September 17, 2014

VIA E-MAIL TO capacityperformance@pjm.com

The PJM Board of Managers
c/o Howard Schneider, Chairman
PJM Interconnection, L.L.C.
2750 Monroe Boulevard
Audubon, PA  19403

RE:  Ex Parte Communication on Capacity Performance

Dear Mr. Schneider and the PJM Board of Managers:

The undersigned parties (“Signatories”) have collectively joined to express their concerns with respect to the Transition Auction Mechanism (“Transition”) that PJM has proposed as part of its Capacity Performance Proposal (“CP Proposal”). In addition to sending this letter to the email address listed above, the Signatories believe this issue is important enough that they wanted to direct that this be sent directly to the PJM Board of Managers as an Ex Parte communication.

PJM states that the purpose of the Transition is to incrementally procure capacity that would meet the performance standards of the CP Proposal. Many, if not all of the Signatories, are submitting comments separately on the CP Proposal. However, given our collective concerns on the Transition, we feel it is important to focus PJM on this issue specifically. In sum, PJM has yet to provide any meaningful details regarding the Transition. While we recognize the time pressure PJM has placed on itself, even if we do not all agree on the need for such fast track, the impact is too large not to afford sufficient time to design provisions for the Transition.

PJM is Moving Too Quickly on the Transition

PJM proposes substantial changes to the capacity market to be considered by stakeholders over an extremely short time horizon. Market participants have been given only 28 days to review, understand, and comment on the CP Proposal, significant aspects of which remain entirely undefined. Even for those aspects of the CP Proposal that are defined, only two stakeholder meetings (one of which was a half-day meeting on September 11) have been held to discuss and understand it. The CP Proposal is the most significant change to the Reliability Pricing Model (“RPM”) since its initial implementation in 2007 and is likely to significantly increase capacity costs. It is critical to take the time necessary to properly design these market changes.

As of the date of these comments, PJM has yet to provide any meaningful details regarding the Transition, which constituted only two paragraphs on the last page of PJM’s CP Proposal. Details are wanted regarding the need for Capacity Performance product for the 2015/16, 2016/17 and 2017/18 Delivery Years, the amount of Capacity Performance product that PJM will attempt to procure for each of these Delivery Years, the availability of resources to provide the Capacity Performance product on relatively short notice, and the anticipated cost of procuring the Capacity Performance product in the
Transition. Given the expanse of PJM’s CP Proposal, it is no wonder that the Transition has been given little attention, yet without this information it is impossible to support what effectively amounts to immediate implementation of the CP Proposal through the Transition. And while we look forward to more detail from PJM in its final Whitepaper, there will still be little time to digest and discuss the Transition prior to the November 4, 2014 Enhanced Liaison (“EL”) Committee.

The Transition will have a Significant Impact on Load that Cannot be Ignored

The change in rules for the interim Delivery Years (2015/2016, 2016/2017, and 2017/2018), after the Base Residual Auctions (“BRAs”) for those years have already been conducted and parties have undertaken contractual arrangements, made investment decisions, and otherwise relied on the rules that were in effect at the time of those BRAs, is highly prejudicial to market participants and seeks to do indirectly what PJM cannot do directly. Capacity market changes typically are applicable only to future Delivery Years for which BRAs have not yet been held, given that for the earlier Delivery Years, capacity sellers and buyers alike are already committed based on a specific capacity product definition. Further, it takes time for market participants to invest in new infrastructure or implement new operating practices and for load entities to adjust commercial arrangements based on prior BRA results. Load Serving Entities (“LSEs”) have already purchased capacity for the 2015/16, 2016/17 and 2017/18 Delivery Years. LSEs have taken on obligations and entered into retail contracts to serve load based on the pricing in the BRA for those years, with no foreseeable expectation that PJM would suddenly declare its intent to replace 85-90% of such capacity with the new, more expensive Capacity Performance product.

The amount that customers will pay for Capacity Performance resources in the Transition is a significant number that PJM has not even begun to estimate. It is unclear whether stakeholders will have that number from PJM at the conclusion of this EL process. Customers will also incur the potential cost impact associated with the risks of high penalties suppliers will price into their bids, risks that load will pay regardless of whether the suppliers are actually penalized at all during the Delivery Years. Additionally, customers will also be paying costs incurred by suppliers to comply with increased operational requirements, e.g., enhanced fuel acquisition, staffing levels, etc.

Not all LSEs have the ability to pass-through these new costs. Even for those that can and/or do, they risk creating customer backlash and churn. Ultimately the end users bear the increased cost burden. The dollar impact on customers is likely to be severe, particularly if PJM is looking to procure a 12-month product in the Incremental Auctions at a level it is targeting for the 2018/2019 BRA (“85% of Capacity Performance resources).

The rule against retroactive ratemaking restricts PJM’s ability to change the existing incremental auctions to implement the CP Proposal, as it would alter the terms on which existing resources agreed to capacity supply obligations. So PJM instead proposes a separate auction mechanism to procure CPR as an additional product, leaving prior BRA results in place for those resources that do not voluntarily participate in the Incremental Auctions for the Capacity Performance product. But this would do to customers exactly what the rule against retroactive ratemaking prohibits with respect to generation, i.e.,
changing the market outcomes on which LSEs have relied to make investment decisions. Neither PJM nor FERC is in a position to undertake all of the necessary accommodations to remediate such detrimental reliance. Therefore, the Signatories’ view is that any changes that would take effect for the Delivery Year after the BRA for that Delivery Year has been conducted would amount to retroactive ratemaking prohibited by FERC.

**PJM’s Proposed Transition Mechanism May Do More Harm than Good**

PJM has not demonstrated that changes to the existing resource adequacy construct are necessary to achieve substantially better generator performance than was experienced during last winter’s polar vortex. While fuel interruptions and problems with gas supply contributed to the high forced outage rate, other causes had to do with the aging fleet and mechanical generator failures due to the fact that many units were simply unprepared for such low temperatures. PJM, to its credit, is addressing the issues concerning the performance of the generators in a number of stakeholder processes, e.g., gas unit commitment procedures, generator testing prior to winter conditions, etc. PJM has not quantified how many units have already taken actions to prepare for next winter. There are already incentives in the energy markets for units to want to be able to perform – and make money – when called upon. PJM should not ignore the "lessons learned" effect experienced by generators who missed out on energy revenues last winter by failing to run.

Even if the existing rules are inadequate to properly incentive performance, implementing the CP Proposal in the Transition may do more harm than good. Entities that have on-site fuel and that have already secured a capacity obligation for the 2015/16, 2016/17 and 2017/18 Delivery Years can simply re-enter an Incremental Auction and receive additional windfall payments. While such entities will be subject to potential penalties, which are low if the unit runs frequently, there is nothing different that the unit is doing by way of operating to receive additional revenues. It is also questionable whether non-baseload units such as gas generators will be able to practically improve operations in the intervening Delivery Years to qualify for the Capacity Performance product, e.g., it can be very difficult for a unit to gain or re-gain dual fuel capabilities. PJM could hit RPM ceiling prices without generators having the physical ability to upgrade in the short time frame - money spent without purpose.

PJM has not addressed whether units will have an obligation to offer into the Incremental Auctions, potentially creating incentives for suppliers to withhold capacity in order to increase prices for Capacity Performance products. PJM has not addressed how it would manage the potential (and possibly artificial) shortage of Capacity Performance resources during the Transition and corresponding spike in capacity prices. In light of the foregoing, the earliest the Capacity Performance product should be acquired, if at all, is in the 2018/19 BRA. To the extent PJM remains concerned about the intervening Delivery Years, including 2015/16 in particular, it ought to have comprehensive discussions with stakeholders to identify targeted measures that would specifically address its concerns, rather than trying to combine it with a significant overhaul of the RPM.

Sincerely,
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