Reform ERCOT's market guidelines

COMMENTARY | Dr. David Cherney, Ethan Paterno and Ryan Hardy

Texas, one of our nation's energy leaders with a commitment to free market principals and limited government intervention, is heading towards a storm.

Texas' competitive wholesale electricity market — known as ERCOT — provides power to 24 million customers and today enjoys some of the lowest electricity prices in the nation. However, unless the Texas Public Utility Commission acts soon to introduce new reforms to the electricity market's structure, Texans could be subject to rolling blackouts and high electricity prices in the near future.

One of the fundamental principles of any competitive market is that producers should have a reasonable opportunity to recover their costs and make a fair market return, otherwise existing producers could go bankrupt and new producers will not enter the market. If new electricity producers (i.e. power plants) do not enter the electricity market, electric service to customers could be in jeopardy. This could lead to rolling blackouts like those experienced in 2011 by Texas customers.

Over the past several years, the Texas Public Utility Commission has attempted to address the electricity market's reliability risk by instituting several reforms; most notably introducing the Operating Reserve Demand Curve in 2014. This mechanism, which remains true to free market principals, was designed to help power plants recover their costs and make a return, providing a framework for new power plants to enter the market.

Unfortunately, it's not working. Over the past two summers, Texas has seen record highs in electricity demand, but 2015 and 2016 were among the least profitable years for power plants in recent memory. If this continues, it's doubtful that new power plants will be built.

While Texas power plants struggle with profitability, the electricity market's reliability risk will remain an issue.

ERCOT's 2016 actual reserve margin — a measure of the market's backup power to help avoid blackouts — was below 11.5 percent.

In all other highly competitive wholesale electricity markets in the United States, actual 2016 reserve margins were above 20 percent.

This reliability risk is further evident by the fact that this summer marks the first time since 2011 that ERCOT signed an out-of-marketreliability contract with an unprofitable power plant to prevent it from exiting the market. ERCOT also signaled, earlier this month, that it is considering a similar contract to prevent the retirement of a second power plant.

Such contracts, which are not available to all Texas power plants, go against free market principals. As such, they are not ERCOT's preferred approach to maintaining system reliability.

It's likely that during the next several years — as demand for electricity increases and potential power plants retire due to poor profitability — ERCOT's reserve margin will decline absent the development of new power plants. As a result, the 24 million customers that ERCOT provides power to could face sustained rolling blackouts and high electricity prices.

As we head into autumn, with its cooler temperatures and lower electricity demand, now is the time for the Texas Public Utility Commission to act.

That action should introduce new reforms needed to fix Texas' wholesale electricity market. These reforms could include reshaping the Operating Reserve Demand Curve, but may also require new market mechanisms are in line with Texas' commitment to free market principals.

Further inaction on the part of the commission could leave Texas customers in the dark.

Dr. David Cherney, Ethan Paterno and Ryan Hardy all work for PA Consulting Group and have extensive experience in the Texas electricity market. During the past five years, they have collectively supported the sale, purchase or financing of over $5 billion in Texas power generation infrastructure.
