

Control Number: 40000



Item Number: 89

Addendum StartPage: 0

40000  
PROJECT NO. 37897

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PUBLIC UTILITY COMMISSION  
OF TEXAS

**COMMENTS OF THE ALLIANCE FOR RETAIL MARKETS IN RESPONSE  
TO QUESTIONS IN NOTICE OF WORKSHOP**

The Alliance for Retail Markets (ARM)<sup>1</sup> timely files these Comments in response to the questions included in the public notice of a workshop scheduled to convene on February 23, 2012 for the purpose of addressing proposed changes to P.U.C. SUBST. R. 25.504, relating to Wholesale Market Power in the Electric Reliability Council of Texas Power Region, and P.U.C. SUBST. R. 25.505, relating to Resource Adequacy in the Electric Reliability Council of Texas Power Region.

Most of the questions posed by the Commission solicit input from interested parties as to whether the Commission should modify certain provisions in the two rules. Other questions open-endedly request feedback regarding the need or desirability for other amendments to those rules. These Comments do not express a position in response to each of the seven questions in the workshop notice. ARM reserves the right, however, to file reply comments addressing other parties' proposals and recommendations submitted in response to any of the Commission's questions.

1. *How have the recent changes to the protocols that affect reliability deployments of ancillary services affected your views on your proposed changes to these rules?*

ERCOT revised nodal protocols relating to the deployment of ancillary services for reliability purposes in December 2011 and completed its implementation of those revisions early

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<sup>1</sup> The members of ARM in support of this filing are: Champion Energy Services, LLC; Constellation NewEnergy, Inc.; Direct Energy LP; GDF Suez Energy Resources NA, Inc.; and Noble Americas Energy Solutions LLC.

last month.<sup>2</sup> These revisions aim to mitigate the distortions in the real-time price of wholesale energy that occurred when ERCOT deployed ancillary services for the purpose of maintaining network reliability, *e.g.*, non-spin reserve service (NSRS). Empirical evidence demonstrated that improper price reversals in the real-time energy market followed the deployment of NSRS for reliability reasons. This ancillary service deployment occurs two steps before ERCOT declares an emergency event.<sup>3</sup>

To address this suppression of real-time energy prices at a time when resource scarcity is occurring, the recently adopted modifications of the nodal protocols incorporate the energy offer floors for on-line and off-line NSRS approved by the Commission at the October 27, 2011 open meeting. Mitigating the reversals in the real-time price of energy will improve the accuracy of the price signals communicating the need for new generation and other resource investment in the ERCOT power region and the economic viability of any such investment in the ERCOT wholesale market. ARM believes that these and other recent modifications to the nodal protocols relating to ancillary services used for reliability purposes constitute a step forward for a viable energy-only market in the ERCOT power region.

At this time, ARM has not formulated any specific proposals to modify either P.U.C. SUBST. R. 25.504 or P.U.C. SUBST. R. 25.505. Therefore, it cannot respond to this question directly. ARM recognizes the possibility, however, that amendments to those two rules could further advance the objective of a sustainable energy-only market in the ERCOT power region for reasons similar to or different from those justifying the recently approved nodal protocol

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<sup>2</sup> These protocol revisions require: (1) the routine release of certain on-line NSRS energy to Security-Constrained Economic Dispatch (SCED) without the need for an NSRS non-spin deployment instruction from ERCOT; (2) an Energy Offer Curve for on-line NSRS capacity equal to or greater than \$120; (3) an Energy Offer Curve for off-line NSRS capacity equal to or greater than \$180; and (4) an Energy Offer Curve set at the System-Wide Offer Cap (SWOC) for capacity reserved for Responsive Reserve Service (RRS) and Regulation Up (Reg-Up) upon ERCOT's reassignment of resource responsibility for those services.

<sup>3</sup> ERCOT Nodal Protocol 6.5.9.4.1(e).

revisions. In other words, it does not view the protocol revisions and possible amendments to the two rules as mutually exclusive.

Also, certain amendments to the rules could facilitate the participation of new generation and load resources in the ERCOT wholesale market in other ways. The ERCOT reserve margin is projected to barely exceed the targeted 13.75 percent level in 2012 and to decline significantly below the threshold target after 2013.<sup>4</sup> The paucity of new planned generation coming online in upcoming years is the major reason for these substandard reserve margin calculations. The likelihood of more extremely hot summers and continued drought conditions in the next few years only further exacerbates the situation. Given the significance of resource adequacy to the ERCOT market as a whole, ARM is open to reasonable, market-based proposals to expand the level of generation and demand-response resources included in the calculation of ERCOT's reserve margin through amendments to one or both rules.

Regardless of whether the Commission pursues amendments to P.U.C. SUBST. R. 25.504 and P.U.C. SUBST. R. 25.505, ERCOT should continue to vigorously monitor real-time energy prices in the wholesale market and identify the reasons for any remaining distortion of those prices. If sufficient and credible evidence demonstrates that a particular component in the operation of the ERCOT market is improperly affecting real-time energy prices, ERCOT should take immediate steps to address the price distortion using a market-based solution that keeps within the parameters of the energy-only market design.

2. *Should the Commission consider an increase in the System Wide Offer Cap (SWOC)? If so, on what schedule should any increase be implemented? What would be the likely impact on contracting decisions by existing and prospective generation owners, retail electric providers, electric cooperatives, municipally owned utilities and retail customers? What would be the impacts on forward price signals and would those impacts be conducive to the development of new generation capacity in the ERCOT market?*

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<sup>4</sup> Report on the Capacity, Demand, and Reserves in the ERCOT Region at 6 (Dec. 2011); Project No. 37897, *Proceeding Relating to Resource and Reserve Adequacy and Shortage Pricing*, ERCOT's Resource Adequacy Status Report at 2 (Jan. 18, 2012). ERCOT's most recent forecast calculates a 13.86 percent reserve margin for 2012.

P.U.C. SUBST. R. 25.505 establishes two versions of the SWOC: the low system offer cap (LCAP) and the high system offer cap (HCAP). Subsection (g)(6)(A) of the rule sets the LCAP each day at the higher of: (1) \$500 per megawatt-hour (MWh) and \$500 per megawatt (MW), or (2) 50 times the daily Houston Ship Channel gas price index of the previous business day, as expressed in dollars per MWh and dollars per MW. Subsection (g)(6)(D) sets the current HCAP in the nodal market at \$3,000/MWh and \$3,000/MW per hour.<sup>5</sup> Under subsection (g)(6)(E), the HCAP is the applicable SWOC in ERCOT's wholesale energy market beginning on January 1 of each year, the starting date of the annual resource adequacy cycle. The HCAP serves as the offer cap during the annual resource adequacy cycle (i.e., the calendar year) until the peaker net margin (PNM) equals or exceeds \$175,000 per MW. (This PNM threshold is further discussed in response to Question No. 4.) In such an event, the SWOC is reset at the LCAP for the remainder of the annual resource adequacy cycle.

Technically, the HCAP or the LCAP may serve as the SWOC under P.U.C. SUBST. R. 25.505(g)(6). ARM interprets the term "SWOC" in this question, however, to refer only to the HCAP, rather than both possible offer caps.<sup>6</sup> The initial inquiry in Question No. 2 asks whether the Commission should increase the HCAP to a specified level. In ARM's view, the continued mitigation (and ultimate elimination) of any distortions in the price of real-time energy in the wholesale market takes priority over any arbitrary upward adjustment of the HCAP. Regardless of the price at which the HCAP is set, any distortion of real-time energy prices in the wholesale market will impede the accurate reflection of scarcity pricing during resource shortage periods. In other words, if the real-time price of energy is suppressed or dampened, scarcity pricing is compromised regardless whether the HCAP is based on a value of \$3,000 or a higher dollar amount.

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<sup>5</sup> P.U.C. SUBST. R. 25.505(g)(6)(B)-(D) established a staggered schedule in which the HCAP increased over time. Beginning March 1, 2007, the HCAP was based on a value of \$1,500/MWh. It increased to \$2,250/MWh on March 1, 2008. It subsequently increased to the current value of \$3,000 MWh two months after the opening of the nodal market.

<sup>6</sup> This interpretation is based on Question No. 3, which asks whether the Commission should increase or eliminate the LCAP and its accompanying triggering mechanism in P.U.C. SUBST. R. 25.505(g)(6)(E). Reading Question No. 2 to apply only to the HCAP avoids overlapping responses to the two questions.

For example, an HCAP of \$2,250/MWh served as the ERCOT offer cap in 2010. The ERCOT power region experienced 66 shortage intervals in the first eleven months of that year. Although shortage conditions existed during those periods, the price of real-time energy set for each of those intervals varied significantly. In fact, the majority of the real-time energy prices reflected the marginal offer of the most expensive generation resource dispatched, as opposed to the value of foregone operating reserves that one would expect to establish the market-clearing price of energy under such circumstances. Furthermore, the clearing price of real-time energy based on an offer submitted by a market participant exceeded \$1,000/MWh in only one of those intervals in 2010.<sup>7</sup> Stated another way, no submitted offer during those shortage periods approached the applicable SWOC of \$2,250/MWh.

As another point of reference, the ERCOT-wide average energy price in the day-ahead market substantially increased in August 2011 in contrast to other months in the year, as one might expect. Indeed, compared to the preceding month, it nearly quadrupled. The ERCOT-wide average energy price in the real-time market, however, did not experience a similar proportional increase. At \$60/MWh, this system-wide price average does not comport with level of scarcity pricing one might expect to occur during the state of emergency that lasted a number of days last August.<sup>8</sup> In that month alone, ERCPT issued six energy emergency alerts, two of which proceeded to the second level of emergency.<sup>9</sup>

On its face, this data for the years 2010 and 2011 does not support an increase in the HCAP. Rather, it justifies keeping the HCAP at the current level today, given the infrequency and limited duration of the instances in which this offer cap set clearing prices in the real-time energy market. In ARM's view, the duration of the HCAP's function as the clearing price-

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<sup>7</sup> 2010 State of the Market Report for the ERCOT Wholesale Electricity Markets at 54-55, Figures 38 and 39 (August 2011).

<sup>8</sup> ERCOT Wholesale Electricity Market Monthly Report at 1 (Jan. 9, 2012).

<sup>9</sup> External Affairs Update, ERCOT Board of Directors Meeting (Oct. 18, 2011).

setter—and not the dollar amount reflected in the HCAP—is the more crucial element of this “primary” offer cap in P.U.C. SUBST. R. 25.50(g)(6). A longer duration period increases the level of net revenues reflected in the price signals communicated to generation and other resource entities in a more efficient and meaningful manner than a simple adjustment to the HCAP itself. Accurate price signals in the ERCOT real-time energy market will lengthen the duration of time in which the HCAP sets the clearing price because those unhindered signals will reflect scarcity pricing in periods of resource scarcity.

Again, ARM asserts that the Commission, ERCOT, and stakeholders should focus their time and resources today on the critical objective of accurate price signals in the real-time energy market. Unless those prices appropriately rise or spike during periods of resource scarcity, the question of whether to increase to the HCAP is irrelevant. Absent convincing evidence that an increase to the HCAP will improve the accuracy of price signals in ERCOT’s real-time energy market or serve some other legitimate goal, the HCAP should remain at \$3,000/MWh for the time being.

If inaccurate or confusing price signals continue to occur through the summer of this year despite the steps taken to mitigate price distortions in the real-time energy market, the Commission should comprehensively review the manner in which P.U.C. SUBST. R. 25.505 establishes caps on both energy and capacity offers in the competitive wholesale market. This would entail a review of the HCAP and the LCAP (including the PNM threshold). Given ARM’s position on the issue regarding an increase to the HCAP, it does not address the remaining inquiries in Question No. 2.

3. *Should the Commission raise or eliminate the Low System Offer Cap (LCAP) and its triggering mechanism? If so, on what schedule should the change be implemented? What would be the likely impact on contracting decisions by existing and prospective generation owners, retail electric providers, electric cooperatives, municipally owned utilities and retail customers? What would be the impacts on forward price signals and would those impacts be conducive to the development of new generation capacity in the ERCOT market?*

4. *Does the Scarcity Pricing Mechanism that uses the Peaker Net Margin to monitor the adequacy of price signals to bring new generation to the ERCOT market still have value? Are other changes needed in P.U.C. SUBST. R. 25.505 (g)(6)(E) to give better data about whether the market design allows for adequate revenues to cover the cost for new entry?*

ARM addresses these two questions in tandem in light of the relationship between the LCAP and the PNM threshold in the establishment of the SWOC pursuant to P.U.C. SUBST. R. 25.505(g)(A) and (g)(E). ARM supports modification of these elements of the "secondary" SWOC if retained in P.U.C. SUBST. R. 25.505. In the six years since the Commission codified by rule the ERCOT offer cap in Project No. 31972, the LCAP has never acted as the SWOC. Consequently, there is no history or experience upon which to rely in evaluating either the operation of the LCAP or its effectiveness in terms of its intended purposes. Simply dismissing the LCAP on these grounds, however, is unreasonable in view of its potential utility in the future. The combination of ERCOT's implementation of corrective measures aiming to achieve more accurate price signals in the wholesale market and its execution of other market-based measures promoting resource adequacy will increase the likelihood of triggering the LCAP's role as the SWOC in the future.

Furthermore, the intended purposes of this secondary mechanism in establishing the SWOC should be reviewed to determine whether they make sense in today's wholesale market. In adopting the provisions in subsection (g)(6) that address the manner in which the SWOC is established, the Commission stated that "an important purpose of the LCAP is to prevent excessive transfers of wealth from load to generation during years when reserve margins are thin." Although no hard data exists with respect to the manner in which the LCAP operates or its impact on other elements of the wholesale market, such matters relating to this administrative pricing mechanism should also be examined. As the Commission observed, the LCAP should be set at a level that "will permit most generating units in the market to operate profitably under the cap" and will "provide incentives for generation and load resources to respond to shortage

conditions in the remaining portion of the annual resource adequacy cycle when the PNM has exceeded the \$175,000 per MW threshold.”<sup>10</sup>

Finally, the threshold level required to trigger the change in the SWOC must be thoroughly reviewed. As stated earlier, the current rule requires the PNM to reach a cumulative total of \$175,000/MW in the calendar year before triggering the LCAP’s role as the SWOC. This PNM threshold is intended to measure the annual net revenue of a hypothetical peaking unit in ERCOT, as calculated pursuant to P.U.C. SUBST. R. 25.505(g)(6)(2)-(4). The PNM reached a cumulative total of \$125,000 in 2011, the highest level reached since its inception.<sup>11</sup> Still, this amount significantly fell short of the requisite amount of \$175,000/MW to trigger the automatic designation of the LCAP as the SWOC. While the administratively-established trigger of \$175,000/MW appeared unattainable in the last six years for the reasons stated, a new threshold level may be necessary if a modified version of the LCAP (including use of the PNM threshold) is retained in P.U.C. SUBST. R. 25.505. Case in point: based on estimates of investment costs for new units, the IMM has calculated the annualized net revenue requirement for a new gas turbine’s entry in the ERCOT wholesale market in 2010 as approximately \$80,000 to \$105,000 per MW-year.<sup>12</sup>

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<sup>10</sup> Project No. 31972, *Rulemaking on Wholesale Electric Market Power and Resource Adequacy in the ERCOT Power Region*, Order Adopting Amendment to §25.502, New §25.504 and New §25.505 as Approved at the August 10, 2006, Open Meeting at 121 (Aug. 23, 2006).

<sup>11</sup> ERCOT Wholesale Electricity Market Monthly Report at 10 (Jan. 9, 2012).

<sup>12</sup> 2010 State of the Market Report for the ERCOT Wholesale Electricity Markets at 45, 48-49, Figures 33, 35 (August 2011).

5. *Should the Commission consider an increase in the amount of generation owned by a single generation entity in order for the entity to qualify for the exemption listed in P.U.C. SUBST. R. 25.504(c)? Should the Commission consider excluding new generation installed by an entity after January 1, 2012 in the calculation prescribed by that subsection?*

ARM does not have a position on these issues at this time. It reserves the right to file reply comments addressing other parties' proposals and recommendations submitted in response to this question.

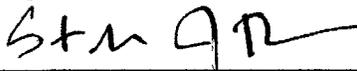
6. *Would the creation of a "safe harbor" with respect to a level of pricing that would not constitute an offer "substantially above... marginal cost" according to P.U.C. SUBST. R. 25.504(d) provide benefits to the marketplace? If so, what should be the form and level of that "safe harbor"?*

ARM does not have a position on these issues at this time. It reserves the right to file reply comments addressing other parties' proposals and recommendations submitted in response to this question.

7. *Are there other changes to P.U.C. SUBST. R. 25.504 that would be conducive to ensuring that the market effectively signals and is conducive to the development of new generation capacity in the ERCOT market?*

At this time, ARM has not formulated any specific proposals to modify either P.U.C. SUBST. R. 25.504 or P.U.C. SUBST. R. 25.505. It reserves the right to file reply comments addressing other parties' proposals and recommendations submitted in response to this question.

Respectfully submitted,



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