



## Organization of PJM States, Inc. (OPSI)

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October 22, 2008

Howard Schneider, Esq.  
Chairman, Board of Managers  
PJM Interconnection, L.L.C.  
955 Jefferson Avenue  
Norristown, PA 19403

### Re: Request for Information

Dear Mr. Schneider:

We, the OPSI Board of Directors, thank you and your colleagues on the PJM Board as well as PJM's technical staff for participating in OPSI's 4<sup>th</sup> Annual Meeting last month in Chicago. We agree with your observation during that event that the relationship between the PJM Board and the OPSI Board has improved vastly since last year. As part of continuing that relationship and ensuring the success of the regional electricity grid on the transmission as well as distribution level, we ask, under the existing Memorandum of Understanding, that PJM undertake further study and analysis before taking further action on the following three important issues:

#### 1. Installed Reserve Margin

As you are aware, PJM is contemplating increasing the current level of the Installed Reserve Margin (IRM) from 15.5% to 16.2% for the 2012-13 Planning Period.<sup>1</sup> We believe this change could have significant cost implications for the system and, ultimately, for ratepayers. At this time, we urge the PJM Board not to approve this increase until PJM's Markets staff led by Andy Ott has completed a thorough analysis on

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<sup>1</sup> 2008 PJM Reserve Requirement Study, September 17, 2008, Planning Committee Agenda Item 6; p. 6.

the cost implications of this change. This should be undertaken on a fast track given the PJM Members Committee's apparent desire to have the 16.2% IRM approved and filed at the FERC by December 15.

While Mr. Ott has provided some brief analysis on these issues in preliminary discussions with Commissioner Paul Centolella, we believe that an increase of such potential magnitude cannot be justified without a more thorough analysis. We understand that PJM follows the NERC standards on reliability; nevertheless, we are not aware of any crisis that necessitates the need for such an expedited change. In fact, in response to flaws pointed out by the staff of the Old Dominion Electric Cooperative, a PJM staff member indicated during an informational presentation before PJM's Markets and Reliability Committee that this change is needed for the upcoming RPM auction and that a detailed analysis could be undertaken later. We find the suggestion that the IRM be raised for use in one auction and detailed examination undertaken later totally unacceptable, and we ask that PJM not place the cart before the horse in this fashion.

## 2. Reliability Pricing Model

In the last few months, OPSI has formed a Reliability Pricing Model (RPM) Working Group (WG) chaired by Commissioner Paul Centolella to examine and track RPM. Mr. Ott and his staff have provided background information, ideas, and documents to the RPM WG and we appreciate those efforts. As a result of these exchanges, the RPM WG has identified several long-term issues that need further investigation by a PJM-funded consultant. Accordingly, the OPSI Board respectfully requests that PJM retain one or more consultants to study and report on the matters listed in Attachment "A" to this letter. We do not, of course, know at this point whether any of these issues will warrant further study or work, but we think it is important for PJM and OPSI to understand better our longer-term options for this important market.

## 3. Calculation of CONE

We believe everyone associated with the PJM capacity and energy markets realizes the importance of the Cost of New Entry (CONE) as an integral input for RPM, especially the calculation of net CONE, which has been brought up at various levels of recent PJM committee meetings. We urge the PJM Board of Managers to take affirmative steps to address timing lags in the net CONE offsets for energy and ancillary services, which we believe could have the effect of artificially inflating the net CONE. Specifically, we support setting capacity prices by the most accurate method, which is to link them to actual net revenues in the delivery year.

We look forward to working with the PJM Board of Managers on these and other important issues, particularly those that are time-sensitive. For the purpose of coordination on these issues, please feel free to contact Commissioner Paul Centolella at the PUC of Ohio and/or Raj Barua (OPSI's Executive Director).

We appreciate the PJM Board of Managers' cooperation in these matters.

Sincerely,

/s/ Dallas Winslow

Commissioner Dallas Winslow  
Delaware Public Service Commission

/s/ Gregory Server

Commissioner Gregory Server  
Indiana Utility Regulatory Commission

/s/ Douglas Nazarian

Chairman Douglas Nazarian  
Maryland Public Service Commission

/s/ Paul Centolella

Commissioner Paul Centolella  
Public Utilities Commission of Ohio

/s/ Jon McKinney

Commissioner Jon McKinney  
Public Service Commission of West Virginia

/s/ Richard Morgan

Commissioner Richard Morgan  
District of Columbia Public Service Commission

/s/ David Armstrong

Chairman David Armstrong  
Kentucky Public Service Commission

/s/ Frederick Butler

Commissioner Frederick Butler  
New Jersey Board of Public Utilities

/s/ Tyrone Christy

Vice Chairman Tyrone Christy  
Pennsylvania Public Utility Commission

/s/ Steven Transeth

Commissioner Steven Transeth  
Michigan Public Service Commission

cc: PJM Board of Managers

Terry Boston, CEO & President, PJM

Bill Whitehead, VP – St. Govt. Policy, PJM (via email)

Andy Ott, Sr. VP – Markets, PJM (via email)

Mike Kormos, Sr. VP – Operations, PJM (via email)

## ATTACHMENT "A"

### OPSI's Long-Term Issues on RPM

OPSI believes that long-term improvements in RPM will require additional analysis beyond what was contained in the June 2008 Brattle Group Report. The Brattle Group did not address the desirability of forward capacity markets in comparison to fundamentally different market designs. OPSI initiated a conversation with PJM regarding the potential for PJM to pay for a consultant to address issues related to the long-term evolution of RPM capacity markets.

OPSI would like to see key issues addressed prior to a planned PJM stakeholder Summit on Long-Term RPM Issues. FERC will have a technical conference on RPM in February 2009, and, PJM is planning a Summit on Long-term Issues related to its RPM for March 2009.

OPSI's initial conversation with PJM covered a broad set of topics related to:

- (i) RPM versus other possible mechanism;
- (ii) RPM cost effectiveness;
- (iii) The nature of the RPM product;
- (iv) Evolution away from a capacity market; and,
- (v) Other issues.

Following that conversation with PJM, OPSI has narrowed the scope of issues a consultant might address. The more narrowly defined list of issues appears below:

Long-term issues to be discussed with PJM for investigation by a PJM-funded consultant:

1. RPM Versus Other Possible Mechanisms.

Prior to the Long-term Issues Summit, produce a background paper comparing and contrasting alternate market designs. The paper should include a description of U.S. and international experience with alternative approaches and a summary of potential advantages and disadvantages of different approaches, including Forward Capacity Markets such as RPM, an Energy and Ancillary Services Only market design, and reliance on bilateral contracting.

2. RPM Cost Effectiveness.

While RPM has reduced capacity market price volatility when compared to PJM's earlier Capacity Credit Market, an analysis of the residual uncertainty and risks facing investors, the risk premiums in RPM prices, and their impact on generation costs would provide a better understanding of the extent to which RPM is a cost-effective approach to facilitating investment in new capacity. A supplemental report should include:

- (a) Additional analysis of circumstances leading the development of new baseload capacity. Are there specific conditions which facilitate and may be necessary to the development of such capacity?
- (b) Further evaluation of investor claims regarding the uncertainty and risk as barriers to investing in new capacity in PJM. Are there additional RPM program design features that can be changed to reduce the risk premiums that suppliers incorporate into their RPM

auction bids so as to reduce RPM and total generation costs? What would be the anticipated impacts?

3. Evolution Away From Capacity Market.

As demand becomes price elastic – flattening load shapes, limiting price spikes, and moderating price volatility and related investment risk – the capacity payments required to achieve any given level of resource adequacy should decline. States and utilities are considering significant investments in advanced metering infrastructure (AMI) and retail rate designs that incorporate dynamic pricing, which could significantly increase price elasticity. As a further step, price responsive demand could be given an expanded range, on a voluntary basis, by:

(a) Enhancements to Scarcity Pricing, including allowing demand response to set prices potentially, for willing consumers, at levels above current generation offer caps; and,

(b) Security Interruption Pricing, i.e., allowing prices to be specified (at or above the Value of Lost Load) at which certain loads could be automatically curtailed.

An analysis of the potential role of price elasticity in the evolution of, and as a potential off ramp from, capacity markets should be pursued and should include modeling that:

(i) assesses the impact of different degrees of price elasticity on the level of capacity payments needed to elicit investment in new generation; and (ii) compares the consumer cost and reliability impacts of RPM to an energy and ancillary services only market design assuming significantly increased levels of price responsive demand. The analysis also could address approaches to more efficiently incorporate price responsive demand into PJM market operations.

4. Other Issues. PJM reserve margins are set based on a conservative calculation of the reserves needed to achieve a 1 in 10 year Loss of Load Expectation (LOLE). PJM should evaluate the impact on RPM prices and consumer costs of alternative approaches. Additionally, PJM should calculate under a realistic set of assumptions the marginal cost per additional MWh of expected load served by the current approach to setting reserve requirements and provide a comparison to available estimates of the consumer Value of Lost Load (VOLL).