March 7, 2014

PJM Board of Managers  
C/o Howard Schneider, Chairman  
955 Jefferson Avenue  
Norristown, PA 19403

RE: Replacement Capacity

Dear Mr. Schneider and the Board of Managers:

We are writing to introduce the Board of PJM Interconnection to the Advanced Energy Management Alliance (AEMA). AEMA is a newly launched trade association of end use customers and demand resource providers formed for the purpose of advocating for rules and structure that promote healthy markets and the successful advancement of Demand Response. We are also pleased to note that former FERC Chairman Jon Wellinghoff has joined our leadership as Strategic Advisor. We are reaching out, in addition, on a more specific issue: concern about PJM’s proposed replacement capacity changes and the impact that it will have on both our members and on customers in general through higher Reliability Pricing Model (RPM) costs.

AEMA comes to you at this time regarding Replacement Capacity, the subject of recent stakeholder votes and a decision by the PJM Board to take action at the Federal Energy Regulatory Commission (FERC). While we recognize that several decisions are very far along, we are concerned that PJM’s proposal to address an as yet unproven concern regarding “speculation” in capacity markets will lead to significant adverse impacts on customers and the markets, and which may in turn impact PJM’s leadership role in advancing demand response.
beyond the PJM borders. As such, because the mission of AEMA is to be the voice of consumers and demand response providers on market changes impacting demand response interests, we believe it is important to reach out to the Board on this matter. Our membership supports the need to ensure commitments made in RPM are for physical resources, but we believe the changes PJM is expected to file will carry adverse and unintended consequences on the market.

In considering this matter, it is important to take note of one key and unanticipated characteristic of RPM that has dominated market dynamics – that is the persistent overestimation of load in the three-year forward forecasts. This feature creates several circumstances that are closely related to the concern about purported speculation in RPM. First, high Base Residual Auction (BRA) load forecasts contribute to lower Incremental Auction (IA) prices that, in turn, undermine the ability of end use customers to offset their capacity costs through participation in the IAs. Second, the lower forecast volume results in the reduction or elimination of the opportunity to sell Short Term Resources such as Demand Resources into the IAs, as was intended in the current design. These outcomes create a situation where loads that are able to provide demand based resources must participate in the BRA or rely on Curtailment Service Providers (CSPs) to take a position on their behalf in order to offset their capacity costs. CSPs are forced into the BRAs due to the prospect of untenable pricing for products in IAs.

The BRA positions of parties offering Demand Resources are necessarily somewhat prospective because few customers are willing to contract 4 years in advance for commitment of Demand Resources. No customers know precisely how much curtailment capability they will have four years hence, and the uncertainty of the clearing price which impacts their revenue potential is not yet known. This does not mean that Demand Resources will not commit – only that the precise nature of the commitment may occur in a shorter term with the exact commitment determined a few months prior to the delivery year. As a result, CSPs take positions in the BRA with the intent and commitment to bring to physical delivery three years forward as planned.

A common business model for CSPs is to contract with end use resources (consumers) to share the capacity revenue from RPM, with the consumer often receiving the majority of the capacity revenues and the CSP retaining the remaining to cover the cost of securing the
customer (Sales), the cost of systems and operations and for overhead. There is a persistent misconception regarding this common business model and how that necessarily impacts RPM bidding for Demand Resources in both the BRA and IAs. AEMA feels the misconception has prompted misplaced concerns regarding bidding activity, and as such has yielded pursuit of unnecessary and inappropriate rule changes that will create adverse unintended consequences for the market in general and unreasonable barriers to entry. As stated above, AEMA supports the pursuit of ensuring that resources offered into RPM are physical in nature, and as it pertains to DR, believe that the recently FERC approved DR Plan Enhancements already address those concerns.

The PJM proposal penalizes a fundamental characteristic of Demand Resources and therefore is inconsistent with comparability concepts.

One of the characteristics of Demand Resource Capacity that differs from Generation Capacity is the flexibility and uncertainty of Demand Resources. Demand Resources can enter, exit, and adjust volume commitments in the market on an annual basis in a way that is unique the Demand Resources. This flexibility affords significant benefit to the efficiencies of the PJM capacity market. Likewise, a Curtailment Service Provider’s (CSP) portfolio of customers can change as well. PJM’s proposal for changes to replacement capacity rules directly attacks this characteristic of Demand Resources and therefore significantly harms DR and end users by erecting unreasonable barriers to entry for these proven resources.

Settlement Adjustment

A key misguided feature of the PJM proposal is the Settlement Adjustment. It is problematic for the market because it imposes unnecessary administrative limits, preventing efficiencies of supply resources, and skewing market signals. It is specifically problematic for Demand Resources because it significantly penalizes flexibility and inherent uncertainty that are characteristic of Demand Resources.

The Settlement Adjustment mechanism effectively requires that entities bidding in the BRA auction three years ahead of the delivery year deliver exactly the same amount of supply that was bid and cleared. A generator typically knows very precisely how much supply can be
delivered - there is minimal uncertainty\(^1\). A CSP has inherent variability even among existing and contracted customers due to changes in PLCs and other factors. The Settlement Adjustment penalizes any uncertainty in supplied quantity be it too much or too little.

The Settlement Adjustment will needlessly increases costs to CSPs and consumers needlessly by inherently favoring generation resources that have more precise indications of capability. The Board should consider, as we do, that all load is potentially a curtailment resource – it is “physical.” A view of Demand Resource utilization of replacement capacity as “speculation” is badly misplaced and speaks to the misunderstanding of business models of demand response providers. Again, the recent Order approving PJM’s DR Plan Enhancements address any concerns about the physicality of Demand Resources offered into the market. Simply said, the view that replacement transaction activity, for any kind of supply resource, is somehow wrong or risky for PJM is unfounded and is an inappropriate target for the stated concern of eliminating speculative behavior.

Replacement Transactions

In the Stakeholder Process, PJM proposed an Amendment (which received less support that the original proposal in MRC voting) to impose the Settlement Adjustment mechanism on all replacement transactions and not just those that are derived from resources procured in an Incremental Auction. This is another component of the PJM proposal that disproportionately impacts DR and in ways that were not discussed in the stakeholder process and have nothing to do with the speculation concerns. While AEMA greatly appreciates that PJM, via its pursuit of the Amendment referenced here, sought to ensure there was no inappropriate shifting of behavior in order to avoid the Settlement Adjustment, and no discrimination resulting in the application of the Settlement Adjustment, the need for the Amendment in and of itself highlights that the nuances and complications of imposing the administrative solution of a Settlement Adjustment causes this change to be unjust, unreasonable, and unduly discriminatory.

Timing Issues

Finally, regardless of any party’s position on the substance of the anticipated filing, AEMA feels it is critical to highlight to the Board the issues that PJM’s proposed timing imposes

---

\(^1\) There is a slight uncertainty regarding EFORDs, however there are generous mechanisms available to address this. No such similar mechanisms are available to DR.
on all Suppliers for the upcoming 2017-18 BRA. A Commission ruling on the Replacement Proposal would ordinarily be contemplated mere days before the BRA. This means that participants must undertake substantial preparations for the auction, notably making arrangements for collateral, which will be based on rules that are uncertain. The significant changes in auction structure create new and substantial risks for market participants. These risks include uncertain and substantial credit issues with the potential for an increase of credit by a factor of 2.5 times, just before or possibly even during the auction window. The credit changes may not allow enough time to remedy any shortfalls. In addition the settlement adjustment, if implemented, would necessitate significant reductions in offered Demand Resources due to the new taxes on transactions that PJM is proposing. The sheer uncertainty of the outcome of any filing will create added costs and risks for many participants, and instability in the market.

We urge the Board to consider accepting the stakeholder majority proposal sponsored by ODEC. At a minimum the implementation of the proposal should be targeted for the 2018-19 DY to assure the proposal and any desired modifications can be fully vetted by stakeholders and regulators.

Thank you for your attention and consideration. Please contact me at 202-524-8832 or info@aem-alliance.org should you have any questions about this letter.

Best regards,

Katherine Hamilton
Executive Director