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PROJECT NO. 40480

**PUC PROCEEDING REGARDING
POLICY OPTIONS ON RESOURCE
ADEQUACY**

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**PUBLIC UTILITY COMMISSION
OF TEXAS**

CITY OF HOUSTON COMMENTS

The City of Houston ("City") is pleased to provide comments regarding policy options on resource adequacy and the recommendations in the Brattle Report, filed on June 1, 2012 in Project No. 40268.

The City's interests in this proceeding regarding resource adequacy policy options focus primarily on the potential impact to electric service reliability and costs for electric customers in the Houston area. The potential for insufficient generation capacity to compromise reliability of electric service delivery in the Houston area understandably concerns the City. The City is committed to working towards policies and regulations which would preserve the reliability of electric service in the Houston region. In addition, the City itself is one of the largest retail electric customers in the Houston area and its own costs for electricity may be significantly impacted by the Commission's electricity market policy decisions. Finally, the City also acts as a consumer ombudsman for Houston residents on electricity issues and therefore has an interest in the potential impact on rates charged to Houston area customers.

City's Recommendation

The City of Houston currently does not advocate a particular policy recommendation in the Brattle Report. However, the City does view with some concern the Commission's resolute adherence to the existing energy-only market design despite mixed evidence in the Brattle Report and other literature documenting energy-only market performance to promote resource

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adequacy. The City urges the Commission to take this opportunity to thoroughly review all of the policy options outlined in the Brattle Report, including those options which deviate from a strict energy-only market design. In addition, the Commission should thoughtfully examine the data and literature which illustrate varying degrees of success in existing energy-only markets around the world.

Performance of Energy-Only Markets

The Brattle Report clearly states that despite an increase in the system-wide offer cap, “the energy-only market will not dependably support ERCOT’s current reliability target until sufficient demand response penetration is achieved.”¹ According to the Brattle Report, it would “take years”² to reach the amount of voluntary curtailment by customers needed to satisfy ERCOT’s reliability target. ERCOT projects a reserve margin of only 9.8% by 2014, before sufficient demand response will be able to materialize.

The recent experience in the Australian NEM energy-only market, after which the Texas energy-only market is modeled, exemplifies the City’s concerns. Evidence indicates issues with the energy-only market in Australia which appear very similar to the ERCOT situation. A paper by an Australian economist, Paul Simshauser, concluded that the Australian energy-only market did not support the development of new peaking plants because in an energy-only market investment in peaking resources would occur when scarcity and load shedding occur, an unacceptable market outcome:

“... while the energy-only gross pool market has served Eastern Australia well over the past decade, deep structural faults on the supply-side remain, and appear to be deteriorating. The reason for this outcome is that competitive energy-only markets do not have a definable equilibrium solution unless reliability constraints are violated, or

¹ Brattle Group Report at 4.

² Brattle Group Report at 3. The Report finds only 1,000 MW in the market today but estimates the ERCOT market could need between 3,600 and 5,600 MW on price responsive demand to maintain an acceptable level of reliability.

market power is exercised. The densely compressed marginal running cost curves of the base, intermediate and peaking plant stock make cost recovery an almost impossible task for all plants, and particularly for peaking plant. Without policy intervention, the NEM is headed for periods of supply shortages and unacceptable levels of load shedding. This represents a political hazard for State Governments, who are ultimately held accountable for the performance of the deregulated NEM.”³

Like the ERCOT market, the NEM is also experiencing tightening reserve margins. Like Texas, Australia experienced a boom in electricity capacity when the market first opened. Over time this margin has gradually diminished with the growth in electricity demand. In the NEM, capacity has primarily been maintained by state government investment; 6,309 MW or 55% of all new generating capacity in the NEM has either been originated or underwritten by government businesses between 1997 and 2011. Private sector merchant investments represent only 9% of investments. The last pure merchant plant in the NEM was financed in 1999. The remaining 4,050 MW of new capacity, all added since 2002, has been originated or underwritten by investment grade retail utilities. In the NEM, State governments have withdrawn their state-owned enterprises from the development market to avoid crowding-out the private sector.⁴

In the NEM, the market price cap for spot electricity is currently set at \$AUD 12,500/MWh⁵ against system average spot prices of about \$AUD 40–50/MWh. In order to incent the development of new peak resources in the Australian energy-only market, a recent study found that even a \$AUD 12,500/MWh is not sufficient. Modeling results revealed that given current policy settings, only 57–65% of costs of peaker plants would be recovered through the NEM. To achieve 100% cost recovery in the NEM, the market price cap would need to be

³ Paul Simshauser, *The Dynamic Efficiency Gains From Introducing Capacity Payments In The NEM Gross Pool*, Australia Economic Review (December 2008), at Page 1.

⁴ Paul Simshauser, *Vertical Integration, Credit Ratings and Retail Price Settings in Energy-only Markets: Navigating the Resource Adequacy Problem*, 38 ENERGY POLICY 7429, 7430-33 (2010).

⁵ AUD to USD exchange rate = 1.0267 as of July 5, 2012 (International Monetary Fund)

lifted to about \$AUD 24,500/MWh given the NEM's stated reliability criteria. This could lead to the risk of financial collapse by a participant if exposed to such extraordinarily high spot prices for any meaningful period of time.⁶

There is also evidence of exercise of market power in the NEM, especially in South Australia. A major generation plant was strategically bid three summers in a row to raise the price to the market cap on numerous hours. In Queensland the exercise of market power seems to have included simultaneous actions by a number of different generating companies, resulting in the concerted withdrawal of a relatively small amount of capacity across a number of generating plants.⁷

Conclusion

The City of Houston believes that the Commission is at an important crossroads in the ERCOT market development. Perhaps as soon as 2014, reserve margins be insufficiently robust to ensure reliability. The City believes that there is still sufficient opportunity for a better market outcome. The City urges the Commission to undertake a thorough and open-minded investigation of all the policy options outlined by the Brattle Report because secure resource adequacy relies on it.

The City of Houston looks forward to working with the Commission, the Commission staff and other stakeholders to ensure that the citizens of this state have access to both an affordable and a reliable electricity supply.

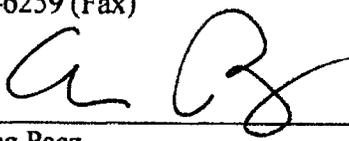
⁶ Simshauser, *Vertical Integration* at 7429.

⁷ Darryl Biggar, *The Theory and Practice of the Exercise of Market Power in the Australian NEM*, Working Paper, April 26, 2011, at 61-63

Respectfully Submitted,
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