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**RELIANT RESOURCES, INC.'S RESPONSE TO  
STAFF PROPOSAL OF MARCH 18, 2003**

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**March 20, 2003**

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**RELIANT RESOURCES, INC.'S RESPONSE TO  
STAFF PROPOSAL OF MARCH 18, 2003**

On March 18, 2003, Staff issued recommendations related to the bidding behavior for the balancing energy market which appear to be shaped by the events of the week of February 24. Staff also re-urges its recommendation for the ancillary services markets. Reliant Resources, Inc. (RRI) understands that these recommendations may be considered at the Open Meeting on March 21. As explained below, Staff's proposed recommendation would drastically affect the design of the ERCOT market, and implementation of the recommendation will have numerous negative consequences that must be considered. It is important for the Commission and the market participants to be afforded the ability to discuss these recommendations, alternatives to the recommendation, the impacts of the recommendations and alternatives, and whether any changes need to be made at all.

RRI submits that two independent processes should be undertaken. First, if the Commission is concerned that there may have been market power abuse during the week of February 24, the Commission should initiate an investigation and determine whether or not any participant exercised market power abuse. Separately, the Commission can initiate a project to gather information on the pricing of balancing energy service and ancillary services and the interrelationship of that pricing with the underlying design of the ERCOT market and allow market participants to contribute their views on this important subject matter. In support of its request that the Commission refrain from implementing Staff's recommendations and separate these issues into two, distinct processes RRI submits the following:

## **Revising the Bidding Process for Balancing Energy Service and Ancillary Services**

Staff's recommendations appear to be a reaction to a result, higher prices for balancing energy services than Staff believes should have occurred, not a root cause. The recommendations are clearly driven by an assumption that it is inappropriate for balancing energy prices to rise absent a change in marginal fuel cost.<sup>1</sup> In fact, Staff appears to believe that even in extreme scarcity when the last megawatt available is deployed, prices should only reflect changes in marginal cost, not the value of power to customers.<sup>2</sup> There appears to be no appreciation of the possibility that high prices may be a reflection of a single energy price market working as it was designed. In such a market, in periods when capacity is scarce prices should rise toward the value of electric service to customers.

Given that the design of the ERCOT market is currently a single price energy market, Staff's recommendation represents an ad hoc change to the design and therefore would lead to many undesirable consequences. In isolation, mitigating prices to short-run marginal costs in a single price energy market such as ERCOT: (1) harms generation adequacy over time, (2) eliminates incentives to commit units in time to be available for the real-time market, (3) encourages market participants to lean on the balancing market instead of contracting bi-laterally, and (4) increases credit risk issues. Since the Staff's proposal was first published on March 18 for consideration only 3 days later, there has not been time to fully develop each of these issues. Given the ripple effects of changes to fundamental design elements of market design, market participants must have the opportunity to address these recommendations before they are considered for implementation by ERCOT.

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<sup>1</sup> "[A] modified form of the Competitive Solution Method...would have mitigated these spikes to a level more in line with the *increase in fuel costs* that occurred during the cold weather event." March 18 memo from MOD to Commissioners (emphasis added).

<sup>2</sup> "If another extreme weather event were to increase system load beyond ERCOT forecasts, the amount of UBES required could again exhaust the eligible bid stack. Hockey stick bidding is most likely to harm the market under such conditions: the last megawatt is deployed, yet the bid price of the last megawatt is abnormally high due to strategic bidding *rather than to changes in marginal costs*." March 18 memo from MOD to Commissioners (emphasis added).

## **Design Change and Market Power Abuse**

RRI maintains that it is premature to assume that the market is flawed and that additional price mitigation measures are necessary simply because prices were higher than marginal fuel cost for a short period of time. When they are logical reactions to economic conditions being faced, higher market prices play a fundamental role in the market. For one, they encourage retailers to enter into long-term supply contracts with generators, which protects them against market volatility. Second, higher prices are necessary to encourage new generation to enter the market and to allow existing merchant generation the opportunity to fully recover fixed costs. So long as the higher prices are not artificially created through market power abuse, there is no reason to artificially manipulate the forces of competition through regulatory measures. Cold temperatures, higher than expected demand and gas supply disruption were likely contributors to the price increase, and it is too soon to know if market power abuses also created the higher prices.

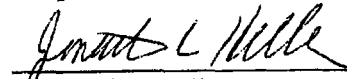
If the Commission believes that market power abuses may have occurred, it should launch an investigation. If the Commission does find market power abuse, the remedy would not be a revision in balancing energy service pricing, but implementation of the provisions in PURA that address market power abuse. Policy guidelines concerning general principles and methodologies for pricing balancing energy service and ancillary services are questions to be analyzed in context of a broader, more comprehensive review. They are not fact-based and should not be part of the Commission's investigation of the events of the week of February 24.

## **Conclusion**

Based on the foregoing, RRI respectfully submits that three days is not sufficient time to decide such significant issues that would dramatically affect competition in the state of Texas. First, the Commission should sever the issues into two processes. The first should be an investigation addressing the facts surrounding the events of the week of February 24 to determine if market power abuse occurred. The second should provide a forum for market participants to address the broad policy implications of bidding on ancillary services and the balancing energy market, the results of which could be used by ERCOT when considering

whether design changes should be implemented. Further, RRI requests that the Staff's recommendations of March 18 not be adopted so that the market participants are afforded ample time to address the important issues raised therein.

Respectfully submitted,



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ATTORNEYS FOR  
RELIANT RESOURCES, INC.

#### **CERTIFICATE OF SERVICE**

I hereby certify that a true and correct copy of the foregoing document was served on all parties of record in this proceeding by hand delivery, overnight delivery, or United States first class mail on this 20<sup>th</sup> day of March, 2003.

