Written testimony concerning recent drought impacts on retail electric pricing in the Texas competitive retail electric market

Prepared by TXU Energy Retail Company LLC, for the Senate Business and Commerce Committee hearing January 10, 2012, relating to Drought Impacts on Electric Generation.

Thank you for this opportunity to submit written testimony regarding the impact of the ongoing drought on electricity markets. Specifically, you asked TXU Energy to provide its view on any current or anticipated effects on retail electric prices resulting from the drought. As a retailer, TXU Energy is keenly aware of the drought as one of the many factors that could influence wholesale electricity prices, which are a key determinant of retail prices. While no one can precisely isolate the effects of the drought from the many other factors influencing wholesale prices, we are in a position to comment on the directional impacts that the drought would have on market prices, the likely impacts that will have on the retail electricity segment, and, most importantly, the potential impacts to customers.

In 2011, the drought was just one of the weather patterns that strained generation resources and the reliability of the Texas electric grid. Even with recent rains, the U.S. drought monitor shows that 100% of Texas is in drought conditions with a little over 41% of the state in exceptional drought conditions. This is actually a modest improvement from the start of the water year (9/27/2011) when almost 86% of the state was in extreme drought conditions. Regardless of this recent improvement, Texas remains in a very serious drought situation.[1]

As of December 2011, only 24 MW of generation capacity was unavailable due to drought. ERCOT has reported that, if no significant rainfall is received, the unavailability of generation resources could exceed 3,000 MW (over 4% of ERCOT capacity)[2] by May 2012. Across ERCOT, there is over 11,000 MW of generation (over 15% of ERCOT capacity)[3] that is dependent on water rights from sources that are at historically low water levels.[4]

Unfortunately, the drought and the related potential unavailability of generation resources is just one of many factors that are contributing to the broader resource adequacy challenge that we face in Texas. This resource adequacy challenge relates to whether we have adequate generation resources to meet future demand for electricity. Even in the absence of potential drought limitations, ERCOT is facing a period of tight reserve margins. It is well documented that the confluence of low natural gas prices, an influx of low marginal cost wind power, increased wholesale market efficiencies, low wholesale power prices, tight credit markets, and pending environmental regulations all translate into challenging economics for attracting investment for building new generation resources or even continuing to maintain/upgrade existing capacity. ERCOT's latest forecast shows an anticipated available capacity

[1] National Drought Mitigation Center, "U.S. Drought Monitor: Texas," University of Nebraska-Lincoln, http://droughtmonitor.unl.edu/DM_state.htm?TX,S (cited December 13, 2011 version).

[2] Based on available peak capacity of 72,444 MW. ERCOT, "Report on the Capacity, Demand, and Reserves in the ERCOT Region," (Dec. 2011).

[3] Ibid.

[4] ERCOT, "Grid Operations and Planning Report," (prepared for December 12-13 Board of Directors Meeting), p. 22.

reserve margin for summer 2012 of 12.1%, already below the target level of 13.75%. And that's before any drought effects, which could exacerbate this challenge further.[5]

No one can predict with certainty what kind of weather Texas will experience over the next summer and beyond. For that reason, we must factor in uncertainty about the drought as we face this broader resource adequacy issue. Unfortunately, weather driven variables – like the drought or summer heat-driven demand peaks – are big drivers in the resource adequacy equation and ones around which we have little control.

This broader resource adequacy challenge should manifest itself in the wholesale electricity market with increasing volatility and eventually higher forward power prices. In our energy-only market, it's critically important that the market be allowed to work to send the proper price signals to investors and consumers.

As a retailer, TXU Energy's perspective on any wholesale market issue is driven by what our customers need. TXU Energy's business depends on meeting those needs better than the next retailer in our competitive market. Managing volatility in the wholesale market for our customers is an important part of our role. The drought adds an unprecedented weather-driven dimension of risk to the wholesale market and could exacerbate the market-based pricing volatility that we observe there. This is notable to TXU Energy as a retailer because we want to shield or protect end-use customers from risks – like fluctuating prices – that they generally don't want to bear. To meet customer needs we need multiple supply options in a liquid forward market for longer term price certainty. Buying wholesale supply in the longer-term forward market is not always the lowest cost alternative in the short run. However, TXU Energy believes this strategy provides the best opportunity for longer term pricing stability and thus is better for our customers and is more likely to ensure resource adequacy going forward.

We believe our customers value both reliability and price stability. With our strategy of taking a longer-term view on supply procurement, retail price stability has been a key part of how we offer service to our retail customers. We have minimized the number of retail price changes to our customers, and we do not flow through wholesale prices changes to our customers without giving them advance notice. We have differentiated our retail electricity service to customers with this strategy. We believe we offer good prices and more price stability than our competitors.

Importantly, highly volatile wholesale markets offer significant challenges to other retailers who, unlike TXU Energy, rely too heavily on short-term wholesale markets for supply and do not appropriately manage their commodity risks when serving customers. Retailers like this may expose themselves and their customers to short term price volatility. This can create bad experiences for the customers of retailers that follow that practice.

[5] ERCOT, "Report on the Capacity, Demand, and Reserves in the ERCOT Region," (Dec. 2011).

Customers, while not homogenous in their needs, will generally put reliability of service very high on their list of priorities – especially when they have experienced a lack of reliability. They will generally balance reliability with price stability, affordability and environmental sustainability.

These customer needs drive what retailers look for in the wholesale market. So again, reliability is a key. That's why TXU Energy as a retailer supports appropriate price signals that drive investment in a viable, sustainable wholesale market. Without those price signals and the ensuing investment in generation, the long term viability of the market will be negatively impacted, with the potential for reliability issues and supply disruptions that would directly impact our customers. Outages are the ultimate bad customer experience. When the lights go out, customers aren't likely to spend much time trying to figure out whether it was a generation shortage, or an electric transmission/distribution issue, or something the retailer did. Hence, we all have an interest in ensuring a reliable electricity supply.

The Public Utility Commission and ERCOT are engaged on the resource adequacy issue. While higher prices are not necessarily an attractive prospect, the alternative of suppressing the appropriate price signal could actually yield a much worse customer experience in the form of sustained longer-term high volatility or – much worse – reliability challenges.

As a retailer, we encourage policy makers to consider market design changes to address the resource adequacy issue that, to the extent possible, address price stability as well as reliability. While we understand that price volatility likely will be one of the near term outcomes, we favor policies that result in appropriate prices over the long haul as opposed to policies that just encourage extreme longer-term price volatility.

In the Texas competitive electricity market, some retailers, like TXU Energy, respond to the possibility of higher and more volatile wholesale and retail market prices by investing in innovative consumer solutions that help them manage demand and reduce overall consumption. Through load management and energy efficiency programs, TXU Energy and other retailers can help industrial, commercial, and residential customers mitigate some of the retail customer impacts of higher and more volatile wholesale prices. The benefits of these programs not only accrue to customers, through lower overall energy costs, but also accrue to the market through lower resource requirements, helping to mitigate portions of the resource constraints Texas is currently facing, including those driven by the droughts.

In summary, the retailer perspective on any wholesale market issue is driven by customer needs. TXU Energy doesn't want to see customers impacted by volatility and reliability issues. We want to see a reliable, sustainable wholesale market that is attracting investment. For that reason, we continue to encourage actions that will enhance the very successful Texas market, foster Texas's ability to deal with issues like drought and extreme weather, and lead to more long-term resource stability for the benefit of Texas electricity consumers.

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