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COMMISSION PROCEEDING TO ENSURE RESOURCE ADEQUACY IN TEXAS	**§ § §**	**PUBLIC UTILITY COMMISSION OF TEXAS**

COMMENTS FROM OCCIDENTAL POWER MARKETING, L.P. ON THE BRATTLE GROUP'S OCTOBER 19, 2012 FILING

I. Introduction

Occidental Power Marketing, L.P. ("OPM") filed before this Commission on August 16, 2012 a limited backstop proposal that was designed to further ensure adequate reserves while preserving the energy-only market that has worked so well in ERCOT. The Brattle Group ("Brattle") has failed to evaluate OPM's proposal in its recent filing before the Commission. Brattle also failed to evaluate other proposals that the Commissioners had indicated an interest in seeing evaluated. Instead, without analysis or support, Brattle dismissed those proposals out of hand. OPM respectfully submits that the October 19, 2012 Brattle filing is seriously flawed and should not form the basis for any decisions.

Brattle's most recent filing sets up a false choice for this Commission between either (a) a forward capacity market to get an assured level of reserves or (b) a clearly unattractive "composite" option created by Brattle without an assured level of reserves. Brattle then compares this unattractive "composite" option to an unrealistically positive picture of a mandated forward capacity market that glosses over a multitude of intractable and inherent problems with forward capacity markets. OPM submits that this analysis should not form the basis for abandoning a vibrant and successful electricity market that has attracted and continues to attract prodigious amounts of new investment. Brattle failed to evaluate or present the multiple options presented by other parties, which would be at least as effective as a forward capacity market in assuring a certain level of reserves while providing much better market signals. In addition to OPM's limited backstop proposal in this docket, the mechanisms suggested by Texas Industrial Energy Consumers (TIEC), EDF Trading North America, LLC and IPR-GDF SUEZ Energy North America, Inc. are all capable of ensuring a certain level of reserves within the context of maintaining the energy-only market in ERCOT. In addition, in Project No. 24255, *Rulemaking Concerning Planning Reserve Margin Requirements*, OPM also

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suggested a viable and simple full backstop procurement process.[1] OPM still suggests an approach based on a limited or a full backstop to assure a certain level of reserves; however, any of the above options, if properly implemented, could assure a certain level of reserves in a way that would be less complicated, more likely to attract new investment in Texas, more in keeping with Texas' highly successful pro-competition philosophy, and that would cost less for all Texas consumers.

Commenters have been allowed only one-and-one-half business days and seven pages to comment on Brattle's recent filing, so discussion of its flaws is necessarily limited at this time. However, as one example, Brattle based its relative cost analyses on an assumption that all market designs will result in revenues equal to the administratively determined cost of new entry (CONE). It hardly needs to be pointed out that an analysis with such a starting assumption will obtain a conclusion equal to the starting assumption. It is also quite arguable as to whether this assumption is true in the real world, but there is no need to have competing Ph.D. economists hold forth on the subject. The Commission can look to the numerous statements of sophisticated market participants who clearly do not believe Brattle's economic analysis. The public presentations and comments of the large incumbents and the reports of Wall Street firms projecting the size of the windfall to incumbents all demonstrate that a mandated forward capacity market will result in significantly higher prices for Texas consumers versus other means of assuring a certain level of reserves. In fact, Texas consumers would be worse off under a forward capacity market than they were under regulation. This is not a complicated calculation. Under traditional cost-of-service regulation, consumers pay based on the pre-inflation, fully depreciated cost of capacity and the actual cost of energy. If customers were forced to pay the administratively determined CONE for all generation under a mandatory forward capacity market ***plus*** whatever the market would bear for energy, then consumers would be paying far more than under traditional cost-of-service regulation. Various efficiencies gained from a deregulated market would not come close to offsetting this effect. This is not to suggest a return to regulation, but only to point out that moving to a mandatory forward capacity market would represent a failure of the main goal of deregulation, which was to improve on traditional cost-of-service regulation.

Make no mistake, however: a mandated forward capacity market is not about resource adequacy. It is about incumbent rent-seekers seeking to maximize their rents by using the

[1] Comments of OPM in Response to Second Staff Strawman (Feb. 27, 2003).

forward capacity market administrative process to artificially raise prices, thwart competition and obstruct new entry. All one has to do is read the comments of many incumbents on forward capacity markets, which focus on who should *not* be allowed to participate and what new entrants should *not* be allowed to bid competitively. And if one looks to other regions with mandatory forward capacity markets, the extent to which incumbent rent-seekers use the forward capacity market construct as a tool to artificially raise clearing prices, thwart competition and obstruct new entry is readily apparent. Unlike other regions with forward capacity markets, Texas has a healthy, growing economy that will require large amounts of new capacity and new investment. It is precisely because Texas will need lots of new capacity going forward that a mandatory forward capacity market needs to be rejected. Texas will need all the investment it can get, and a forward capacity market sends all the wrong signals.

In a mandatory forward capacity market, generators will earn the large majority of their margins from capacity payments. This drives at least three profit-maximizing behaviors by incumbents. First, large incumbents are encouraged to shut down generation in order to artificially drive up capacity prices (profits are far higher selling 90% of capacity at ten times the price than selling 100% of capacity at one times the price). Second, incumbents have an incentive not to add capacity in order to keep capacity prices high for their existing generation. Third, incumbents have a financial incentive to obstruct new entry. Imagine a world in which you can build a new plant, but you will be banned from selling your capacity in the market if the clearing price is below what your incumbent competitors worked to have determined as your "fair price." Or, you can build your own plant, but you will not be able to use it to meet your capacity obligations and will be forced to buy from the incumbents instead. No bank would finance a new plant knowing that, at some point, the new generator may be told "Your price is too low, so to protect the incumbents you will not be able to sell your capacity at all and you can't use it to meet your own capacity needs either." In other forward capacity markets, many incumbents exploit this ability to obstruct and delay new entry by creating uncertainty about whether a new entrant will be allowed to sell its capacity. The entrenched incumbents have both the means and the incentive to employ teams of lobbyists and consultants to manipulate the administrative determination processes in a forward capacity market. Regardless of whether a forward capacity market can deliver a certain level of reserves, the problem is that a forward capacity market can only achieve the objective at a much higher cost, and at the expense of free competition. The more one learns about the real-life operation of mandatory forward capacity markets in other regions, the more it becomes clear that this design is antithetical to the free-market principles that have served the Texas economy so well.

Brattle's assessment of its Texas Capacity Market option is consistent with this anti-market view. As an example, the very first thing that Brattle suggests is adopting price floors by Spring of 2013 for the 2015 mandatory capacity purchase. There is no more anti-market idea than mandatory bid floors or price floors. Adopting bid floors, which are *de rigueur* in virtually every mandated forward capacity market, sends the unmistakable message to the investors Texas hopes to attract: "Those who think they can build a better mousetrap are not welcome if their better ideas will threaten incumbents" and "You can compete, but only if you do not compete too hard and only if you compete just for load growth and not for the whole market." Brattle also suggests that the Commission issue a "policy statement" intended to substitute for a price floor, while still having the same anti-competitive effect. Despite Brattle's attempt to reject long-term price in the hope that a Commission policy statement will have the same discouraging effect on potential competitors, the Brattle presentation clearly presages that those price floors are likely to be sought and could be adopted in ERCOT (as they have in every other mandated forward capacity market). This is one of the most insidious aspects of mandatory forward capacity markets: incumbents are highly incentivized to succeed through investments in lawyers, consultants and lobbyists to obtain a very high, administratively determined CONE-based bid floor in order to maximize their rents and minimize the ability of new entrants to compete in the market. Market success does not come through competition in the market; rather it comes through competition in influencing the forward capacity market administrative proceedings. This mechanism necessarily shifts most of the risk of generation development back on to consumers. It is disingenuous to suggest that a system that mandates that consumers buy forward capacity at a systematically high administratively set price is somehow protecting consumers from the risk of paying for unnecessary capacity. The opposite is true.

OPM continues to support ERCOT's energy-only market design. OPM's support is based on its assessment that an energy-only market is the most efficient and least-complicated market design. It relies on natural market incentives rather than administrative interventions and mandates. The energy-only market rewards participants that are quicker, more efficient, and provide better quality service than their competitors. It also empowers all technologies, both emerging and established, to compete on an even playing field. In contrast to this, and in complete disagreement with Brattle's presentation, mandated forward capacity markets do not have this character. Imagine if fiber optic communication providers were told that they could not bid to enter the market at a cost less than what previous administrative proceedings, dominated by incumbent copper wire makers, had determined to be the "net cost of new entry" for a copper wire based communication provider. The examples could go on and on.

II. Conclusion

The reason that Texas chose to restructure the ERCOT electricity market is outlined in PURA. It was to unleash the forces of competition for the benefit of Texas. It was to reward entities that can operate more flexibly and reliably and provide resources when Texas needs them the most. It was to welcome those innovators—whether technical innovators or financial innovators—who can do things better, cheaper and faster. A mandated forward capacity market will instead result in a poorly constructed regulatory outcome that is entirely inconsistent with the reasons that Texas chose to move to a free market. Adopting a mandatory forward capacity market would be an exceedingly poor choice for Texas.

Contrary to the Brattle recommendation to quickly set a price floor and issue a "policy statement" on not welcoming low-cost competition into the ERCOT market, the Commission should instead make clear that it welcomes all comers to the ERCOT market and that the Commission does not intend to allow any mechanism to be put in place that would obstruct or disadvantage new investment in Texas.

For the foregoing reasons, OPM encourages the Commission to conduct its own, thorough examinations of all the options to maintain the current energy-only market and to take stock of the serious and very damaging consequences of implementing a mandatory forward capacity market in Texas.

Respectfully Submitted,

Tom Payton
Vice President
Occidental Power Marketing, L.P.