**Comments on ERCOT’s Draft Amendments to P.U.C. Subst. R. 25.507**

**by the ERCOT Steel Mills**

*November29, 2011*

Chaparral Steel, Nucor Steel and Commercial Metals (“ERCOT Steel Mills”) appreciate the opportunity to provide comments on ERCOT’s draft amendments to the Public Utility Commission’s P.U.C. Subst. R. 25.507. As three of the largest participants in the current EILS program and very active proponents for adoption of the original rule and subsequent rule iterations, the ERCOT Steel Mills have a strong and vested interest in ensuring the continued success and further improvement of the program, while avoiding inadvertent harm to the program as a result of the rulemaking process and/or the process of crafting and implementing conforming revisions to ERCOT documents and processes. The ERCOT Steel Mills’ comments herein are necessarily brief and limited due to the limited time to review and comment on the draft. It should go without saying, but in excess of caution, that the ERCOT Steel Mills expressly reserve our rights to make additional comments or take different positions throughout the rulemaking process as more information becomes available.

Potential market changes facing ERCOT over the next several years necessitate changes in the EILS program, including: expansion of program participation to a higher level; enhancing the flexibility in the program; maximizing the program’s value to ERCOT when managing EEA events; and, providing a robust mechanism for the avoidance of firm load shedding. We thank ERCOT for the obvious effort it has made in crafting draft rule amendments intended to achieve this objective.

The added flexibility which the draft amendments afford ERCOT Staff in structuring and administering the details of the program can benefit program growth greatly. That said, it is most important to “first, do no harm.” With broad discretion also comes the risk of modifications to the program through the process that could be harmful to the program in general or the ERCOT Steel Mills in particular. For example, EILS has historically been bitterly opposed from its inception by certain market participants, and continues to be, notwithstanding that the program’s value has been amply demonstrated in two successive contract periods during the past year. A number of the program changes proposed by ERCOT may attract even more virulent opposition. EILS only exists because of the Commission’s and ERCOT Staff’s steadfast support for the program, which we very much appreciate. We are very concerned about the potential for negative impacts on the program as a result of opposition by certain ERCOT stakeholders at the Commission during the upcoming rulemaking process and during ERCOT processes to develop and implement program improvements.

Attached hereto is a redlined edit of ERCOT’s draft rule, reflecting certain revisions and additions to the rule language which the ERCOT Steel Mills believe will improve the robustness of ERCOT’s proposed rule amendments, enhance the odds of attracting additional load participation, and minimize the potential for the program to be “gutted” by hostile market participants in a protracted fight over the language of any necessary conforming Protocol or other document revisions. Set forth below is a brief description of the rationale for each substantive revision we propose. The various subsection references are keyed to the subsections as numbered in our redlined edits to the clean copy of ERCOT’s draft amendments.

**Title of Rule 25.507**

We believe that there is no need to mention ERCOT, and in any event, that terms are best defined in the text of the rule and not the title. See section (a) for ERS and section (c)(4) for ERCOT.

**25.507(a)**

We believe it imperative that this new subsection be added to the draft rule in order to make crystal clear to all that the intent of the rule is to ensure expansion of the program to an optimal level, and not to impede it. The draft rule amendments remove many of the specifics currently in the EILS rule. While moving to more broad discretionary language in the rule may be appropriate to enhance ERCOT’s flexibility, it is important to guard against the risks inherent in such an approach. Adding a “purpose” section delineating the overall direction the Commission has in mind for ERS can serve to provide essential guidance when ERCOT develops the details of the program.

One deliberate purpose of including great specificity in the current rule was to ensure that successful implementation of the program could not be sabotaged through the post-rule-adoption Protocol revision process necessary to implement the program. The draft amendments seek to eliminate the specificity in the current rule in order to allow ERCOT staff leeway to structure and administer program requirements in a manner that will grow the program and its value to ERCOT, without the necessity of resorting repeatedly to the cumbersome and time-consuming rule and/or protocol revision process. However, removing the specificity from the rule could have unintended and undesirable consequences. For instance, if the definition in the draft rule amendments of “ERCOT” were to be changed from “the Staff of the Electric Reliability Council of Texas, Inc.” to another which omits the “Staff” qualifier, the vast program design flexibility envisioned for the Staff by the draft rule amendments could easily default to stakeholders through the Protocol revision process, allowing the potential for adverse stakeholders to not only thwart future program growth, but to cripple the success of the existing program as well. Similarly, during the process of adopting the conforming Protocols, it is distinctly possible that adverse market participants could prevent deletion of the current program specificity in the Protocols or add other specific requirements, thereby preventing ERCOT staff from being able to exercise envisioned flexibility in structuring and administering the program on a going-forward basis.

Adoption of the language we propose will provide a clear statement of the Commission’s intent, which we believe will help to prevent the EILS program gains achieved to date from being undermined and minimize impediments to expansion and improvement of the service.

**25.507(b)**

We propose changing “may” in the first sentence of this subsection to “shall.” The value of this service as a reliability tool has been amply proven this year. While we support ERCOT’s desire to have maximum flexibility over the details of the program and its administration, we do not think it desirable or appropriate to suggest that establishing and procuring ERS is somehow discretionary or to permit ERCOT to discontinue entirely the procurement of this service as a reliability tool for use in managing EEA events.

The Commission has consistently been a staunch supporter of EILS. One of the Commission’s two stated purposes in adopting the EILS rule was to promote the growth of demand response within ERCOT. The Commission by using the word “shall” in the current rule signaled the strong intent that this service will be used. Substitution of the word “may” in the proposed rule weakens the perception of that intent. The language of the proposed rule should not convey, even inadvertently, the impression that this is a program that ERCOT can simply terminate. Conveying that impression by use of the word “may” serves only to provide fodder for long-time opponents of the program. Retention of the word “shall” will not unduly diminish ERCOT’s otherwise proposed substantial latitude provided by the draft rule amendments in properly structuring, contracting for and administering this service.

**25.507(b)(2)**

ERCOT’s draft amendment should either remove or include a substantial increase in the annual program cost cap. We would prefer no cap. But, if a cap must remain, the cap should be substantially increased. While we understand that the ultimate value is up to the Commission, we think ERCOT would send the wrong signal to the Commission if it does not propose to substantially increase the cap. At a minimum, ERCOT should leave the amount blank and at least tell the Commission that increasing the cap would be of benefit to the market and the Commission should set the cap, whether it be in the form of an annual dollar amount or a per megawatt offer/price cap.

ERCOT desires to grow this program and there is every reason to believe that, if the draft rule amendments are adopted, the program will continue to grow in size, provided the current annual expenditure cap is removed or increased sufficiently to prevent the stunting of that growth. Even a participation level near the current EILS quantity cap (1,000 MW) would require an average price per megawatt lower than the lowest average price ever paid by ERCOT for contracted EILS load. It is unrealistic for ERCOT to believe that program participation can grow to a level approaching 1000 MW, or exceed that level, by paying less for participation. This is especially so, given that Protocol amendments were adopted earlier this year that substantially increase the likelihood of deployment of the service. ERCOT’s proposed rule amendments in several respects further increase that likelihood, not to mention the impact of other market and non-market forces that may require outages of more protracted outage duration and increased deployment. These developments increase the economic cost of participating in the EILS/ERS program. Participants will consequently expect that increased cost will result in a higher, rather than a lower, level of compensation.

The expectation of a higher risk premium for increased risk of deployment is reflected very plainly in the average prices paid this year for other ancillary services, the prices of which were extremely high this summer. The higher valuation of ancillary services will doubtless continue over the next few years given potential market conditions. While a service such as Responsive Reserve Service may have a higher overall value than EILS in terms of system reliability, that value differential has decreased substantially due to the assignment this fall of the same deployment priority for EILS and RRS during EEA events. At the same time, the disparity between participant compensation for RRS and EILS has increased dramatically in some time periods.

Perhaps ERCOT could opt to ameliorate the impact of the current expenditure cap on future growth by opting not to purchase EILS/ERS during certain time periods. However, that would be a mistake. An EEA event can occur during off-peak as well as on-peak hours. Regardless of when an EEA event occurs, EILS/ERS needs to be available to ERCOT as a tool for EEA event management and the avoidance of the need to shed firm load. Leaving action on the annual expenditure cap to a future rulemaking only serves to ensure that sub-optimal growth in participation will persist for an extended period when EILS/ERS is most needed.

**25.507(b)(3)**

This recommended new provision is intended to ensure that all participants are paid on a market clearing price basis as opposed to a pay as bid basis. This conforms ERS payments to the custom and practice with respect to almost all ancillary services within ERCOT and in other jurisdictions. ERCOT would still determine the maximum offer price that would be accepted, but participants would be more fairly compensated. No one wants to be in a position of being paid less than others for providing a service of equal value. Under the current pay as bid process, bidders are subjected to a great deal of angst in determining what level they should bid in order to ensure that they don’t leave money on the table, and the realization after the contracts have been awarded that they have left money on the table only results in resentment and dissatisfaction. With this change, some participants will receive more revenue than they would have on a pay as bid basis, but their realization that their participation is valued at a higher level than anticipated will only serve to increase their satisfaction in participating, and their willingness to participate in the future.

This change to a clearing price methodology does not necessarily mean that annual program costs will increase. Economists have often asserted at ERCOT that paying all offers the same price promotes lower offers. Knowing that they will be paid a clearing price, bidders may well submit lower offers in order to ensure that their acceptance is guaranteed.

The ERCOT Steel Mills have long advocated the need for a true market clearing price compensation methodology. This solution falls well short of that objective. However, until the liquidity of the market increases, and a workable method can be devised to apply a true market clearing price in the absence of a specified procurement quantity, our proposed language change at least steers program compensation in the right direction.

**25.507(d)(3)**

The proposed additional language is intended to permit ERCOT to establish different classes of ERS, which would provide different value and be compensated at different levels. For example, some ERS resources may be able deploy more quickly than the current 10 minutes in EILS, perhaps even instantaneously (some of the steel mills have this capability). On the other hand, other ERS resources may require longer than 10 minutes, but could still be of value in avoiding curtailment of or allowing reinstatement of firm load, such as in situations faced earlier this year (some of the steel mills have additional load that could curtail with longer notice periods). ERCOT should be permitted to develop and test such approaches to expand potential participants and ERCOT flexibility, while providing more opportunity to potential participants.

**25.507(d)(5)**

The proposed additional language is intended to provide some assurance to existing EILS participants that the program requirements will not be revised to exclude them in the future. For example, the ERCOT Steel Mills rely on the “alternative baseline” under the existing rule to be able to participate. The proposed new sentence is intended to provide the assurance that the EILS requirements, such as the alternative baseline, will not be changed under ERS so as to preclude loads like the steel mills from continuing to participate.

**25.507(d)(7)**

The language of this provision has been modified in several respects. First, the initial reference to the annual expenditure cap has been removed and replaced with the phrase “subject to the limitations specified in this rule” in order to clarify that the frequency, timing and duration of deployment has nothing to do with the annual expenditure cap except in the instance of the exercise of a renewal option. The annual expenditure cap caveat has been moved to a more appropriate and logical location, which in our opinion would be 25.507(d)(8).

Second, the two deployment limit existing under the current EILS program has been restored. For many loads, including some process loads within steel mills, interruption of service requires can cause very significant negative economic impact. Not all curtailed load is capable of being restored quickly, and significant cost and effort can be involved in bringing the plant back to normal operation. In some instances, significant loss of product can occur due to a deployment of very short duration. Eliminating the two deployment limit will radically increase the potential for deployment during system peak periods. It will also correspondingly decrease the willingness of loads to participate in the program during periods when participation is most critical, given that prices are artificially constrained to a level subjectively determined by ERCOT without the objective value and cost clarity imposed by free market forces.

Third, we have added the requirement that if ERCOT chooses to select a standard contract term longer or shorter than four months, the limit on maximum cumulative hours of interruption per contract term will be adjusted proportionately. This is being added for the same reasons that the two deployment limit has been reinserted. A major change in the standard contract term can produce a radical change in the economic risk associated with program participation absent a corresponding adjustment of the maximum period of cumulative hours of deployment. For instance should ERCOT choose to select one-month contract terms for the summer peak months instead of using the current four-month contract term, this would produce a four-fold increase in the cumulative hours of deployment permitted during that four-month period. This does not necessarily pose a problem if contract prices are to be determined by market forces. But it becomes a huge problem if they are not and ERCOT, in selecting the maximum offer amount it is willing to accept, fails to appropriately recognize the vast change in economic risk associated with the greatly increased performance obligation.

**25.507(d)(8)**

This provision has be modified by adding the caveat that exercise of the renewal option is subject to the annual expenditure cap not being thereby exceeded.

More importantly, it has also been modified to provide ERCOT added flexibility with respect to the renewal of exhausted contract performance obligations. Under the rule language ERCOT has proposed, ERCOT’s exercise of the renewal option is limited solely to the original terms of the contract, subject to the consent of the participants. Language has been added to provide ERCOT the ability to renegotiate a renewal based upon mutually agreed terms in the event the initial exercise of the renewal option is declined. This addition does not require the negotiation of renewed contract obligations, but gives ERCOT the flexibility upon refusal of the initial renewal option to nonetheless renew upon agreed modifications to the contract quantity, price, performance obligation or other relevant term or condition.

**Mark W, Smith**

**Smith Trostle & Huerta LLP**

**(512) 494-9500, Ext. 2**

[**msmith@smithtrostle.com**](mailto:msmith@smithtrostle.com)