, any significant increase to the SWOC should be implemented on a timeline that gives the market sufficient opportunity to process the increased risk and to adjust accordingly.

[4] *See* Project No. 37897, CPS Energy Comments at 3-4 (Oct. 14, 2011). This curve would need to be extended to $4,500 instead of $4,000.

Respectfully submitted,

ANDREWS KURTH LLP

Katie Coleman

Phillip Oldham
State Bar No. 00794392
Tammy Cooper
State Bar No. 00796401
Katherine Coleman
State Bar No. 24059596
111 Congress Avenue, Suite 1700
Austin, Texas 78701
(512) 320-9200
(512) 320-9292 FAX

ATTORNEY FOR TEXAS INDUSTRIAL
ENERGY CONSUMERS