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Dear Members, States and Stakeholders:

I have followed the progress of the Capacity Construct/Public Policy Senior Task Force (the Task Force) closely. I thank and commend the stakeholders for their consideration, work and many hours of valuable time spent discussing a very difficult topic: How to respond to state public policy programs that promote state-specific environmental, social or political objectives focused on generation that participates in PJM Interconnection's federally regulated competitive wholesale electricity markets.

Beyond this important stakeholder debate, PJM has engaged on this topic before FERC, in public industry forums, through extensive dialogues with the PJM Independent Market Monitor, interested stakeholders, staff from ISO-NE, OPSI, individual state staff, and representatives from industry associations.

Reconciling individual state public policy objectives associated with generation, while providing efficient, cost-effective and reliable electricity across an interconnected regional competitive wholesale market, is no simple matter. Despite all of our collective efforts in the stakeholder process, a workable consensus solution – or even a shared agreement on the nature and extent of the problem to be solved – appears unlikely.

In broad terms, two approaches emerged from the Task Force. First, several variations on a "two tiered" approach to settling the capacity market, including PJM's Capacity Repricing Proposal. Second, an expansion of PJM's existing minimum offer price rule (MOPR) to include all plants regardless of age or type – as opposed to the current rule, which is limited to new investment in natural gas generation.

I have prepared this letter to express appreciation for the efforts of PJM members, states and other stakeholders as this issue has progressed through the stakeholder process. I am also writing to provide PJM's reaction to what has emerged from the process and our current thinking.

The Issue is Real and Requires Action

Though we appreciate the good work of PJM members, states and other stakeholders, PJM management disagrees with a key argument made in the Task Force deliberations that there is no conflict between state programs that financially support generation and the efficient operation of PJM's markets. Those who hold this view point to a very healthy reserve margin and suggest that PJM need only act should these margins degrade. Today's high reserve margins appear, at least in part, to result from legacy generation receiving but ignoring an unmistakable market signal to retire. Subsidies will further mask prices that would otherwise signal resources to exit and bring reserve margins into equilibrium.

PJM has discussed this issue with stakeholders for more than 12 months and the Task Force has spent more than 20 meeting days during the past six months grappling with this issue.

Meanwhile, a district court in Illinois has upheld the State's ZEC legislation providing out-of-market compensation to certain nuclear plants in Illinois that had threatened to retire. This decision included an important instruction to FERC (and by extension, to PJM):

> So long as FERC can address any problem the ZEC program creates with respect to just and reasonable wholesale rates – and nothing in the complaints suggest that FERC is hobbled in any way by the state statute – there is no conflict.[1]

We find support in this instruction for our decision to pursue a market-design response to address state programs enacted to promote a state's public policy interest relating to capacity resources. When such a program prevents the wholesale electricity market from producing just and reasonable rates, the first order of responsibility falls on FERC (which acts on filings made by public utilities like PJM) to determine whether changes to market design can be effected to maintain just and reasonable outcomes, given the state program.

PJM has repeatedly voiced a preference to address state programs by respecting the stated policy goals of these programs and designing the wholesale market to accommodate state programs advancing these goals while still protecting the integrity of the wholesale market investment signals. This preference favors a "two-tiered" capacity market settlement approach ahead of an expanded MOPR.

Given a distinct potential for additional state programs in 2018, I will be recommending to the PJM Board at its February 2018 meeting that PJM address these programs by filing to make market design changes with FERC in the first quarter of 2018.[2] More specifically, I will recommend the Board endorse filing PJM's "two-tiered" capacity market settlement proposal, known as Capacity Repricing.

PJM urges action now to promote market certainty. This is particularly true in light of the recent U.S. Court of Appeals MOPR decision in the *NRG* case. As a result of *NRG*, FERC required PJM to refile its MOPR without the categorical exemptions, including the one that allowed load-serving entities such as municipal and vertically integrated entities engaging in self-supply to move forward without being mitigated. FERC left open the door for PJM to make a further filing. The time is ripe, therefore, to put PJM members, states and other stakeholders on notice of the direction in which PJM supports moving to implement a market-design response addressing state programs enacted to promote a state's public policy interests in capacity resources. I do not make this recommendation lightly, recognizing valid concerns arise with any course of action PJM may take, including Capacity Repricing.

Market Design to Address State Programs: Two-Tiered Settlement

PJM has updated and offers an expanded definition of the design elements of Capacity Repricing based on stakeholder feedback, which can be found as a new version of the Capacity Repricing work paper (version 7) published on the PJM website at http://www.pjm.com/-/media/library/reports-notices/special-reports/2018/20180116-capacity-market-repricing-proposal-updated.ashx?la=en. PJM intends to review the

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[1] *EPSA v. Star, et al*., Case No. 17-CV-01164, p.34 (N.D. Ill.)(017/14/17).

[2] It is apparent from abundant public reports that efforts similar to those in Illinois are underway in other PJM states, actively seeking legislative or regulatory support for generation to advance various political, social and environmental interests.

updates to the work paper with stakeholders during the January 25, 2018 Markets & Reliability Committee meeting.

Given the stakeholders' recent examination of the expanded MOPR (MOPR-Ex) alternate proposal, I think it is appropriate that I share the reasons I am not recommending such an approach to the PJM Board. I agree that MOPR-Ex would provide the most direct and effective means to preserve price integrity necessary for the PJM Capacity Market to discharge its resource adequacy function. I can also accept, as argued by our IMM, that it offers the most economically sound response to the issue. However, PJM management continues to favor Capacity Repricing because it regards that approach as substantially less punitive and less likely to frustrate the operation of state programs. PJM believes it is vital for the regional market design to respect individual state interests while protecting consumers in other states from potential cost shifts. While MOPR-Ex would not prevent state programs from providing support to individual generators, it would most likely exclude generators obtaining this support from clearing the PJM Capacity Market. PJM believes this approach is not sustainable and does not strike an appropriate balance between legitimate state interests and wholesale market integrity.

In contrast, Capacity Repricing virtually guarantees that a resource obtaining state support will receive a capacity commitment and receive payment from PJM for its committed capacity. From the standpoint of both the state program and the plants benefiting from such a program, the only direct impact of Capacity Repricing is that the offer submitted by the sponsored plant will not be considered in price formation, but instead will be replaced by a cost-based or administratively determined reference offer. Inherently, the two-tiered proposal separates the procurement of resources from the price formation function of the auction. In the price formation function, the proposal substitutes the offer of a plant receiving out-of-market support with a reference offer. This substitution is done to approximate what would have occurred had all offers been competitive.

If the Board supports management's recommendation, PJM will actively listen, consider and engage on alternative design suggestions that stakeholders might offer in the course of the FERC proceeding.

Next Steps

The PJM Board is scheduled to consider this matter at its February 2018 meeting. In addition to management's recommendation, the Board will also review the results of the January 25, 2018, stakeholder meetings. If the Board acts on the matter, I would expect PJM to file with FERC before the end of February, seeking action and an effective date after the May 2018 Base Residual Auction.

Again, I appreciate the efforts of all stakeholders working to resolve the challenge of integrating the effects of individual state policy decisions into competitive regional wholesale electricity markets. At this stage, I believe we must move the debate forward to FERC to make progress.

Sincerely,

Andrew L Ott

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