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Item Number: 273

Addendum StartPage: 0

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PUC PROJECT NO. 40000

**COMMISSION PROCEEDING TO §
ENSURE RESOURCE ADEQUACY IN §
TEXAS §**

**BEFORE THE PUBLIC UTILITY
COMMISSION OF TEXAS**

PROPOSAL BY JON COHEN, FINANCIAL ANALYST, ISI GROUP, LLC

INTRODUCTION

Part of my role as a research analyst covering the Merchant Power sector is to inform investors on developments impacting the US power markets. In that capacity, I have been closely following the current policy discussion in ERCOT. While I have no specific interest in the outcome of the proceeding, I thought it would be worthwhile to share a proposal that may further the discussion in some way. I offer my thoughts as an individual; my comments in no way reflect the views of my employer, ISI Group, LLC, or its clients.

POLICY OPTION 6 – BACKWARD LOOKING DEMAND CHARGE

I refer to this proposal as Policy Option 6 to distinguish it from the five policy options offered by the Brattle Group. The proposal could be viewed as variation on Policy Option 2 – Energy-only market with “adders” to support a target reserve margin

A well-designed power market should aim to achieve the following:

1. Consumers of electricity bear accountability for their individual contribution to peak load
2. Payments to providers of generating capacity increase as the reserve margin declines
3. Risks and potential opportunities can be traded in well-organized, transparent markets

To advance these objectives I propose a backward looking demand charge mechanism that incorporates the following elements:

- Every consumer (including residential, commercial and industrial customers) pays a monthly, fixed demand charge from September through May, which is based on that

273

customer's contribution to system wide peak demand during the past summer season (June through August).

- Each consumer's contribution to system-wide peak demand is calculated during the top [x] hours of load in a given summer season.
- All generators with available, operational capacity during those [x] peak hours (generators need not have been dispatched) share in the total pool of customer demand payments that will be collected from September through May.
- Payments to generators are allocated based on their proportion of available MW during the [x] peak hours, to the system-wide available MW during those hours
- The total payment to be received by generators depends on the weather-normalized realized reserve margin during the past summer season.
- The lower the realized reserve margin, the higher the total payment to be divided amongst the generators (and vice versa).
- As the realized reserve margin approaches a critical reliability threshold, the total demand charge approaches some function of CONE .
- As the realized reserve margin rises above a certain level, the total demand charge approaches zero (or some floor value)
- Customer demand charges are billed and collected as part of the T&D charge. Customers who switch providers are not able to avoid payment of the demand charge. Credit risk for this portion of the bill remains with the regulated distribution company, not the retail provider.
- Owners of generating capacity are permitted to trade the "right to receive future demand payments" in the open market. Contracts may be for any tenor (each MW represents a future stream of potential cash flows, the value of which will depend on the realized, weather normalized reserve margin in future years). The risk for non-performance for a particular MW would rest with the seller. Note that the right to receive these payments is "stripped" from the right to receive energy revenues; they are two separately tradable products.

I believe the above proposal has several noteworthy attractions:

- All customer classes (including those that contribute 70%+ of peak load) are properly incentivized to manage their demand during peak conditions.

- Industrial customers are rewarded for their relatively flat load shape. This mechanism does not disadvantage Texas industrial consumers vs. those in other states
- A weather-normalized reserve margin is far easier for market participants to predict than the frequency and duration of scarcity intervals
- There is no reserve margin "mandate", but rather transparent parameters that reward generators when conditions are tight
- The mechanism does not depend on ERCOT's projection of future demand, as payments are based on actual demand data.
- Other than for dispatchable emergency resources and certain ancillary services, "organized" demand response plays no role in above proposal. While customers who reduce demand during peak conditions pay *less* throughout the year, they do not *get paid* to do so.
- Market participants with different views on future scarcity conditions are free to trade available MWs
- The demand charge is paid from September to May only. This may help smooth out the average monthly customer bill

If customers are properly educated about this market mechanism, I believe they will adjust their behavior accordingly, and bring about the desired reliability objective at the "efficient" price. I thank you for your time and your consideration of this proposal.

Respectfully Submitted,

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