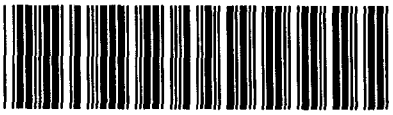

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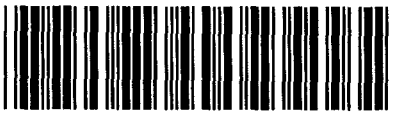

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DOCKET NO. 24770

REPORT OF THE ELECTRIC	§	**PUBLIC UTILITY COMMISSION**
RELIABILITY COUNCIL OF TEXAS	§	
(ERCOT) TO THE PUCT REGARDING	§	**OF TEXAS**
IMPLEMENTATION OF THE ERCOT	§	
PROTOCOLS	§	

RELIANT RESOURCES, INC.'S COMMENTS TO ORDER No. 19

Contact: Jonathan L. Heller
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May 1, 2003

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DOCKET NO. 24770

REPORT OF THE ELECTRIC RELIABILITY COUNCIL OF TEXAS (ERCOT) TO THE PUCT REGARDING IMPLEMENTATION OF THE ERCOT PROTOCOLS	§ § § § §	**PUBLIC UTILITY COMMISSION OF TEXAS**

RELIANT RESOURCES, INC.'S COMMENTS TO ORDER No. 19

Reliant Resources, Inc. ("RRI") appreciates the opportunity to provide comments on the issues presented by the Public Utility Commission of Texas ("Commission") in Order No. 19.

Executive Summary

The Commission is now in the process of reviewing proposals to address and mitigate the effects of "hockey stick" bidding. To date, the Commission has received three proposals for consideration: Staff's Modified Competitive Solution Method ("MCSM"), a proposal from City Public Service San Antonio ("CPS"), and RRI's. RRI is concerned that the implementation of Staff's proposed MCSM could have detrimental effects on the spot market and hinder new construction. If implemented in ERCOT, MCSM would mitigate prices to short run marginal costs, which in a single-product, single-price market such as ERCOT, would likely have the following adverse effects: (1) harm generation adequacy over time, (2) eliminate incentives for generators to commit units in time to be available for the real time market, (3) encourage market participants to lean on the balancing market instead of contracting bilaterally, and (4) increase credit risk. In addition, MCSM could lead resources to forego the risk of not being dispatched (and avoiding the MCSM 90% cap) by offering a larger portion of their output at higher prices, distorting price signals, and thus causing higher overall balancing energy prices. Clearly, the risk of harm to the market through the implementation of MCSM completely outweighs the purported benefit of "ease" with which this method could be implemented.

CPS proposes to mitigate the effects of "hockey stick" bidding by capping the Market Clearing Price for Energy ("MCPE") after 95% of the bids have been deployed and allowing the remaining 5% of the bids to be paid-as-bid if deployed, but does not allow those prices to set the zonal MCPE. This method like MCSM, makes the arbitrary assumption that the end of the bid

stack always represents "hockey stick" bids and does not directly address what defines a "hockey stick" bid. Furthermore, although the proposal includes a pay as bid mechanism in an effort to allow for scarcity price signals, those signals are highly diluted in the market since they are not capable of setting MCPE and thus fail to provide an indication of the value of the energy during a scarcity event. This proposal does not define "hockey stick" bids; it only prevents "all bidders" from reaping the benefit of the assumed "hockey stick" bids contained in the last 5% (since they can not set MCPE). It also does not address the potential for "hockey stick" bids to set MCPE within the first 95% of the bid stack.

Although it is RRI's preference that no action is taken on this issue for the reasons stated herein, if the Commission does decide to take action, it should ensure that the mechanism does not adversely affect appropriate spot prices in periods of scarcity or appropriate prices set by the competitive market. According to the RRI proposal, which takes these concerns into account:

"A hockey stick bid is not eligible to set market clearing prices in ERCOT. A hockey stick bid is defined as a bid included by a QSE as part of its balancing energy bid curve where:

a) The last price/volume pair submitted:

   i) has a volume less than 3% of the QSE's total volume included in that bid curve; and,

   ii) is greater than three times the price of the immediately-preceding price/volume pair included in that bid curve;

b) ERCOT has not declared an Emergency Alert or any EECP event; and,

c) No more than one bid has already been declared a hockey stick bid.

The price-setting mechanism is as follows:

If ERCOT has declared an Emergency Alert or any EECP event, then the last volume (MW) selected shall set the MCPE for the interval.

If ERCOT has not declared an Emergency Alert or any EECP event, then ERCOT shall determine whether the last volume is a hockey stick bid. If not, that bid will set MCPE. If it is a hockey stick bid, ERCOT shall determine whether the next-lower bid is a hockey stick

bid. If not, that bid will set the MCPE. If it is, ERCOT shall use the next-lower bid as the bid setting MCPE."

The approach taken in the RRI proposal is the only one that prevents a "hockey-stick" bid from setting the MCPE while at the same time allowing for scarcity price signals in ERCOT. Scarcity pricing is a requirement in this market, and both Staff's and CPS's proposals fail to meet this requirement and should be rejected.

Response to PUC Issues

I. How the "verifiable cost" determination would be made under the MCSM model.

The MCSM proposal requires ERCOT to "(s)ettle each deployed resource at the greater of the OOM floor price or its verifiable cost"[1]. However, this will only lead to after-the-fact marginal cost pricing that has been proven to be unworkable in any market. In other words, Staff acknowledges that its proposal will likely over-mitigate not just "hockey-stick" bids, but all bids above a certain level, which is why they offer resources the opportunity to recover their verifiable costs. Actually Staff's proposal doesn't really over-mitigate the legitimate operational costs that would have been represented in the bids, but rather those costs associated with scarcity that are not, by their nature, "verifiable." Therefore Staff's proposed remedy, vis-à-vis verifiable cost recovery, is not a cure to the shortcoming in the MCSM proposal, which denies appropriate scarcity cost recovery.

Notwithstanding the above, how to determine what qualifies as verifiable costs and whether to allow recovery of those costs are pricing structure issues for both Out-Of-Merit ("OOM") and Reliability Must Run ("RMR") units under review at ERCOT. Unlike the situation that occurs under MCSM, a resource that has been OOMed by ERCOT has been taken "out-of-merit order" and, as such, may not recover its cost through the proxy price. In this instance, the ERCOT Protocols allow the resource owner to request recovery for certain verifiable costs. However, creating a "one size fits all" definition of verifiable cost applicable to all generators is incompatible with ERCOT's market design where scarcity and opportunity costs are fundamental tenants of the market. Scarcity, by its very definition, is

extremely difficult to "verify" by an administrative approach. The same is true of opportunity costs. Rather, market forces can "verify" what scarcity and opportunity costs are, and inappropriate market intervention to supplant market forces will inhibit the efficient solution, despite the otherwise good intentions of those who would want to intervene.

Pursuant to RRI's proposal, mitigation would occur only when a "hockey stick" bid would otherwise set the clearing price. In comparison, MCSM would affect all bids above a certain level, not just "hockey stick" bids; thus the need for a verifiable cost provision. Staff's approach is akin to prescribing medicine that causes unwanted side effects to a patient to rectify a particular condition when an alternative that is more effective and won't require additional medicine to control the side effects, is available. MCSM would require more medicine and is not as effective as RRI's proposal in treating the problem in the first place. For the reasons above and those mentioned earlier, the Commission should not adopt MCSM.

II. The relative merits of the MCSM and of alternative proposals, including those suggested by Reliant Resources and City of Public Service of San Antonio, and any new proposals, along with subsequent comments from ERCOT on the feasibility and estimated costs of implementing the alternative proposals as well as the system impacts of such proposal.

RRI has already commented on MCSM. Therefore RRI further explains the merits of its proposal to address "hockey stick" bidding and comments on the proposal submitted by CPS.

RRI would prefer that no action be taken to mask the competitive nature and scarcity price signals in the market. However, if such action is to be taken, the RRI proposal should be adopted for several reasons. The proposal's mitigation measure is implemented only when those bids meeting the definition of "hockey stick" bids, as such is defined in the proposal would otherwise set the clearing price. Thus, RRI's proposal addresses "hockey stick" bids without disrupting the competitive market.

Second, the price-setting mechanism in the RRI proposal acknowledges the importance of allowing competition to set the price during times of non-scarcity. The proposal does this

[1] Docket No. 24770, Memorandum from Staff "*Proposal to Apply Modified Competitive Solution Method to Balancing Energy Service and Update on Applying the Competitive Solution Method to Ancillary Services*", March

by allowing the third-highest bid in the bid stack to set the price in non-emergency situations. Using the third bid in the bid stack is consistent with ERCOT's traditional metric that three independent bids constitute a competitive price

Third, RRI's proposal also recognizes the need to preserve spot prices in periods of scarcity by allowing the last volume selected during an Emergency Alert or any EECP event to set the MCPE. During these times, the bids should be allowed to send price signals reflecting the correct value of energy during scarcity and should not be subject to mitigation. New generation entrants will monitor and forecast scarcity price signals over a period of time in order to make prudent decisions regarding new investment. Over time, as capacity reserves decrease, the existing and forecasted price signals will indicate that new generation should be built. These signals, which will not occur with MCSM, must exist in the market or generators will be unable to intelligently decide whether to build.

Finally, the cost effects on the market to implement this proposal are not outweighed by the benefits received by the market from the proposal. According to ERCOT, RRI's proposal can be easily accommodated in the ERCOT system by adding only a few conditional statements to ERCOT's "Package 1" (operations) system. These changes would validate and flag potential "hockey-stick" bids without requiring changes to the ERCOT settlements system.

In comparison, the proposal presented by CPS does not really target "hockey stick" bids. Rather, it applies to all bids that are dispatched within 95% of the bid stack. Also, while the CPS proposal allows "pay-as-bid" for the remaining 5% of the bid stack when deployed, it mitigates the impact of scarcity pricing by limiting the payment of those prices to the bidders only, rather than allowing them to set the zonal MCPE. Furthermore, it is unclear in the CPS proposal how the "pay-as-bid" mechanism would be integrated into ERCOT's existing single price settlement system for each zone; a complexity CPS has acknowledged but not fully addressed.[2] The mitigating provisions in the CPS proposal and the potential effects on the market are similar to those in MCSM. Both proposals all but eliminate the opportunity for scarcity prices to be realized, neither of them directly addresses "hockey stick" bids, they

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both contain an arbitrary price threshold on the bid stack, and their individual resource pricing alternatives ("pay-as-bid" in CPS and "verifiable costs" in MCSM) have no place in the current ERCOT settlement system.

After reviewing the proposals to date, if the Commission decides it is necessary to take action on this issue, the RRI proposal should be adopted because it is the only one that successfully benefits the market, defines a "hockey stick" bid, addresses concerns regarding the market impacts of hockey stick bidding, allows a workable competitive market to thrive, and provides an opportunity for scarcity pricing to present itself when necessary.

III. How alternative proposals could identify and distinguish true shortages so possible mitigation measures do not adversely affect legitimate scarcity prices, which may be necessary to stimulate new resource development.

Only RRI's proposal distinguishes between times of normal operations and those when there are emergency events. Any emergency event, no matter the cause, indisputably indicates a scarcity situation, and the market price signals should not be blunted during those time periods or during times of scarcity in non-emergency events. To do otherwise could inappropriately delay the building of new generation in ERCOT, and lead to perverse and adverse market consequences that will not serve the long-term interest of a workable, functioning marketplace.

Conclusion

RRI looks forward to participating in the Technical Conference where these and other issues will be addressed. Due to broad and detrimental impacts the implementation of a poorly-designed mitigation method would likely have on the ERCOT market and new entrants, RRI urges the Commission to carefully consider whether such a mechanism is necessary and whether the proposal ensures that the integrity of the competitive nature of the ERCOT system is maintained, while at the same time addressing the concerns regarding "hockey stick" bids. Only RRI's proposal accomplishes these goals.

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[2] Docket No. 23220, *"San Antonio City Public Service's Initial Brief,"* January 26, page 7

Respectfully submitted,

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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 1st day of May, 2003.