COMMENTS OF FINANCIAL MARKETERS ON
PROPOSED TWO-MONTH RESETTLEMENT OF MARKET

Date: April 15, 2011
To: Board of Directors
From: Longhorn Energy LP, SESCO Southwest LLC, and West Oaks Energy LLC
Subject: ERCOT's Proposed "Price Corrections" for De-Energized Settlement Points in Day-Ahead Market ("DAM") and Real-Time Market ("RTM") Affected by Alleged "Data Error"

Issue for the ERCOT Board of Directors

ERCOT Board of Directors Meeting Date: April 19, 2011
Agenda Item No.: 16a

On April 12, 2011, John Dumas, Director of Wholesale Market Operations for the Electric Reliability Council of Texas ("ERCOT") submitted a memorandum (the "Dumas Memorandum") to the Board of Directors ("Board") recommending that the Board approve what Mr. Dumas refers to as "price corrections" of certain day-ahead market ("DAM") locational marginal prices ("LMPs") and Settlement Point Prices ("SPPs") for Operating Days December 1, 2010 through February 1, 2011, and real-time market ("RTM") LMPs and SPPs for Operating Days December 1, 2010 though January 31, 2011. These so-called "corrections" would be made with respect to de-energized Settlement Points which were assigned LMPs of system lambda due to what the Dumas Memorandum calls "data error." However, contrary to characterizations in Dumas Memorandum, there has been no data error. Therefore, no retroactive price adjustment is warranted or even permitted under law.

The undersigned Financial Marketers strongly support ERCOT's efforts to develop a vibrant nodal trading market and promote efficient market pricing. To achieve these goals, however, it is vitally important that market participants be able to rely on the market rules and prices that are duly calculated in accordance with those rules. The resettlement proposed by the Dumas Memorandum would not only be inconsistent with ERCOT protocols; it would send a message to new market participants that they cannot rely on published rules and that the profits they have made can be taken away by retroactive rulemaking anytime ERCOT wants to do so. Such a message—particularly when sent so shortly after commencement of the nodal market—would inhibit the development of vibrant nodal trading and greatly discourage market entry and participation. For these reasons, and as explained more fully below, the undersigned Financial Marketers hereby urge the Board to reject the recommendation to resettle the market.

There Is No Basis for Resettlement Because the LMPs and SPPs Were Not Affected by a Software or Data Error.

Under ERCOT Sections 4.5.3 and 6.3 of the ERCOT Protocols, LMPs and SPPs cannot be altered retroactively unless they are shown to have been "significantly affected by a software or data error."[1] The LMPs and SPPs at issue here were correctly and properly determined in

[1] Dumas Memorandum at 1-2.

accordance with ERCOT Protocols. There was no software or data error. Thus, there is no basis on which the LMPs and SPPs could be lawfully modified retroactively.

Protocols 4.5.1 and 6.6.1 specifically address how LMPs and SPPs are to be determined with respect to a de-energized bus. Specifically, they require ERCOT to determine the LMP and SPP for de-energized Electrical Buses by using heuristic rules applied in the following order:

(a) Use average LMP for Electrical Buses within the same station having the same voltage level as the de-energized Electrical Bus, if any exist.

(b) Use average LMP for all Electrical Buses within the same station, if any exist.

(c) Use system lambda.

Thus, when there is a de-energized bus, the LMP and SPP are to be determined by reference to the prices of Electrical Buses within the same station. If there are no "Electrical Buses" within the same station, the LMP and SPP are to be determined using the system lambda.

For the de-energized buses at issue here, pricing was properly determined using the system lambda because there were no other Electric Buses within the same station. Section 2 of the ERCOT Nodal Protocols defines an "Electric Bus" as:

> A physical transmission element <u>defined in the Network Operations Model</u> that connects, using breakers and switches, one or more: (a) Loads; (b) Lines; (c) Transformers; (d) Generators; (e) Capacitors; (f) Reactors; (g) Phase shifters; or (h) Other reactive control devices to the ERCOT Transmission Grid where there is negligible impedance between the connected Transmission Elements.[2]

During the intervals at issue, there were no other physical transmission elements "defined in the Network Operations Manual" within the same station as the de-energized buses. Thus, as the Dumas Memorandum acknowledges, "there were no other Electrical Buses in the station with which to calculate an LMP."[3]

Under ERCOT's protocols, the issue of whether there were other "physical transmission elements" in the same station as the de-energized buses is, in and of itself, inconsequential. Only those transmission elements that are defined in the Network Operations Model qualify as Electric Buses. While ERCOT may deem it appropriate to change its Network Operations Model to include additional transmission elements going forward, that does not change the fact that the LMPs and SPPs were properly calculated under the market rules, and that under those rules there were no other "Electrical Buses" in the same station.

There is no basis under the ERCOT Protocols for the Dumas Memorandum's proposal to retroactively adjust the LMPs and SPPs by reference to the LMPs of Electrical Buses in the "next

[2] Emphasis added.

[3] Dumas Memorandum at 1.

connected stations."[4] The heuristic rules do not allow for the calculation of LMPs and SPPs in this way. In fact, there is no reference in the protocols whatsoever to using the LMPs from the "next connected stations." Where, as here, there were no transmission elements within the same station that met the definition of Electrical Bus, the LMP is required to be determined using the system lambda.

The ERCOT network model used during the period at issue worked properly and without software or data error. There has been no claim that ERCOT's software failed to properly apply the heuristic rules set forth in the Protocols. Nor has there been any claim that Electrical Buses within the same station were missed, or that the system lambda used was incorrect. In addition, the buses at issue were not treated as de-energized due to any software or data error. The buses at issue were, in fact, de-energized as a physical matter due to a variety of factors, including generation and transmission outages. Thus, no showing has been made that the LMPs and SPPs were significantly affected by a software or data error.

If a Change Is Needed, It Should Be Applied Prospectively Only.

Market participants are lawfully entitled to rely on ERCOT's nodal protocols and must be able to do so if ERCOT wishes to encourage vibrant nodal trading. Testing of the CIM network model began in August 2009, more than a year before the nodal market went online in December 2010. In addition, Transmission Service Providers ("TSPs") review and update the ERCOT model on a daily basis. Yet, until January 2011, no one had asserted that the alleged data error at issue here even existed.

Undoubtedly, market rules can always be fine-tuned and improved in ways that produce more efficient market outcomes. But that does not mean that ERCOT or any other system operator should go back and adjust the rules retroactively to reflect what the system operator now believes the rules should have been. The mere fact that pricing at system lambda in accordance with established Protocols may have yielded market outcomes here that ERCOT and certain market participants find inappropriate is no basis for changing prices retroactively.

ERCOT has recently taken action to address the issue on a prospective basis. On January 31, 2011, ERCOT has changed the network model by adding 609 new Electrical Buses.[5] All of these newly added buses are fictitious and have been added for the sole purpose of reducing the frequency in which the ERCOT De-Energized Bus heuristics rules result in pricing at system lambda. Thus, the issue here has been addressed prospectively. No retroactive action is warranted or permitted under the protocols.

The Proposed Resettlement Would Not Produce "Correct" Market Results.

Correcting for a perceived modeling error, such as that claimed here, would not produce "correct" market results. Market participants determine the volume and price of their daily bids based on a number of factors and information, including the price and volume of bids that cleared at a given node on the prior day. For example, if yesterday's LMP at a particular node

[4] *See* Dumas Memorandum at 2.
[5] Dumas Memorandum at 1.

was $45/MWh, a trader will likely bid a different price today than if yesterday's LMP was $44 or $46/MWh. In short, market participants rely heavily on pricing data to determine the price and volume of their subsequent bids. Retroactively adjusting LMPs and SPPs for any given interval will not result in "correct" outcomes because the price for that interval formed a basis for the LMPs and SPPs for all subsequent days. Market participants would have no opportunity to go back and change their bids to the price and volume they would have bid had the LMP and SPP been different.

The issue here is one of ERCOT market design, not software or data error. It is a matter that should be addressed on a prospective basis only, not by futile efforts to recreate what the market would have been had the rules or model been designed the way ERCOT now wishes.

The Proposed Resettlement Would Harm the Market and the Public Interest.

Promoting vibrant participation by financial marketers in ERCOT's nodal market is essential to the success of that market. It is critical that the Board not lose sight of the fact that market participants need to be able to rely on established protocols and prices. If the nodal market is to achieve sufficient trading volumes to promote efficient market operations, the Board should be focused on ways to attract participation, not on unwarranted measures that will increase uncertainty and thereby discourage market entry and vibrant trading.

Approving the two-month resettlement proposed by the Dumas Memorandum would also be detrimental to the public interest. It would engender a decline in virtual trading and liquidity that would allow generators to regain the market power that was a major reason for having virtual trading to begin with. It also would create market mitigation issues for the market monitor and send poor pricing and investment signals to the market. It also would provide an opportunity for market manipulation issues resulting from the lack of competition faced by generators. Generators would have the ability to raise their offer prices, and load-serving entities would be forced to pay a higher price for energy. This would have adverse effects on the overall market and the public.

For the foregoing reasons, Financial Marketers respectfully urge the Board to reject the resettlement proposal.

Respectfully submitted,

/s/

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