The Impacts of Raising the Energy Price Cap in ERCOT

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Problem Statement

After the summer heat wave in 2011 forced the Electricity Reliability Council of Texas (ERCOT) to declare Energy Emergency Alerts (EEA) in order to meet system demand, the concerns about whether there will be sufficient generation capacity going forward to meet growing demand in Texas’ energy-only market have increased. This concern about resource adequacy, though, is not solely based on the fear of summers of above normal temperatures becoming the norm. The ERCOT region experienced one of the hottest summers in history, setting records in August 2011 (Figure 1); but these extreme conditions are often seen as one in 100 years type of occurrences based on historical weather data.2

Demand for electricity has been growing fast along with the population and economy of Texas; total consumption of electricity in Texas has grown about 1.5% per year on average over the last decade. More importantly, peak demand has increased more than 10 GW between 2002 and 2012 but net operational capacity declined by over 7 GW over the same time period (Figure 2). Electricity prices reflected the tight conditions in the market, hitting the $3,000 price cap for 17 hours during August of 20113 and averaging, in load-weighted terms, about $160/MWh in August 2011 as compared to the annual average of $53/MWh (Figure 3). Not load-weighted, the average price in August 2011 was about $127/MWh. Historically, electricity and natural gas prices have been highly correlated in the ERCOT market (0.95 for the 2002-12 period in Figure 2), which kept the margins of gas-plant operators tight in the environment of lower gas prices since late 2008. This correlation was broken in 2011 mainly due to high prices caused by extreme weather in February and August 2011 but was re-established in 2012 in the absence of such extreme weather events.

Figure 1. Departure from normal temperature (F) 8/2/2011 – 8/31/2011

Source: National Weather Service
Industry analysts have concentrated on several factors that could explain the generation investment falling behind demand growth. Low natural gas prices leading to low electricity prices may have squeezed profit margins; although a benefit of competition for consumers, this squeeze also hurt annual revenues for generators. In addition, the low level of price caps in an energy-only market combined with the infrequency of scarcity periods did not allow for sufficient revenue generation during summer peak hours, except for 2011.\(^4\) Finally, wind energy from West Texas has been supplied to the market at negative prices, mainly in order to collect federal tax credits.\(^5\) The frequency of negative bids have been high since 2007 and might continue at least until the Competitive Renewable Energy Zone (CREZ) transmission lines are completed.

It is also possible that the recession triggered by the financial sector crisis in 2008 raised uncertainty regarding demand growth and caused generation investors to be more cautious. Given the difficulties of the financial sector, the lending practices have also become more rigorous with increasing cost of borrowing for some investors, especially smaller ones. The fact that electricity demand in Texas grew faster than many expected after the 2008 crisis probably surprised both developers and lenders.

**Figure 2. Year on year changes in peak demand and net operational capacity; and natural gas and electricity price indexes in ERCOT**

![Graph showing changes in peak demand, operational capacity, electricity price index, and natural gas price index from 2002 to 2012.]

Sources: capacity and demand from EIA Electric Power Annual (January 2013 release) except for 2012 data, which are from ERCOT; price of natural gas delivered to power plants from [http://www.eia.gov/dnav/ng/hist/n3045us3a.htm](http://www.eia.gov/dnav/ng/hist/n3045us3a.htm) and ERCOT wholesale electricity prices from [http://www.potomaceconomics.com/index.php/documents/C6](http://www.potomaceconomics.com/index.php/documents/C6) except for 2012, which is calculated based on the ERCOT hourly data.

Work is under way to modify the market design to create additional incentives for generation investment and demand response. Although initiatives on demand response are limited at this time, there are changes to encourage more supply. The Public Utility Commission of Texas (PUCT) raised the energy price cap (high system wide offer cap, SWOC, also known as HCAP) from $3,000/MWh to $4,500/MWh\(^6\) starting on August 1, 2012. In October 2012, the Commission approved gradually increasing the system-wide offer cap to $5,000 MWh in 2013, $7,000 MWh in 2014, and $9,000 MWh in
In late 2012, the Commission raised the low system offer cap (LCAP) to $2,000/MWh or 50 times the daily Houston Ship Channel gas price index of the previous business day and the peaker net margin (PNM) to $300,000 from $175,000. The PNM is the accumulation of operating margins of a gas combustion turbine (CT) with a heat rate of 10 MMBtu/MWh. For illustration purposes, let us assume that the marginal cost of a CT is $100/MWh. Every time the market clearing price of electricity (MCPE) in the ERCOT system exceeds $100/MWh, the PNM is calculated as the difference of MCPE and $100. Over the year, the cumulative PNM continues to increase every time MCPE exceeds $100/MWh. Brattle Group (2012) concludes that, if price spikes occurred once every five years and energy margins in non-scarcity years are half of the cost of new entry (CONE), the PNM in a year of price spikes would need to be about three times of CONE to attract investment. If the cumulative PNM reaches $300,000 within a year, then the offer cap is lowered from the HCAP to the LCAP. There have also been changes to “scarcity pricing threshold” with ERCOT increasing required amount of responsive reserves and the price floor for dispatch of regulation-up services. All of these changes are targeted to allow scarcity pricing signals to be stronger.

![Figure 3. Load-weighted electricity prices in ERCOT, 2008-2011](source: See page iii in Potomac Economics (2012)).

**Reserve Margin Predictions and History**

The electricity industry has generally followed the reliability standard of one loss of load event (LOLE) every 10 years, which can lead to prices in the range of $3,000-$20,000/MWh depending on target LOLE and cost of a combustion turbine. Prior to 2011, the LOLE standard led ERCOT to calculate 13.75% as the target reserve margin given historical weather and load patterns. The inclusion of 2011 weather indicates an increase in target reserve margin to at least 16% to maintain the 1-in-10 criteria (ECCO
Ideally, the price cap should be set at this value of lost load (VOLL). Given ERCOT’s interpretation of the reliability standard as one loss of load event, which is more stringent than one day in 10 years interpretation used by other entities responsible for grid reliability elsewhere, one generator reported $26,000/MWh for ERCOT. Sener (2013) offers $15,000 to $20,000 to achieve the 13.75% target.

Since 2005, ERCOT has been releasing the Report on the Capacity, Demand and Reserves in the ERCOT Region (from here on, CDR), which includes a forecast of the reserve margins in future years. These forecasts are based on demand growth projections and expected resource additions. In these annual reports, ERCOT only includes planned units with signed interconnection agreements and in the case of thermal units those with air permits. By definition, these numbers will be conservative.

Demand growth assumptions are often based on high growth scenarios for the Texas economy. For example, in May 2012 CDR (ERCOT, 2012b), load growth was assumed at about 4.4% from 2013 to 2014, 4.9% from 2014 to 2015, 3.3% from 2015 to 2016, and 2.1% from 2016 to 2017 before falling below 2% based on high economic growth scenario for the Texas economy provided by Moody’s.

As a result, the combination of conservative estimates for new generation capacity and high demand growth assumption leads to a forecast of declining reserve margins. However, reserve margins have remained mostly above predictions and above the target of 13.75% as more resources came online and/or demand fell short of the peak forecasted, except for 2011 (Figure 4).

**Figure 4. Forecasts of reserve margins**

All forecasts are from ERCOT’s CDR reports except the following: May 2012 CDR Update 1 is done by ERCOT at the request of the Commission to capture additional resources and using Moody’s 2011 low economic growth forecast (filed under PUCT Project 40000); May 2012 CDR Update 2 is from a presentation by Commissioner Anderson, capturing mothballed units ([http://www.puc.texas.gov/agency/about/commissioners/anderson/pp/ANALYSISERCOT_CAPACITY_RESERVE_MARGIN.pdf](http://www.puc.texas.gov/agency/about/commissioners/anderson/pp/ANALYSISERCOT_CAPACITY_RESERVE_MARGIN.pdf)).
During the resource adequacy project of the PUCT, several updates were filed. The alternative estimates were based on a lower demand growth scenario and/or additional resources (either new or mothballed). The December 2012 CDR (ERCOT, 2012c) report predicts higher reserve margins than the May 2012 CDR report for both of these reasons but still follows a declining trend. In between these two reports, ERCOT filed an update of its May 2012 estimates at the request of the Commission under Project 40000 on October 22, 2012 (Update 1 in Figure 4). This update includes generation additions announced since the release of the May 2012 CDR and assumes the low growth scenario from Moody’s. Commissioner Anderson provides an estimate that includes additional resources and 1,786 MW of mothballed capacity that can return to service in less than six months (Update 2 in Figure 4). Clearly, assumptions about growth scenarios, new and mothballed resources are crucial for forecasting future reserve margins. Given the wide range of these estimates, in mid-December 2012 the Commission decided to open a rulemaking on what inputs should go into the CDR Report.\(^\text{13}\)

In ERCOT (2012d), seven additional economic growth scenarios developed by Moody’s are evaluated; the low scenario was selected for the long-term demand and energy forecast. The CDRs released in December 2012 and May 2013 use lower growth scenarios. We use the lower demand growth scenario from the December 2012 CDR in our baseline case, and analyze the higher demand growth scenario of the May 2012 CDR in an alternative scenario (Figure 5).

**Figure 5. ERCOT Peak Demand Growth Scenarios**

The observed reserve margin during the August 2011 peak was 7%. The margin would be 9.6% if we consider 1,612 MW of load resources (LRS), emergency response service (ERS) and energy efficiency programs to consistently compare to 17.5% predicted by ERCOT in May 2011.\(^\text{14}\) To secure availability of resources during the summer of 2012, mothballed units were called upon to add nearly 2,000 MW of capacity.\(^\text{15}\) In contrast to 2011, the 2012 summer was milder than feared and the ERCOT grid met all summer demand without the need of any emergency procedures.\(^\text{16}\) As a result, ERCOT decided that several units did not need to be classified as RMR and could consequently be mothballed or retired.\(^\text{17}\) The reserve margin in 2012 was 13.7% when 1,577 MW of LRS, ERS and energy efficiency resources from
ERCOT (2011b) are accounted for (Figure 4), and 11% without those resources, which is significantly better than it was on August 3, 2011.

Hence, the long-term concerns regarding resource adequacy remain. Under project 40000, PUCT is considering two main options: 1- enhancements to the energy-only market, including the promotion of demand response to support price cap increases; and 2- establishment of a capacity market. These options are based on a study by the Brattle Group commissioned in early 2012 and feedback to that study and recommendations by market participants.¹⁸

Evaluating the Impact of Higher Price Caps

We evaluate the impacts of increasing price caps on net capacity additions, reserve margins, average prices and demand curtailments among other market and reliability indicators. We run two scenarios: the previous price cap ($3,000/MWh), and the future price cap ($9,000/MWh).¹⁹ We do not impose the target reserve margin (13.75%) but rather let the model yield actual peak reserve margins under these scenarios. We assume electricity peak demand growth levels of December 2012 CDR. For base load, we assume 1.5% annual growth based on the average electricity consumption growth in Texas over the last 10 years. We use the natural gas price forecast from the Annual Energy Outlook 2012 (Figure 6). We also evaluate the sensitivity of the results to assuming the higher demand growth scenario of the May 2012 CDR and an alternative gas price scenario based on Foss (2012), CEE in Figure 6.

![Figure 6. Nominal natural gas price through 2022($/MMBtu)](image)

*Source: Annual Energy Outlook 2012, Energy Information Administration*

We use AURORAxmp, an economic dispatch model, to run these scenarios on an hourly basis. Because 2011 was an extreme year, we first calibrated the model to reproduce the actual 2011 conditions of 17 price cap hits ($3,000/MWh), the monthly wholesale price average of $127/MWh, and the reserve margin of 7% in August 2011 (without accounting for LRS, ERS and energy efficiency). The model produced 17 price cap hits, a monthly wholesale price of $122/MWh, and a reserve margin of 6.7% in August 2011. Also, the model’s average annual wholesale price for 2011 is $41/MWh as compared to $53/MWh in the actual market. The actual wholesale price is higher than the model’s price due to the unexpected outage of several generating facilities that occurred during an extremely cold day in February 2011, which lead to the price cap being hit 6 additional times.²⁰ We do not model this February outage since such winter outages are very infrequent and unpredictable. More importantly, we focus
on peak demand growth in summer months as the period of concern for the resource adequacy debate. Hence, we feel confident of the model’s robustness to capture ERCOT market developments as accurately as possible over an extended period of more than ten years.

**Extreme prices**

There are more extreme price instances under the lower price cap (Table 1). This is likely due to the fact that investors realize more potential revenue under the higher price cap; even when the price cap is not hit, the market experiences prices between $3,000 and $9,000 under the higher price cap scenario. Thus, generators are more inclined to invest in generation, particularly in the earlier years. Overall, though, there are not many extreme price periods in either case; probably because we are analyzing a low demand growth scenario.

**Table 1. Extreme Price Hours by Year**

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**Retirements, new builds, net capacity additions**

Between 2013 and 2022, there will be about 9.6 GW of retirements under the $3,000 scenario and 10 GW of retirements under the $9,000 scenario (Figure 7). The retirements pick up in later years because demand growth slows down in that period (Figure 5) and more generation would have been built by then (Figure 8).

**Figure 7. Retirements (MW)**

About 24.2 GW of additional new generation capacity is expected to be built under the $3,000 scenario and roughly 24.8 GW new generation capacity is expected under the $9,000 scenario between 2013 and 2022 (Figure 8).
Through 2022, we can expect 14.8 GW of net capacity additions under the $9,000 scenario and 14.7 GW of net capacity additions under the $3,000 scenario (Figure 9). Although there are fluctuations from year to year, the higher price caps will lead to more new builds in the near future (Figure 8); between 2013 and 2016, 8.4 GW is expected to be built under the $9,000 scenario, and 7.3 GW is expected under the $3,000 scenario. When retirements are taken into account, between 2013 and 2016, there would be roughly 740 MW of additional net capacity additions under the $9,000 scenario relative to the $3,000 scenario. When comparing the $9,000 and $3,000 scenarios, we determine that the price cap increase would lead to a 12% increase in net capacity in the short run (2013-2016) but only a 1% increase in the long run (2013-2022).

Type of new builds

Combustion turbine (CT) plants appear immediately in 2013 under both scenarios; close to 1,700 MW of CT capacity is built under the $9,000 case as compared to about 1,000 MW in the $3,000 case. The current issue with the ERCOT grid resides in meeting load during summer peak hours; it is not surprising
that CTs are built first to address this market need. There will be significantly more CC capacity built in the long-run to replace retiring units and to meet growing market demand not just peak demand.

**Figure 10. Average wholesale electricity prices ($/MWh)**

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<tr>
<th>Year</th>
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*Impact on average prices*

One of the concerns about raising the price cap is the impact on wholesale (and, indirectly, retail) electricity prices. For the same number of scarcity events, the higher price caps will lead to higher average prices; but it is also possible that there will be a larger number of scarcity periods going forward, at least in some years, under the $3,000 scenario since there may not be enough new builds to increase the reserve margin. There seems to be several years in our model runs that are consistent with this latter interpretation (Table 1). Overall, the average wholesale prices remained roughly the same over the years for both scenarios (Figure 10); the 2013-2022 average wholesale electricity price is roughly $49 for both cases. Note that the electricity price is highly correlated with the natural gas price and increases in parallel to the increase in the natural gas price (Figure 6). The model does not provide results on retail prices but given that the average wholesale prices are basically the same in both cases, we can safely assume that raising the price cap will not impact retail prices.

**Figure 11. Total Demand curtailment (MWh)**
Demand curtailment

The model indicates that the more involuntary demand curtailment will occur under the $3,000 than the $9,000 case; total MWh curtailed in each year under both scenarios are reported in Figure 11. The most curtailment occurs in 2016, probably because demand growth was very high in the 2013-16 period (Figure 5) and net builds were not sufficient to keep up with it (Figure 9). Nevertheless, curtailment amounts represent a very small percentage of the load; electricity consumption in the ERCOT market was 335,000,000 MWh in 2011 and will grow going forward.

Reserve margin

Overall, the peak reserve margins are higher under the $9,000 price cap for almost every year the 2013-2022. The average reserve margins (adjusted for LRS, ERS and energy efficiency from CDR to compare with ERCOT CDR forecasts) are 13.0% under the $3,000 cap and 14.1% under the $9,000 cap. Without adjustments, reserve margins would average 8.8% and 9.8% for the $3,000 and $9,000 cases, respectively. These numbers can be compared to 6% ($3,000) and 10% ($9,000) estimates reported in page 3 of Brattle Group (2012). It is noteworthy that our estimates for the 2014-16 period overlap with ERCOT (2013); the model continues to build new capacity afterwards, leading to higher reserve margins than ERCOT (2013), which can only count new capacity with interconnection agreements and air permits (Figure 12).

Overall, our modeling exercise suggests that the price cap increase will help raise the reserve margin by an average of 1% over the long term without much impact on the average prices while eliminating most of involuntary demand curtailment, which is not large even in the $3,000 case. However, this analysis is based on a docile natural gas price path and low demand growth assumptions. It would be beneficial to evaluate the sensitivity of the results to changing some of these assumptions.
Alternative Scenarios

We ran a combination of other scenarios using higher demand growth from the May 2012 CDR and a different natural gas price scenario (CEE). The AEO scenario is our base case discussed above.

<table>
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<td>AEOHD</td>
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<td>CEE*</td>
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<tr>
<td>CEEHD</td>
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<td>ERCOT High Demand</td>
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* based on Foss (2012)

The number of extreme price hours under each scenario can be seen in Table 2. In general, over the course of the next 10 years, the model does not yield too many extreme prices. The lack of extreme prices explains the low differentiation in wholesale average prices under each cap. If prices are only reaching the cap a couple of times per year, we would expect the yearly wholesale prices to be roughly the same over the long term. The AEO natural gas price scenarios seem to experience more extreme price instances than the CEE cases; a possible explanation is that higher prices in the CEE scenario allow for higher electricity prices and revenues for generators in the shorter term.

Table 2. Extreme Price Hours under All Scenarios

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The net capacity additions of each scenario and price cap are compared in Figure 13. In each case, the increased price cap leads to more overall net builds. The higher demand scenarios experience substantially more net builds to keep up with demand; the AEO high demand scenario saw an 11% increase in the $3,000 case and a 12% increase in the $9,000 case in comparison to the AEO baseline scenario. Likewise, the CEE high demand scenario also had more net builds than its lower demand counterpart, with a 14% increase in both the $3,000 and $9,000 cap.
The average yearly wholesale prices are shown below for each scenario under the two cases (Figures 14 and 15). Over the long run, the wholesale prices of the AEO and AEOHD scenarios are nearly identical; the same observation is made between the CEE and CEEHD scenarios. However, the prices between the AEO natural gas scenarios and the CEE scenarios are widely different. Given the high correlation between electricity and natural gas prices, CEE scenarios lead to higher prices. Overall, the CEE scenario saw an increase of 29% in the $3,000 case and a 31% increase in the $9,000 case as compared to the AEO scenario. The CEEHD scenario experienced a 29% increase in the $3,000 case and a 26% increase in the $9,000 case.
Figure 15. $9,000 Cap Wholesale Price

Reserve margins for each scenario under both price caps are displayed Figures 16 and 17. Under each of the four scenarios, the average reserve margin increased when the price cap was raised to $9,000, sometimes by more than a percentage point. Under the $3,000 and $9,000 cases, the lower demand growth scenarios both have significantly higher reserve margins, particularly after 2019; as demand growth slows in the later years, reserve margins reach 18%. One might question why the reserve margins initially are higher in the higher demand growth scenarios; this is because in the December 2012 CDR (low demand growth), demand is forecasted to be higher in the preliminary years, before slowing down relative to the May 2012 CDR (high demand growth) forecast.

Figure 16. $3,000 Cap Reserve Margin
Conclusions

We estimate the effects of increasing the price cap, or SWOC, to $9,000 from $3,000/MWh in ERCOT's energy-only market. Importantly, in our base case, we assume the demand growth scenario from ERCOT (2012d) rather than the higher demand growth scenario used in ERCOT (2012b). Our modeling exercise suggests that the price cap increase will help raise the reserve margin by an average of 1% over the long term from 13% to 14% if one takes into account LRS, ERS and energy efficiency services accounted for in ERCOT CDR reports. This increase would be sufficient to meet the current target reserve margin on average over the next 10 years, albeit not every year; but the 10-year average reserve margins would be less than 16% or higher than is implied in ECCO International (2013), which takes into account 2011 summer weather. The raising of the price cap would not have much impact on the average prices and would eliminate most of involuntary demand curtailment, which is not large even in the $3,000 case. Assuming higher demand growth leads to a slightly higher average price but this effect is not visible under a higher natural gas price path scenario. There is more demand curtailment and reserve margins are lower on average with higher demand growth unless the natural gas price also follows a higher price path, in which case $9,000 leads to an average reserve margin of 14.7%, the highest level in all of our scenarios.
References


Endnotes:

1 This work was supported by funding from BEG’s State of Texas Advanced Oil & Gas Resource Recovery (STARR) program, a revenue neutral initiative. STARR support for energy economics research at BEG is under direction of principle investigator Dr. Michelle Michot Foss, CEE program manager. We thank David Bellman for his advice and EPIS staff for their assistance with the model details; all remaining errors are solely ours.

2 See “U.S. experiences second warmest summer on record; Texas has warmest summer on record of any state” by National Oceanic and Atmospheric Administration (NOAA) [http://www.noaanews.noaa.gov/stories2011/20110908_auguststats.html, last accessed on December 17, 2012].

3 See page vii in Potomac Economics (2012).

4 See page xxii in Potomac Economics (2012).

5 See Baldick (2012).

6 Similar price/offer cap ($4,500/MW) also applies on capacity obtained for ancillary services.


8 See http://www.puc.texas.gov/agency/rulesnlaws/subrules/electric/25.505/25.505.pdf

9 See page 82 in Brattle Group (2012).

10 See Sener (2013) for a more detailed discussion of these and other changes.

11 Also, the authors use higher effective load carrying capability (ELCC) ratios for wind (14.2% for the West, 32.9% for Coastal relative to 12.2% from the 2010 loss of load analysis); and state that the target reserve margin would fall to 15.3% if they were to use 12.2% for ELCC.

12 Heard by the authors at the GCPA Fall Conference in Austin, October 2-3, 2012.

13 Project No. 41060 - Proceeding to examine the inputs included in the ERCOT Capacity, Demand and Reserves Report.

14 See ERCOT (2011a).

15 See ERCOT (2012a).

16 See presentation by Commissioner Anderson at the Gulf Coast Power Association Fall Conference on October 2, 2012 [http://www.puc.texas.gov/agency/about/commissioners/anderson/pp/GCPA_100212.pdf].

17 These changes can be seen in page 6 of ERCOT (2012d).

18 See Brattle Group (2012) and filings under Project 40000.

19 Note that we ignore the transition period with intermediate price caps and assume $9,000 price cap to become active in 2013 in order to capture full impact of price cap changes in the long-term.