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PUC RULEMAKING TO AMEND PUC SUBST. R. 25.505, RELATING TO RESOURCE ADEQUACY IN THE ELECTRIC RELIABILITY COUNCIL OF TEXAS POWER REGION	§ § § § § §	**BEFORE THE PUBLIC UTILITY COMMISSION OF TEXAS**

INITIAL COMMENTS OF TEXAS COMPETITIVE POWER ADVOCATES

Texas Competitive Power Advocates ("TCPA")[1] appreciates the opportunity to file the following comments in the above-referenced proceeding on the proposed amendments to Substantive Rule 25.505. The amendments, if adopted, would increase the high and low system offer caps and make changes to the peaker net margin in subsection (g) of the rule.

On May 8, 2012, the Commission extended the time for initial comments on the proposed rule amendments to allow parties to incorporate in their comments the findings of the Brattle Group in their report entitled, "ERCOT Investment Incentives and Resource Adequacy" (the "Brattle Report"). These comments are, accordingly, informed by the Brattle Report's useful and enlightening modeling results, conclusions and recommendations, including the following:

- "The combination of ERCOT's efficient supply stack, low gas prices, and high wind penetration has greatly reduced the operating margins of existing and potential new generation."[2]
- "Investors' basic requirement is that they can expect future revenues to be high enough, often enough, to cover the costs of building a plant, including a return on capital commensurate with risk."[3]
- "Spot prices in energy-only markets are characterized by moderate prices most of the time and occasional severe price spikes during shortage conditions. Price spikes are essential to a well-functioning energy-only market because they signal resource shortages and provide revenues that can attract new investments."[4]

[1] The comments contained herein represent the position of TCPA as an organization, but not necessarily the views of any particular member with respect to any issue. For more information on TCPA, including a list of its members, please visit our website at www.competitivepower.org.
[2] Brattle at 22.
[3] Id. at 22, 23.
[4] Id. at 11.

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- "Such reliance on scarcity pricing to ensure long-term reliability presents a challenge simply because higher planning reserve margins increase reliability but also decrease the frequency of scarcity pricing...In other words, the high reserve margin needed for reliability eliminates the very scarcity that is required for recovering investment costs."[5]
- "Higher price caps increase generator' margins during scarcity intervals and therefore reduce the number of intervals needed to provide sufficient energy margins to support investment...Our key finding is that all scenarios fall short of the 0.1 LOLE target reserve margin. Even with the highest price caps, ERCOT is projected to experience an annual average of 0.9 loss-of load events, and is exposed to the risk of experiencing more than 30 loss-of-load hours under extreme 2011 weather conditions."[6]
- "Administrative scarcity pricing is unlikely to achieve ERCOT's 1-in-10 reliability target, even with aggressive increases in scarcity pricing parameters."[7]

The Commission, ERCOT and stakeholders have been moving swiftly over the past several months to address the electricity reserve shortages shown in ERCOT's 2012 Capacity, Demand, Reserves Report (May CDR Report), posted on May 22, 2012. The May CDR Report shows reserves just above the minimum target level considered sufficient to maintain reliability for the peak season of 2013, based upon the likelihood of a 1-in-10 year loss of load event ("LOLEV") standard used in ERCOT and other markets. This depends, however, on the mothballed units recalled to service for 2012 remaining in service during 2013, and on the Sandy Creek plant, currently delayed, entering commercial operation prior to the peak season of 2013. In 2014, the May CDR Report shows the reserve margin dropping significantly below the minimum level considered necessary for reliability. Proposing the instant rule amendments is one of several recent actions taken by the Commission to address this disturbing trend. The amendments, if adopted, would effect a structured increase in the high and low system offer caps (the "HCAP" and the "LCAP," respectively) and increase the peaker net margin ("PNM") trigger point. The Commission's expectation is stated in its proposal for publication: "(t)he amendments

[5] Id. at 65.
[6] Id. at 64.
[7] Id. at 71.

will ensure that stronger scarcity-induced prices are sent to the ERCOT market to further incent the development of new generation resources and help ensure that there is adequate generation in the ERCOT market."[8] The extensive modeling done for the Brattle Report, however, demonstrates that while the first objective may be achieved in part, the second is unlikely. The proposed amendments would raise the HCAP over a three-year period, beginning in June, 2013 to a maximum of $9,000. The Brattle Report finds that "increasing the price cap to $9,000 will attract more investment, but ERCOT is still likely to fall substantially short of its current reliability target until several thousand megawatts of additional demand response are able to prevent load shedding without eliminating scarcity prices."[9] The Brattle Report goes on to state that "achieving such a high demand response penetration would take years, not months."[10]

Reserve capacity is necessary to maintain a reliable electric system in any market. Operating reserves are needed on a daily basis to manage unexpected hourly increases in load or decreases in available capacity. Planning reserves include operating reserves, and are necessary to address the uncertainties of long- and short-term forecasting of loads, weather, outages, retirements and changes in system topography. Operating reserves are acquired from existing capacity and paid for on a daily requirements basis by the system operator, but in an energy-only market like ERCOT, no one has a requirement to acquire or pay for planning reserve capacity. ERCOT's target reserve margin was developed pursuant to an LOLE study that is inconsistent with the economic equilibrium reserve margins characteristic of an energy-only market. The Brattle Report defines an economic equilibrium reserve margin as the level at which generation developers are likely to invest, which, in turn, is when energy margins exceed the cost of new

[8] Proposal for Publication at 2 of 9.
[9] Brattle at 54.
[10] Id. at 3.

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entry.[11] The current LOLE reserve margin target in ERCOT is 13.75% (according to the Brattle Report, a 15.25% reserve margin is needed to obtain the same reliability target if 2011 weather is included).[12] Brattle calculates the economic equilibrium reserve margin at 6.1% under the current price caps, and approximately 10% at a price cap of $9,000, both significantly under the LOLE reserve margin target.[13]

TCPA agrees with the Brattle Report's conclusion that ERCOT's energy-only market will not, without significant changes, provide the level of reliability Texas consumers have long enjoyed and expect. Brattle recommends, therefore, and TCPA agrees, that the Commission and ERCOT "first clarify the fundamental design objectives of ERCOT's resource adequacy construct,"[14] and following this decision, the Commission must further decide how such objectives should be implemented. Brattle offers, for the Commission's further consideration, five options for achieving resource adequacy, including three modifications of ERCOT's current energy-only design, a mandatory resource adequacy requirement for Load Serving Entities, and a centralized forward capacity market.[15]

Given the wealth of data in the Brattle Report and its recommendations for further study, TCPA appreciates the Commissioners' swift action in opening Docket No 40480 and instructing staff to schedule a workshop in August. We recommend that the workshop include an examination of the level of reliability acceptable to Texas electricity consumers and policy-makers, and whether such level can be, obtained through market-only mechanisms or administratively determined. Following decisions on these essential issues, we urge the

[11] Id. at 54.
[12] Id. at 55.
[13] Id. at 3.
[14] Id. at 100.
[15] Id. at 103.

Commission to hold another series of workshops, beginning in September, to fully examine options for achieving and sustaining over time the preferred reserve margin levels. Such options should include those identified in the Brattle Report as capable, under current market conditions and considering political feasibility, of achieving the reserve margin levels deemed acceptable.

We would urge, however, that the Commission refrain from consideration of any option that relies on a backstop mechanism involving regulated contracts for new generation supply. TCPA agrees with the Brattle Report's characterization of such an option as "a strong indication of market failure."[16] ERCOT's vibrantly competitive wholesale and retail electricity markets have been a model for the nation, and they will be irreparably harmed by the introduction of state-mandated generation resources. Such resources would enjoy a state-funded competitive advantage over others in the wholesale market that would artificially depress forward prices, discourage other investment, and suppress demand response. The Commission could find itself in a position of having to resort to the state-funded option for all new generation capacity, a result no one desires to contemplate. One of the primary goals of a competitive electricity market is to remove from retail customers the risks of generation development. In the competitive portions of the ERCOT market, that goal has successfully been met. A state-funded backstop procurement mechanism would reverse this success, and burden consumers, once again, with a regulatory mandate to assume generation risk.

TCPA recognizes that undertaking a critical examination of reserve margin and market design fundamentals not only introduces additional uncertainty at a time when potential investors are looking for clarity, but also is likely to extend the time such clarity will be in short supply. Accordingly, we support raising the HCAP to predetermined levels and on a timetable certain, to

[16] Id. at 110.

be effective during the time the examination of market fundamentals is underway. We agree with Brattle that increasing the cap alone, without other measures, will not produce the target reserve margin levels considered minimal today. But an HCAP raised to at least the $4,500 proposed to begin this August may encourage some generation investment while the Commission's deliberations are ongoing, to allow the Commission to focus on gathering the information it needs to make the right decisions for the market.

TCPA supports the proposed increases in the LCAP and the PNM trigger as "no regrets" decisions. The PNM and the LCAP constitute a guardrail that gives consumers some comfort, but the LCAP is unlikely to be used because the trigger will seldom, if ever, be reached.[17] TCPA further urges the Commission to include additional changes to the PNM mechanism, as suggested in its comments filed in this proceeding on February 2, 2012:

> (I)t is TCPA's opinion that the current PNM should be altered.. The Commission should either significantly raise the current PNM to a level that would allow for recovering revenues from under-earning years (TCPA suggests a 3X factor) or the trigger should be analyzed and based on a rolling average of multiple years rather than a single year. The LCAP should also be raised significantly above the $500. At the current level it would collapse prices immediately after the PNM metric was reached, thereby removing any incentive for load to contract forward, not incent load response, and threaten the economic viability of new investments in the market. Furthermore, the current PNM is a static number based on outdated data. The inputs to the current PNM should be immediately re-evaluated by an outside third party and the PNM updated regularly as appropriate.[18]

In light of our extensive comments above and our strong recommendation that the Commission focus on clarifying its reserve margin objectives and methods to achieve them,

[17] See discussion in Brattle at 64, 65.
[18] Comments of Texas Competitive Power Advocates, Response to Q. 4., Project No. 37897, p. 3, Feb. 2, 2012.

TCPA's responses to the Commission's questions related to the proposed rule amendments will be brief:

QUESTION 1: Should the sequence of changing the high system-wide offer cap (HCAP) increase at a different rate and over a different period? For example, are any of the following cases preferable to that proposed in the rule? Whatever is ultimately determined to be the appropriate HCAP, should the increase be in one or two steps, rather than three or four? Should the specific year for each increase or the specific date of June 1 for the increase each year be changed? If so, what should be the effective date of each change?

	Raise the HCAP to:	Effective before the summer of:
Proposed Rule	$5,000	2013
	$7,000	2014
	$9,000	2015
Case 1	$4,000	2013
	$5,000	2014
	$6,000	2015
Case 2	$4,500	2013
	$6,000	2014
	$7,500	2015

RESPONSE:

As stated above, an energy only market alone will not guarantee a reserve margin based on the one in ten year LOLE, regardless of the magnitude of the HCAP. Therefore, TCPA suggests that the Commission begin the evaluation of additional measures that may need to be employed to bridge the gap between the economic equilibrium reserve margin of the energy-only market and those reserve margin levels deemed acceptable to electricity consumers and policy-makers. TCPA is agnostic as to the HCAP levels and timetable that should be in place during the time such evaluation is ongoing, but urges the Commission to finalize its decision on HCAP levels as soon as is reasonably practical.

QUESTION 2: Is the use of the peaker net margin (PNM) method described in the rule the appropriate mechanism to measure resource adequacy in an energy-only market? If not, what should replace it? Should the PNM trigger amount be the cost of new entry (CONE) or a multiple of the CONE as determined by ERCOT? Should the trigger causing the system-wide offer cap to be reset to the low system offer cap be based on a calendar year or

a rolling 12-month period, or should the use of the mechanism be based on hitting the trigger for a single year, or for multiple years? Should variability in the weather be taken into consideration in determining whether the PNM trigger is met?

RESPONSE:

As recommended in our comments on the PNM filed in P. 37897 on Feb.10, 2012, we believe the PNM trigger should be a multiple of CONE (we suggested 3X), and the trigger should be reset based on a rolling average of multiple years. The PNM is not an appropriate method to measure resource adequacy in an energy-only market. The PNM is and was designed to only be a trigger for the LCAP. The PNM should be set at a level that does not interfere with the natural boom and bust cycle of revenue returns, and investors must have an expectation that recovering revenues from lean years is possible without hitting the PNM trigger. The PNM trigger should only serve as a protection from major market failures.

QUESTION 3: How long would it take market participants to adjust their financial exposure to the proposed amendments? Will these changes affect liquidity in the ERCOT market? If so, how? Will financial counterparties in hedging arrangements continue to be willing to participate, and if so, at what cost, if the HCAP is increased significantly? Would there be any difference if changes were made over a shorter or longer period of time?

RESPONSE:

If the price of power rises due to higher price caps, the cost of liquidity will also rise and liquidity will likely decrease. The Brattle Report's extensive modeling demonstrates that no reasonable increase in the SWOC will produce the level of reliability, in our energy-only market, that Texas electric customers expect and enjoy today. If the purpose of raising the SWOC is to increase forward contracting, then raising the SWOC to ever-higher levels will reach a point of diminishing returns. The Commission should, therefore, carefully calibrate any increases in the SWOC intended to create the price formation essential for generation investment against any

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associated decreases in liquidity that can constrain the robustness of a wholesale market also essential for generation investment.

QUESTION 4: Should the HCAP ultimately go to $12,000 or $15,000, and if so, over what time period? If the HCAP is raised to these levels, should the energy from the various ancillary services deployed by ERCOT be priced at the same amount, or should ERCOT procure different amounts of these services?

RESPONSE:

TCPA believes that a HCAP at these high levels may actually have an adverse affect on investment, because the risk profile within ERCOT would far exceed other regions, both domestic and international, that are competing for capital dollars. It would not only be more difficult for customers to cover their exposure to such prices, but it would also increase generators' unit contingency risk to unacceptable levels. TCPA recommends that the Commission abandon consideration of increasing the HCAP to such levels, and focus instead on expeditiously undertaking the comprehensive examination of market fundamentals suggested by the Brattle Group.

Respectfully submitted,

By: Marianne Carroll by gl with permission

Marianne Carroll
State Bar No. 03888800
Brown McCarroll, L.L.P.
111 Congress Ave., Suite 1400
Austin, TX 78701
mcarroll@brownmccarroll.com
Telephone: 512-479-1156
Telecopier: 512-481-4836

ATTORNEYS FOR TEXAS COMPETITIVE POWER ADVOCATES