

January 24, 2008

Mr. Howard Schneider
Chairman, PJM Board of Directors
C/O PJM
955 Jefferson Avenue
Norristown, PA 19403

Dear Mr. Schneider,

On behalf of the PJM Power Providers Group (P3), please accept these comments in advance of the PJM Board meeting scheduled for January 26, 2008.

P3 is a nonprofit corporation dedicated to promoting policies that will allow the PJM region to fulfill the promise of its competitive wholesale electricity markets. P3 strongly believes that properly designed and well-functioning competitive markets are the most effective means of ensuring a reliable supply of power to the PJM region, facilitating investments in alternate energy and demand response technology, and promoting prices that will allow consumers to enjoy the benefits of competitive electricity markets. Combined, P3 members own nearly 74,000 megawatts of power and over 51,000 miles of transmission lines in the PJM region, serve nearly 12.2 million customers and employ over 55,000 people in the 14-state PJM region.¹

P3 supports capacity mechanisms as a tool to encourage long-term capital investments in existing, as well as new, generation resources. Well-constructed capacity mechanisms promote reliability and provide a desirable stability to the market that ultimately benefits the consumers in the PJM region. Likewise, poorly designed capacity mechanisms mask reliability problems and fail to incent generation to be either built or retained when and where it is needed. In the end, generation adequacy in PJM is a reliability issue and must be treated seriously in order to avoid unacceptable long term consequences.

The changes introduced by the Reliability Pricing Model (RPM) have begun to promote the goal of having an adequate supply of generation in the PJM region. In fact, according to

¹ The views expressed in this letter of those of the PJM Power Providers Group and are not necessarily those of individual members of the organization.

PJM's numbers, RPM auctions have added over 2,500 megawatts of new generating capacity, and available capacity in 2009-10 has increased by over 9,000 megawatts. Most importantly, nearly 900 megawatts of demand response participated in the most recent capacity auction. It is important to note that these results only reflect activity *in the transitional auctions*. The compressed schedule for the transitional auctions does not fully account for the lead time necessary to develop generation. Thus, there is a lag between responding to RPM pricing signals and actually offering generation in the auctions. Such capacity may be, for example, pending state or local siting or licensing, and therefore not offered into the auctions that have transpired. The Board must be cognizant of the development lag and recognize that not only is generation being added, but also that this generation is being developed in response to RPM.

To continue the progress that has been made as a result of the recent implementation of RPM, RPM must reflect current market conditions. The settlement that was supported by most parties to the case contemplates that various aspects of RPM would regularly be updated in order to remain relevant. Of all these periodic updates, perhaps the single most significant one is the Cost of New Entry (CONE) calculation.

For RPM to fully achieve its promise, it is critical that the CONE calculation on which the market design is based reflect actual costs of new entry. If CONE is updated properly, the demand curve can be set at a level that will send the appropriate signals to the market. A CONE value that is set too high will encourage the construction of too much generation and likewise a CONE value that is set too low will not incent enough generation. Either way, if CONE is not reflective of present reality; the market's response will likely frustrate the objectives of RPM. That is why it is so important for the PJM Board to send the appropriate signals to the market through its action on the CONE.

The PJM staff, with the help of an independent consultant, have thoroughly analyzed the CONE and concluded that a change to CONE is necessary and appropriate to reflect existing market conditions. Not surprisingly, their analysis found that the cost of building a power plant in PJM has increased significantly. Materials, construction costs, environmental compliance costs and land prices have all risen dramatically since August 2005, when the study upon which the current CONE is based was released. The CONE Revenue Requirements 2008 Update, authored by Pasteris Energy, Inc., attempts to reflect these facts and concludes that the CONE should be increased to approximately \$290 MWperday. For reasons outside of the control of the Board and PJM market participants, the cost of capacity in PJM has gone up. In order for RPM to work as intended, the CONE value used to set the demand curves must reflect this reality.

P3 appreciates the opportunity to communicate directly the Board on this important issue, and we urge the Board to move forward with the necessary and appropriate revisions to the CONE values. While we would prefer to be in a situation where the cost of building capacity in

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PJM is declining, the reality of today's rising cost environment must be understood and recognized. Given the recent improvements to the PJM capacity market, the Board should make the CONE updates that were contemplated in the settlement and that are necessary for the progress to continue. Such steps are necessary to ensure long-term reliability in PJM. We urge the Board to make the filings at FERC that are necessary to implement the updated CONE values in time for the 2011-2012 auction.

Sincerely,

Glen Thomas

PJM Power Providers Group