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BEFORE THE
PUBLIC UTILITY COMMISSION
OF TEXAS

**LUMINANT'S
REPLY COMMENTS FOR FEBRUARY 23, 2012 WORKSHOP**

TO THE HONORABLE PUBLIC UTILITY COMMISSION OF TEXAS:

Luminant Energy Company LLC and Luminant Generation Company LLC ("Luminant") respectfully submit the following reply comments regarding the request for comments by the Public Utility Commission of Texas ("Commission"), for the February 23, 2012 workshop regarding proposed changes to P.U.C. Substantive Rules 25.504 and 25.505 and other resource adequacy issues.¹

I. INTRODUCTION

Luminant submits these Reply Comments to address two issues raised in the initial comments filed on February 10, 2012—(1) allowing all generators to submit offers that reflect the full cost of owning, operating, and maintaining a generation unit, as well as a reasonable return of and on the investment; and (2) increasing the low system-wide offer cap ("LCAP") and the peaker net margin ("PNM") trigger to levels that are reflective of today's costs and that will enable generators to recover their costs and a reasonable return of and on their investment over the life of the unit.

With respect to the first issue, some commenters expressed concern that any amendments to Substantive Rule 25.504(d) that would allow generators to bid above their short-run marginal costs ("SRMC"²) could create the potential for price volatility or market power abuse, and two commenters went so far as to suggest that bidding above marginal cost is *per se* not competitive and only makes economic sense for an entity with the ability to exercise market power. As

¹ PUC Proceeding Relating to Resource and Reserve Adequacy and Shortage Pricing, Project No. 37897, Public Utility Commission of Texas Request for Comments (Jan. 31, 2012).

² While Substantive Rule 25.504(d), on its face, only prohibits a generator with market power from pricing its services "substantially above marginal cost," this prohibition has been interpreted by some of the stakeholders in this market as requiring SRMC bidding. Thus, while the commenters referenced above used the term "marginal cost" in their comments, Luminant believes these comments are likely referring to SRMC.

discussed below, Luminant submits that a regulatory construct essentially imposing an SRMC bidding paradigm is not appropriate for and is detrimental to an energy-only market, which depends solely on adequate energy price signals to attract needed investment in new and existing generation resources, and is unnecessary in EROT's robust competitive market, with its existing mitigation mechanisms and the oversight of the Independent Market Monitor ("IMM").

With respect to the second issue, two commenters urged the Commission not to increase the LCAP or PNM trigger because these measures were understood as customer protections and because the PNM trigger is already set at twice the cost of new entry ("CONE") for a new gas-fired peaking unit. In response to these arguments, Luminant submits that the LCAP and PNM trigger are not just intended as a customer protection against extreme market outcomes, but are also intended to allow for generators to recover their costs and a reasonable return of and on their investment over the life of the unit. Additionally, the LCAP and PNM trigger levels were set six years ago and need to be adjusted to reflect current costs, which are being evaluated by an independent third party at the request of ERCOT.

II. DISCUSSION

A. Bidding above short-run marginal costs is appropriate and legitimate in an energy-only market.

In response to comments that generators should be limited to bidding at the level of their SRMC, Luminant respectfully submits that these comments ignore the financial realities of an energy-only market, as well as the maturity of the ERCOT market and the protections in place to detect and prevent market power abuse. Additionally, if generators are never permitted to bid above their SRMC, then any increase to the system-wide offer cap ("SWOC")—which was supported (or not opposed) by most of the commenters who oppose bidding above marginal cost—becomes much less meaningful with respect to contributing to restoring adequate generation resources in ERCOT. As discussed further below, in the absence of competitively offered energy above SRMC, the only way to set appropriate scarcity pricing is through an administratively determined offer curve (*i.e.*, the power balance penalty curve ("PBPC")) that is intended as a backstop rather than a substitute for the market. Thus, other than through incorporation of the SWOC into the PBPC, raising the SWOC would be meaningless.

First, while SRMC bidding is often touted as the most economically efficient bidding practice in theory, practical considerations typically counsel against such bidding.³ In fact, economist Alfred Kahn has suggested that basing prices solely on SRMC only makes sense “where buyers and sellers of every good and service are infinitely numerous, have perfect knowledge and foresight and act rationally on it, and where resources are perfectly mobile and fully employed.”⁴ No market is so perfect in practice—especially a competitive energy-only market, which depends solely on adequate energy pricing signals to attract investment in the new and existing generation needed to meet demand – and even more especially such a market in which excess supply is conspicuously absent. As the Federal Energy Regulatory Commission (“FERC”) has aptly observed:

Competitive prices over the long run should recover both the fixed and variable costs of efficient generating units. ... If some degree of scarcity pricing is not allowed, and generation only recovers short-term marginal costs, then some generators needed for reliability could fail to recover their full costs and may be retired. Worse yet, prices could be held so low that investors decline to invest in needed generation, transmission and demand-side projects because they do not see a reasonable expectation of recovering their costs.⁵

Stated simply, when supply is not unlimited and adequate price signals are needed to attract investment to meet demand, pricing at SRMC will not send the appropriate signal. Rather, investors need to see that they can recover the full cost of owning, operating, and maintaining their plant, plus a reasonable return of and on the investment. Luminant respectfully suggests this is precisely the circumstance facing ERCOT today.

Second, the ERCOT market is mature and has existing protections against non-competitive offers, as well as an IMM who is statutorily tasked with detecting and preventing market power abuses.⁶ In a mature and competitive market, the Commission can rely on the

³ See ALFRED E. KAHN, THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS, pp. 83-86 (1988) (setting forth circumstances in which SRMC bidding is not ideal). While fully regulated electricity markets were the norm at the time of Kahn’s writing, Kahn suggested that long-run marginal cost pricing might be the preferred metric in a competitive market, and Kahn included in this metric the capital costs that would have to be covered over time in the future if service is to continue to be rendered. *Id.* at p. 88.

⁴ *Id.* at p. 86.

⁵ Notice of Proposed Rulemaking, Remedying Undue Discrimination Through Open Access Transmission Service and Standard Electricity Market Design, 67 FED. REG. 55,452 (Aug. 29, 2002).

⁶ See PURA § 39.1515 (requiring a wholesale electric market monitor to detect and prevent market manipulation strategies and recommend measures to enhance the efficiency of the wholesale market).

market to produce competitive offers,⁷ while still allowing generators to offer prices that are reflective of the full cost of providing electricity, plus a reasonable return of and on their investment. In situations in which a supplier has market power, the Commission can rely on existing mitigation mechanisms, as well as the IMM, to detect and prevent instances of market power abuse. For example, as required by Commission Rule⁸ and ERCOT Protocol,⁹ ERCOT currently mitigates offers by resources that are needed to solve “non-competitive constraints”, meaning “transmission element[s] on which prices to relieve congestion are not moderated by the normal forces of competition between multiple, unaffiliated resources.”¹⁰ These mitigated offers attempt to limit the offers to curves based on the resource’s verifiable Incremental Heat Rate (IHR) Curve and fuel costs.¹¹ Given the current, robust state of the ERCOT market, as well as the existing mitigation mechanisms and the market monitor, generators should be permitted to submit competitive offers that reflect their full costs and a reasonable return of and on their investment, without creating undue risk of market power abuse or price volatility.

Finally, if generators are limited to SRMC-based offers, any increase to the SWOC (which was supported by most of the commenters who oppose bidding above marginal cost) will not be appropriately reflected in prices during periods of scarcity because the SWOC will only be reached through administrative mechanisms, like the PBPC, or through out-of-market reliability products like Responsive Reserve Service.¹² Some of the same commenters asserting

⁷ See *Rulemaking to Address Enforcement of Wholesale Market Rules*, Project No. 26201, Order Adopting New §25.503 as Approved at the January 29, 2004 Open Meeting, at pp. 10-11 (Feb. 9, 2004) (“When sufficient competition exists, the forces of competition set the limits that ensure that profit maximizing activities do not result in unreasonable prices, and no government intervention is needed to protect customers from price gouging. However, the Commission recognizes that competition is not yet fully established in the ERCOT markets, and therefore market behavior rules are necessary to protect the public interest during the transition period.”).

⁸ See P.U.C. SUBST. R. 25.502(f) (requiring ERCOT, through its stakeholder process, to develop and submit for Commission oversight and review protocols to mitigate the price effects of congestion on noncompetitive constraints).

⁹ See ERCOT Nodal Protocol § 6.5.7.3 (creating a two-step process for resolving competitive and non-competitive restraints and mitigating offers in step two).

¹⁰ P.U.C. SUBST. R. 25.502(c).

¹¹ ERCOT Nodal Protocol § 4.4.9.4.1. For generation resources commencing commercial operation before January 1, 2004, the cap is “the greater of (i) 10.5 MMBtu/MWh times the [Fuel Index Price]; or (ii) the Resource’s verifiable incremental heat rate (MMBtu/MWh) for the output level multiplied by ((Percentage of FIP * FIP) + (Percentage of FOP * FOP))/100, as specified in the Energy Offer Curve, plus verifiable variable O&M cost (\$/MWh) times a multiplier described in paragraph (d) below.” *Id.*

¹² See ERCOT Nodal Protocol § 6.4.3.2 (requiring energy offer curve to be set at SWOC for capacity reserved for Regulation Reserve Service and Responsive Reserve Service).

that SRMC is the only legitimate basis for a competitive offer also suggested that mechanisms like the PBPC should, in fact, be relied on instead of competitive offers to reflect scarcity conditions. That would be plainly inconsistent with Texas's deliberately chosen approach, since it would be a regulatory solution, not a competitive solution.¹³ Further, as explained in Luminant's initial comments, the PBPC typically undercuts competitive offers,¹⁴ rather than producing prices that are reflective of scarcity, and only stops undercutting competitive offers when it reaches the SWOC (which is why Luminant advocates starting the PBPC at the SWOC). Luminant supports the changes in progress to the various administrative mechanisms and out-of-market reliability products. However, while these mechanisms play an important role in the market, they should not substitute for market forces and competitive bids in our competitive market—instead, when supply is running out, generators' bids should be able to reflect that scarcity, which is only possible if generators can bid above SRMC. Scarcity pricing reflected in competitive energy bids provides the most effective and market-based price signals to support generation investment.

For all the reasons just stated, as well as those in Luminant's initial comments, Luminant requests that the Commission amend Substantive Rule 25.504 to clarify that generators can make competitive offers that incorporate full costs and reasonable profit without running afoul of the Commission's market oversight rules, regardless of the generator's market share.

B. The low-system wide offer cap ("LCAP") and peaker net margin ("PNM") trigger are intended to allow generators to earn sufficient revenues during periods of scarcity to recover their costs over the long term, and the LCAP and PNM trigger levels in the current rule need to be updated based on current costs.

As noted above, two commenters argued that the LCAP and PNM trigger should not be increased because they are intended as measures to protect consumers and because the PNM trigger was already set at a level that is twice as high as that needed for a new-gas fired peaking unit to recover its costs. Luminant respectfully submits there are two flaws with this argument—

¹³ See PURA § 39.001(d) ("Regulatory authorities ... shall authorize or order competitive rather than regulatory methods to achieve the goals of this chapter to the greatest extent feasible and shall adopt rules and issue orders that are both practical and limited so as to impose the least impact on competition.").

¹⁴ See Initial Comments of Luminant, at p. 8 (Feb. 10, 2012) (explaining how the PBPC is a virtual generator that is struck when the existing competitive offers for the next megawatt of needed capacity are higher than the corresponding price on the PBPC).

one, while the LCAP and PNM trigger are intended as back-stop measures to protect customers against extreme market outcomes, the LCAP and PNM trigger are also intended to ensure that generators can recover their costs and a reasonable return over the life of the unit; and two, the LCAP and PNM trigger were set in 2006 and are not reflective of the CONE today.

With respect to the first flaw, as discussed in Luminant's initial comments, the prior Commission indicated in the order adopting the wholesale market oversight rules that the LCAP and PNM trigger have dual purposes—protecting consumers against extreme market outcomes, while also enabling generators to recover their costs and a reasonable return over the life of the unit.¹⁵ Historical prices in ERCOT in many years since the transition to a competitive market have not been at levels sufficient for generators to recover their costs.¹⁶ With the price-correcting measures currently in place and in process in ERCOT, the LCAP and PNM trigger levels need to be set high enough to allow for sufficient cost recovery in the event the market experiences a period of scarcity and prices that are reflective of that scarcity, in an upcoming year or years. If the PNM trigger remains at its current level, there is a real risk that the trigger could be reached in such a year before generators are able to earn enough revenues to make up for the past years when generators were operating at cost or at a loss. Such an outcome would not send the appropriate price signals to investors regarding the potential for cost recovery in this market or of the need for investment in existing and new generation.

With respect to the second flaw, as discussed in Luminant's initial comments, the LCAP and PNM trigger were set six years ago, and costs for building, operating, and maintaining gas-fired peaking units have increased since that time. Thus, these values should be reset to correlate

¹⁵ See *Rulemaking on Wholesale Electric Market Power and Resource Adequacy in the ERCOT Power Region*, Project No. 31972, Order Adopting Amendments to §25.502, New §25.504 and New §25.505 as Approved at the August 10, 2006 Open Meeting, at pp. 73, 121 (Aug. 23, 2006) (“The resource adequacy rule seeks to balance two competing concerns: providing generation and load resources a reasonable opportunity to cover their fixed costs over time and protecting load from excessive transfers of wealth to generators during periods of low reserve margins. ... The annual resource adequacy mechanism is intended to protect loads from persistent high prices, while providing sufficient high-price signals to entice new generation into the market. ... The Commission recognizes that some peaking resources need the opportunity to recover more than an annualized average of fixed costs in a given year because peakers will have limited opportunities to earn scarcity prices in years when reserve margins are large.”)

¹⁶ See, e.g., ERCOT 2010 State of the Market Report, at p. xiv; ERCOT 2006 State of the Market Report, at pp. 51-52 (showing that, between 2002 and 2010, the PNM only reached the level the IMM believes is the CONE in 2005 and 2008). See also IMM's ERCOT Wholesale Electricity Market Monthly Report (Jan. 9, 2012) (showing the PNM in 2011 reached \$125,000, which is slightly above the level the IMM believes to be the CONE), available at <http://www.potomaceconomics.com/documents/C6>.

with current costs. Luminant recommends (as did several other commenters) that the Commission refer to the third-party study being conducted on resource adequacy issues in the ERCOT market to determine the current CONE. The PNM trigger should then be set to three times the CONE, and the LCAP should be reset to one-half the high-system wide offer cap ("HCAP"), as was the original relationship between these two caps.¹⁷

III. CONCLUSION

Luminant appreciates the Commission's consideration of its comments and looks forward to participating in the February 23, 2012 workshop and working with the Commission to develop means to promote resource adequacy.

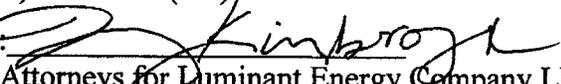
Respectfully submitted,

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¹⁷ See P.U.C. Subst. R. 25.505(g) (setting the LCAP at \$500, and retaining the previously existing HCAP for three months following implementation of the rule); Initial Comments of Luminant, at p. 9, n. 25 (Feb. 10, 2012) (explaining how the original HCAP of \$1000 was set).