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REPORT OF THE ELECTRIC
RELIABILITY COUNCIL OF TEXAS
(ERCOT) TO THE PUCT REGARDING
IMPLEMENTATION OF THE ERCOT
PROTOCOLS

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PUBLIC UTILITY COMMISSION
OF TEXAS
FILING CLERK

COMMISSION STAFF'S RESPONSE TO COMMENTS ON STAFF REPORT¹

Pursuant to Order No. 17, parties filed comments on Staff's report, Application of Competitive Solution Method to Data from ERCOT Ancillary Capacity Services, filed on October 11, 2002 (Report). Staff files this response to those comments.

TXU reiterated its argument that the Competitive Solution Method (CSM) is not needed, saying that it would distort legitimate price signals and add an element of unpredictability that market participants would not be able to hedge. The empirical evidence brought out in Staff's Report suggests the opposite conclusion, however. CSM is designed to leave legitimate price signals untouched; mitigation occurs only when the market is not competitive, in which case the unmitigated price signals would not be legitimate. In the study, \$999/MW per hour price spikes that were due solely to the action of a pivotal bidder were mitigated. When non-pivotal bids also reflected high prices, CSM did not mitigate. Thus, the market would in fact be less erratic under CSM because price spikes due to anticompetitive manipulation would be significantly less probable. In the instance where CSM mitigated a relatively low price, the Staff Report pointed

¹ This pleading uses the following abbreviations: Austin – City of Austin; Austin Energy – City of Austin; Commission – Public Utility Commission of Texas; CSM – Competitive Solution Method; DOJ – Department of Justice; ERCOT – Electric Reliability Council of Texas; FERC – Federal Energy Regulatory Commission; FTC – Federal Trade Commission; MCPC – market clearing price of capacity; MW – megawatt; NYISO AMP – New York Independent System Operator Automated Mitigation Procedure; OOM – out of merit order; OPUC – Office of

out a simple change to the methodology that would eliminate any mitigation at low price levels: mitigate only if the mitigation would result in a reduction in the MCPC of some minimum amount, for example \$50.²

OPUC commented that, in addition to the ex ante CSM, the Commission should use ex post methods to curb the exercise of market power.³ Staff agrees that ex post methods should remain an option. However, ex ante methods are preferred, because ex post methods add uncertainty to the market and are resource intensive.⁴ OPUC also commented that the Commission may wish to adopt a market monitor that would apply market power mitigation measures.⁵ The Commission's Market Oversight Division is the market monitor for ERCOT, and it has proposed CSM as a market power mitigation measure. Finally, OPUC suggested that the OOM floor payments in the Protocols may be too generous.⁶ This issue is outside the scope of this docket.

ERCOT pointed out that CSM would not consistently mitigate all price spikes.⁷ This observation is correct. The goal of CSM is not to mitigate all high prices. CSM discriminates between high prices occurring in a healthy market, and high prices occurring under anticompetitive conditions. If the intent were to mitigate all price spikes regardless of the cause, a low bid cap would be a simpler tool. Staff believes a \$1,000 cap on bids is appropriate as an absolute limit. Below that level, however, there is a need to distinguish between "good" price spikes and "bad" price spikes, and that is what CSM is designed to do.

Public Utility Counsel of Texas; Staff – staff of the Public Utility Commission of Texas; TXU – TXU Energy Trading Company LP and TXU Energy Retail Company LP.

² Report, p. 19, second bulleted paragraph.

³ OPUC comments, p. 3, first full paragraph.

⁴ Staff initial brief (1/25/02), p. 12, first paragraph.

⁵ OPUC comments, p. 3, first full paragraph.

⁶ OPUC comments, p. 3.

Combining caps with automatic mitigation measures such as CSM in the manner advocated by Staff is identical to what FERC has set forth in its proposed Standard Market Design.⁸ Moreover, FERC recognizes that automatic mitigation measures should be tailored to the needs, circumstances, and structure of each region. CSM is an automatic mitigation tool specifically designed to address potential anticompetitive behavior in ERCOT.

In its comments, Austin Energy drew conclusions from the Report that continue arguments it has made throughout this docket. There are important shortcomings in the logic behind its conclusions, however. For example, Austin asserted that the short duration of most price spikes during the study period “appears to show that the market resolved most price spikes in short order.”⁹ But as Staff’s report pointed out,¹⁰ and as Austin itself acknowledged later in its comments,¹¹ there was in fact no hour-to-hour price response because all bids are submitted in the day-ahead market. Even if the real-time market clears at a price of \$999, bids for the following interval are already set and cannot be changed. The day-ahead bidding process does not provide for observing the results of a one hour interval, and modifying bids in the next.

A bidder with market power could in fact take advantage of this absence of immediate price responsiveness. A pivotal bidder can change its bid for one or two intervals in hopes of causing a one or two-hour price spike and hitting the jackpot. Moreover, a short-lived price spike is less likely to attract more capacity; sustaining the strategy for several hours increases the chance of attracting additional capacity in subsequent day-ahead markets, making it harder to hit

⁷ ERCOT comments, p. 4, first paragraph.

⁸ Federal Energy Regulatory Commission, Notice of Proposed Rulemaking, Remedying Undue Discrimination through Open Access Transmission Service and Standard Electricity Market Design, Docket No. RM01-12-000 (July 31, 2002), p. 223-4 and 231-2.

⁹ Austin comments, p. 5, second paragraph.

¹⁰ Staff Report, p. 5, last paragraph.

¹¹ Austin comments, p. 7, last paragraph.

the jackpot. Thus, Staff submits that the same empirical results pointed out by Austin in fact demonstrate how one type of gaming could take place and how it could be prevented by CSM.

Austin discussed the non-spinning reserve service price spike of April 29-30, 2002 and asked whether CSM would have called for mitigation had simultaneous selection of ancillary services been in effect.¹² Staff believes that simultaneous selection would have reduced the non-spin MCPC to something much less than \$999, and that this could have been sufficient to avoid further mitigation. If so, however, it would be incorrect to conclude that simultaneous selection would serve the same purpose as CSM. Staff argues that simultaneous selection, CSM, and bid caps work together to protect the market from a variety of market aberrations. Simultaneous selection significantly improves allocative efficiency; CSM guards against price manipulation by pivotal bidders and through “hockey stick” bids; and bid caps provide fail-safe protection against a run-up in prices. All three are necessary.

Austin also cited the non-spinning reserve service price spike of April 29-30, 2002 for the proposition that the market will respond with increased supply the day after a price spike that results from increased procurement by ERCOT.¹³ However, there is no reason to allow price gouging for the first day that ERCOT’s procurements rise sharply. Under CSM, if the Competitive Sufficiency Test is not met, ERCOT will post an indicative price and extend the closing of the day-ahead market for one hour to allow the market to respond.¹⁴ Furthermore, during times of tight supply due to resource forced outages, the market will be unable to adequately respond.

¹² Austin comments, p. 12, second paragraph.

¹³ Austin comments, p. 9.

¹⁴ Staff initial brief (1/25/02), p. 17.

Austin cited the DOJ's and FTC's definition of market power: "the ability profitably to maintain prices above competitive levels for a significant period of time."¹⁵ Austin suggested that CSM applies a definition of market power that covers too short a period of time.¹⁶ Austin's suggestion is erroneous, because it ignores the unique features of current electricity markets – the essential nature of the service; the short-run inelasticities of both demand and supply; the inability to cost-effectively store supply; and the need to balance demand and supply in real time – that make them particularly susceptible to market failure.¹⁷ Furthermore, although Austin cited the general definition of market power developed by two federal agencies, the federal agency that oversees electricity markets – FERC – has endorsed market power mitigation measures that are applied on a settlement interval by settlement interval basis like Staff's CSM.¹⁸

ERCOT asked three clarifying questions regarding application of CSM in the context of simultaneous selection of ancillary services.¹⁹

- *Whether it is the intent of MOD's proposal to re-solve all markets in the event the Competitive Sufficiency Test conditions are not met for a single service.*
 - ERCOT is correct in surmising that if the Competitive Sufficiency Test fails in any one overlapping market (regulation up, responsive reserve, or non-spinning reserve services), all three would be resolved consistent with CSM.
- *Whether the removal of the pivotal bidder for one service would remove the bidder from the bid stack for other services in the event of simultaneous selection.*
 - Again, ERCOT's interpretation is correct. In calculating the MCP Limit, a bidder who is pivotal in one capacity market is not necessarily pivotal in an overlapping market. If the Competitive Sufficiency Test were to fail, the bidder would be removed when calculating the MCP Limit for the market in which the bidder was pivotal, but would remain in the calculation for markets where the bidder was not pivotal.

¹⁵ Austin comments, p. 13, fn. 9.

¹⁶ Austin comments, p. 12, last paragraph.

¹⁷ Staff reply brief (2/15/02), p. 20; Staff initial brief (1/25/02), p. 14.

¹⁸ See OPUC comments, p. 31, last sentence; Staff's 10/23/02 filing concerning NYISO AMP.

¹⁹ ERCOT comments, p. 5.

- *As described in Staff's Initial Brief, the application of the MCP limit process is applicable to "all procured quantities selected out of the unadjusted bid stack in order of ascending bid price, including quantities from pivotal bidders with bids lower than MCP." This seems to indicate that capacity from a pivotal bidder offered below the MCP calculated through the process envisioned by the Commission might be "put back" into the bid stack. How would this work with the simultaneous selection process?*
 - Strictly speaking, the pivotal bidder's quantity is never removed from the stack; it is removed from the calculation to derive the MCP Limit. Once the MCP Limit is determined, all offer quantities below the MCP limit – pivotal or not – are struck as they normally would be struck, and would be paid the MCP limit. As to the remaining quantity needed after the bids below the MCP Limit are struck, bids priced above the MCP Limit are treated the same as capacity not bid but available. Available capacity is OOMed and paid the higher of their costs or the marginal price corresponding to 90% of the quantity procured from the bid stack.²⁰

Elsewhere in its brief, ERCOT concluded that CSM "makes no check to see whether the minimum of the MCP limit or the marginal bid from the unadjusted bid stack ... is below what the MCP would have been were the bids from the pivotal bidder allowed to be included in the determination of the MCP."²¹ This is incorrect. In fact, the final step in CSM is to see if the MCP Limit is higher or lower than the original MCP; if the MCP Limit is higher, the unadjusted MCP would stand.²²

ERCOT said that its understanding is that the Competitive Sufficiency Test includes a step to "[e]nsure that the MCP is not set by a 'pivotal bidder' by removing pivotal bidder's capacity...." To clarify, the *test* merely *identifies* the bidder who set the MCP and asks whether that bidder was pivotal that hour in that capacity market. The test does not prevent the MCP from being set by a pivotal bidder; instead, it indicates whether to calculate an MCP Limit. In

²⁰ Staff initial brief (1/23/02), p. 18; Staff Report, p. 2, fn. 2.

²¹ ERCOT comments, p. 3, last sentence.

²² Staff Report, p. 18, first paragraph.

fact, the MCP can be set by a pivotal bidder as long as the bidder's offer price is in line with offers from nonpivotal bidders.²³

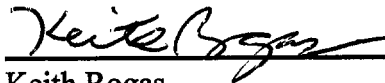
In its briefs, Staff explained the rationale and justification for CSM. In its Report, Staff applied CSM to actual data, which confirmed the merit of CSM, as further evidenced by this response to the comments on the Report.

²³ Staff initial brief (1/25/02), p. 18, first paragraph.

Dated: December 13, 2002

Respectfully Submitted,

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CERTIFICATE OF SERVICE

I, Keith Rogas, certify that copies of this document will be served on all parties on December 13, 2002, in accordance with Public Utility Commission of Texas Procedural Rule 22.74.



Keith Rogas