PROJECT NO. 40000

COMMISSION PROCEEDING RELATING TO RESOURCE ADEQUACY IN THE ELECTRIC RELIABILITY COUNCIL (ERCOT) POWER REGION OF TEXAS	**§ § §**	**PUBLIC UTILITY COMMISSION OF TEXAS**

COMMENTS OF THE TEXAS PUBLIC POLICY FOUNDATION FOR COMMISSION WORKSHOP

Introduction

Texas moved to a competitive electricity market over a period of about 12 years, from 1995 to 2007. The results have been amazing: billions of dollars of new investment in generation, lower prices, and a high level of reliability with robust reserves.

In fact, Texas today has the most competitive electricity market in the United States, if not the world. Robert Michaels attributes the success to the fact that "Texas did not 'design' a retail market in any meaningful sense—it instead set general rules for [market participants] and allowed them to compete as they wished within those rules."

Though the market has been great success, it hasn't always been pretty. Some segments of industry have had a rocky time of it. That, however, isn't surprising. Consumers were in part paying higher prices in the regulated market to provide guaranteed returns for the industry. Without those returns, businesses must compete, and some are competing more successfully than others.

Additionally, the market has become much more efficient, especially after the transition to nodal. Profits are harder to come by, and some fear this means that consumers will soon experience more of the pitfalls of competition. Thus as private sector investment slows, we have calls for the government to step in and once again raise prices to provide reliability.

Except that it is the government, not the market, that is the main source of any problems facing Texas today. And since the market has become more efficient each year it has operated, government intervention is having a bigger impact than in the past.

When we take the regulations/subsidies that exist in this market—the federal production tax credit, the state renewable portfolio standard, market power regulation, the state's energy efficiency program, the high system-wide offer cap, PUC approval of mergers and acquisitions, federal environmental laws, PUC disgorgement authority, etc., it is no surprise that the outcomes of this regulated market fail to satisfy.

The answer is not to increase intervention—as proposed by the Brattle Group (Brattle), but to reduce it. In other words, let's let Texas' world class electricity market work as planned. In particular, we shouldn't abandon Texas' energy-only market, where investors rather than consumers bear the market risk.

Reliability Concerns Need Closer Examination

The record shows that we don't need a capacity market. For instance, Texas' growing population and economy combined with record high temperatures and drought in 2011 strained the electricity grid. But it didn't break, despite the harsh conditions and record load from a 50-year weather event. The market worked, supplying all the electricity Texans needed.

Though Texas made it through 2011, there have been concerns expressed that projected reserve margins will put us in danger again as early as 2014. It is true that investment in new generation has slowed in Texas. But a recent reserve margin analysis update by ERCOT shows a much healthier future supply of electricity than had previously been predicted. ERCOT forecasts feature reserve margins at or above 10 percent through 2018. The reserve margin for 2013 is 16.4 percent and is 13.4 percent for 2014.

ERCOT Reserve Margins 2013-18

	2013	2014	2015	2016	2017	2018
May 2012 Forecast	14.3%	9.8%	6.9%	6.5%	5.8%	5.8%
Oct. 2012 Forecast	16.0%	12.1%	9.7%	9.9%	9.8%	10.4%

Source: ERCOT Resource Adequacy Update October 2012

The new forecast is better for two reasons. First, it includes new generation announced since the last update; most notably those projects announced since the recent increase in the high system wide offer cap (HCAP). Second, ERCOT uses a much better economic forecast—Moody's 2011 Low Economic Forecast—to estimate increases in feature load.

The previous forecast suggested that load would increase by 4.2 percent in 2014 and by 4.8 percent in 2015. This is a very aggressive forecast based on projections that nonfarm employment growth in Texas would increase each year by over 400,000; a level that was not reached even during the boom years of the middle of last decade.

As noted, the resulting reserve margins through 2018 are significantly improved. However, a closer look at the numbers show that it is possible that the reserve margins through 2018 actually might be above the 13.75 percent target.

By adding in potential resources not included in the ERCOT report, i.e., mothballed units and the remaining 50 percent of the non-synchronous ties, this could increase available resources on average by 2400 MW through 2018. Taking this into account, future reserve margins look like this:

ERCOT Reserve Margins 2013-18

	2013	2014	2015	2016	2017	2018
May 2012 Forecast	14.3%	9.8%	6.9%	6.5%	5.8%	5.8%
Oct. 2012 Forecast	16.0%	12.1%	9.7%	9.9%	9.8%	10.4%
Oct. 2012 Forecast Plus	20.63%	17.77%	15.59%	16.06%	15.37%	14.29%

Source: ERCOT Resource Adequacy Update October 2012 and calculations of the author

If this is the case, the lack of a recent investment in new generation begins to make sense from a market perspective. Prices and thus investment are not depressed because the market is broken. Instead, prices are sending the appropriate signal to investors that expensive new generation is not needed because the load can be handled more efficiently through existing resources, even if this means bringing mothballed plants back online.

We don't claim that future reserves will for certain exceed the target or that there are no challenges in the ERCOT market; indeed, we believe that there are significant challenges to be met—especially challenges brought about by excessive government intervention into the market. These numbers do, however, call into question claims that we need to abandon Texas' world-class, energy-only electricity market and replace it with a capacity market that would bring northeastern-style regulation to Texas.

Brattle may claim that a capacity market will provide more reliability than the demand response alternative it presents. However the immense complexity and regulatory risk inherent in capacity markets suggest that they would have a hard time matching the robust record of reliability to date of Texas' energy-only market. Additionally, capacity markets have not proven in practice to be a panacea for reliability. Finally, importing this model to Texas presents even more challenges since capacity markets in the U.S. have generally not experienced the load growth that is occurring in Texas due to our nation-leading economic growth.

Who Should Set Reserve Margins?

Going beyond an examination of which market type can best meet our reserve margin targets, we must ask; is the 13.75 percent target set by the ERCOT board is the proper reserve margin for the state? Furthermore, we should examine whether the state should be setting the reserve margin in the first place.

Much has been made of the fact that Texas could experience "potential electricity shortages within the coming decade as electric use in Texas continues to hit new records." It is important to remember, though, that these concerns were expressed in the context of ERCOT's forecast that Texas would have actually enough electricity to meet the projected load through the rest of this decade (see ERCOT's May 2012 Capacity, Demand and Reserves (CDR) report).

The concerns over "potential electricity shortages" stem from the fact that future generation sources may not be adequate to meet projected demand plus the administratively set 13.75 percent safety margin. It is quite possible, however, that the reserve margin is set higher than needed to ensure reliability.

Until recently, the reserve margin was set at 12.5 percent. Then in 2010, ERCOT increased the target to its current level in part due to the instability that wind has introduced into the system. Past forecasts have usually shown projected supplies unable to keep up with forecast demand plus the reserve margin. However, to date, supply always been adequate to meet demand.

One of the first decisions the Public Utility Commission of Texas (PUC) may make is whether the state should make the reserve margin the hard target—in other words, should the PUC mandate that enough generation be in place to maintain a reserve margin set by the state. In one sense, this may be the most important decision that the PUC makes. If the PUC sets a hard target the energy-only market cannot survive in its current form. It would be a mistake for the PUC to do this.

For one thing, as seen above, it is unclear that the projections of future shortages are accurate. Additionally, it may be that participants in the marketplace do not believe that reserve margins in the future need to be as high as 13.75 percent. This is particularly true in light of the smart meter infrastructure in place and the innovations taking place in the market today when it comes to shedding load. It could be very soon that market participants, policymakers, and regulators are much more comfortable with a lower reserve margin because of the enhanced ability to shed load.

However, whether it is comfortable or not, the only way to maintain Texas' energy-only market is to let market participants set the reserve margin. Fortunately, the marketplace has a strong record of maintaining adequate reserve margins.

Market Distortions Caused by Government Intervention

As already noted, there are some significant challenges to be dealt with in ERCOT. While there are certainly market structure improvements they can be made, the truth is that ERCOT is a remarkably efficient market. Its greatest challenges today stem from government intervention. Renewable energy is one example.

Between the Texas renewable portfolio standard (RPS) and the federal production tax credit (PTC), wind generators receive more than $20 per megawatt in government subsidies, enabling generators to make a profit even if they give away their electricity for free. This doesn't make the electricity any cheaper for consumers, who pay for wind energy through higher taxes instead of their electricity bills. We estimate that renewable energy subsidies in Texas (the PTC, renewable energy credits (RECs), and CREZ construction costs) will cost $6.9 billion from 2006 through 2015.

The subsidies also distort the market by pushing overall electricity prices lower. This in turn reduces the revenues that generators need to make investments in new supply. Wind-generated electricity also does little to make up for the reduction in conventional generation. A recent week, wind provided barely 0.5 percent of the electricity used during peak demand.

Renewable energy subsidies help no one beyond investors and workers in that industry. The federal PTC is scheduled to end this year. Though the renewable energy industry is making a strong push to renew it, the PTC should end. Combining this with repeal of the Texas RPS next year would solve a significant part of Texas' resource adequacy problem.

Another intervention leading to reduced investment has been various forms of price regulation. As Texas moved into full-scale competition, fear of consumer angst over high prices has led regulators to gradually increase regulation of wholesale prices.

This began with claims of market power abuse, based on the theory that there is something wrong with selling electricity. Then a "shame cap" on wholesale prices was introduced, using publicity to shame companies into selling electricity at a loss. Finally, there was the hard high system-wide offer cap (HCAP) we have today.

The problem with the cap is that it reduces prices at times of peak demand, when electricity is the most expensive to produce. If generators can't sell electricity at a profit at times of peak demand, they won't build generation plants that will supply electricity when we need it most. The PUC recently took a good first step in raising the price cap, but should take the next step and eliminate it.

We must also reduce the ability of PUC to regulate prices through other means, such as spurious claims of market power abuse, its recently enacted power to disgorge revenues, and current proposals to increase its fines and issue emergency cease-and-desist orders.

These regulatory actions are all based on highly questionable theories about prices in perfect markets that don't exist. Regulators apply them haphazardly in real life and introduce a high level of regulatory risk in Texas markets. It makes perfect sense that investors move billions of dollars in capital from Texas to other states where they can get more predictable returns because of less regulatory uncertainty.

Conclusion

About the turn of the century, California pretended to have a deregulated electricity market, but it was really a poorly-designed, government-controlled system that eventually collapsed under its own weight. Texas' economy is outperforming California's and the rest of the country because we did not follow California's lead. This is why Texas has the most competitive and successful electricity market in the United States, if not the world.

Calls to "fix" Texas' electricity market with more government and ending our energy only, i.e., free-market, approach to generating electricity won't help—in fact, they will make electricity more expensive for consumers and make our market look more like California's. It would be unfortunate if we lost perhaps the world's best example of introducing competition into electricity markets. If we let it work, the world-class Texas electricity market will power Texas' future.

Here is a summary of the Foundation's recommendation to maintain, protect, and enhance Texas' world-class, energy-only electricity market:

- The Texas Legislature and the PUC should reject the Brattle Group's recommendations for increased market intervention through demand response programs and for a capacity market
- The PUC should not mandate a hard reserve margin target
- The PUC should eliminate the high system-wide offer cap; in the short-term, the PUC should take action this week to raise the cap to $9,000
- The PUC should more closely examine the ability of current total and potential resources and innovative, market driven demand response to meet projected demand.
- Eliminate renewable energy subsidies:
    - the Texas Renewable Portfolio Standard
    - the federal Production Tax Credit
- Redefine the concept of market power abuse to eliminate the bias against pricing electricity above marginal cost
- Determine whether the price distortions caused by the deployment of Non-Spinning Reserve Services could be best addressed by eliminating the service
- Eliminate/Oppose existing and proposed certain PUC authority:
    - Ability to approve mergers and acquisitions
    - Ability to disgorge revenue
    - Proposed emergency cease and desist authority
    - Proposed increase in fines

Respectfully Submitted,

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