

Statement presented by Commissioner Frederick Butler of the New Jersey Board of Public Utilities on Friday, February 3, 2006 to FERC in reference to:

Docket Number: ER05-1410

Docket Number: EL05-148

Commissioners and FERC Staff, I would like to thank you for the opportunity to provide to you a discussion of PJM's RPM proposal and specifically its impact on New Jersey if implemented in its current form. Commissioners, as you know the New Jersey Board of Public Utilities is charged with the regulation and jurisdiction of the retail supply of electric within New Jersey. This includes the provision to ensure safe, adequate, and proper utility services at reasonable rates for customers in New Jersey. As such, the New Jersey Board of Public Utilities has a vital interest in the proposed RPM filing because of the effect it will have on our State's wholesale markets and grid reliability, and ultimately our retail marketplace.

While we recognize that there are shortfalls in today's capacity market, the New Jersey Board of Public Utilities is not ready to support PJM's RPM proposal to replace the current capacity market structure since we believe that RPM, in its current form, will not have the intended effects on investment and will not result in the most cost effective means of solving future reliability problems. Thus, we are concerned that RPM, in its current form, will not ensure adequate electricity supply within New Jersey, and will lead to increased costs to our consumers.

Let me start out by assuring the FERC community that we in New Jersey know there is a problem-we're right in the middle of it. We're taking action to deal with the problem, such as an aggressive demand response program, which will be described in additional submissions under this docket. We realize a solution to the problem will not be free of cost implications. That being said, let me explain our concerns regarding PJM's current RPM proposal.

We have distilled down our concerns to six main points:

1. RPM needs to be fully integrated with the PJM Regional Transmission Expansion Planning Process ("RTEPP") to provide an opportunity for the best possible solution to a reliability problem within a constrained area.
2. RPM does not provide an adequate opportunity for planned transmission upgrades to compete with planned and existing generation resources leading to the most cost-effective and reliable solution
3. RPM does not adequately provide an opportunity for demand response to compete with planned and existing generation resources.
4. RPM fails to address embedded cost inequities between states.
5. PJM does not have sufficient time to properly address announced generation retirements under the current regulatory framework, which prompts the reliability problems PJM is attempting to address with RPM.

6. Explicit market power mitigation rules are necessary in any capacity construct that the Commission adopts.

Point 1: RPM needs to be fully integrated with the PJM Regional Transmission Expansion

Commissioners, the New Jersey Board of Public Utilities is concerned that the current PJM RTEPP and its proposed RPM filing are not sufficiently integrated. We feel that as a result of the RPM filing, this Commission is being asked to approve a long-term capacity model for PJM, without that capacity model having enough interaction with other functions for which PJM is responsible, including its transmission planning process.

As part of the RPM process, PJM will use the RTEPP process to identify areas within PJM, called Locational Deliverability Areas (LDAs) that are projected to have deliverability problems because of physical limitations of the transmission system, voltage limitations, or stability limitations. These are areas within PJM that become constrained and fail to satisfy PJM's RTEPP load deliverability test. Specifically, these are areas where localized reliability problems could exist. While the proposed objective of RPM is to resolve these potential local deliverability issues in the designated LDAs before they become reliability problems, at this point in time we feel RPM and RTEPP lack sufficient interrelationships.

We feel that a goal of RPM should be to coordinate with the PJM RTEPP to ensure that a cost-effective balance of transmission, generation and demand response resolves the reliability problem. We also feel RPM, as currently proposed, weighs heavily towards the development of new peaking generation, as well as the compensation of existing generation that require additional revenues to continue operation. Since RPM favors local generation solutions over other alternatives, we believe that the developers of transmission and demand response solutions will be discouraged from participating in the RPM process.

Only after ratepayers within a designated LDA have been exposed to high locational prices for several years, with no solution in place to relieve the deliverability problem, will PJM reevaluate that particular LDA using the RTEPP process. PJM claims that in the event that higher locational capacity prices do not prompt new entry in a particular area or LDA for two consecutive delivery years, then PJM will *investigate* (through the RTEPP process) the costs and benefits of a regulated transmission upgrade that would relieve constraints on deliveries in that area. This process does nothing more but add several additional years to a situation where ratepayers already have been exposed to higher capacity prices. Assuming that PJM through the RTEPP process was able to develop a transmission solution, New Jersey ratepayers would be burdened with paying unnecessary high capacity prices and also will be burdened for the costs of a regulated transmission upgrade. If the RTEPP process and RPM were more fully integrated, ratepayers in New Jersey and other areas would be assured at the beginning of the transmission planning process that long-term solutions to reliability issues would be dealt with at the lowest possible cost regardless of whether that solution is generation,

transmission or demand response. RPM as proposed would have New Jersey ratepayers exposed to both high capacity costs as well as the costs associated with a transmission solution.

Given that we feel that RPM fails to coordinate its RPM process with the RTEPP, New Jersey feels that the FERC should require PJM to provide a supplemental filing that details the integration of RPM and the PJM RTEPP process, prior to any action by the Commission on PJM's RPM proposal. We feel that a robust and integrated transmission planning approach would better ensure that PJM's short- and long-term resource adequacy will lead to a cost-effective and reliable balance of generation, transmission and demand response.

Point 2: RPM does not provide an adequate opportunity for planned transmission upgrades

Second, RPM does not provide an opportunity for planned transmission upgrades to compete with planned and existing generation resources leading to the most cost-effective and reliable solution. We feel that given the longer lead times associated with the development of many transmission projects, such transmission projects will not be able to participate in RPM, and thus RPM will fail in this regard.

According to PJM, RPM is based on four-year-forward capacity commitments, where PJM will administer a series of auctions for a given "delivery year" beginning four years in advance to match the regions needs for capacity. PJM indicates that planned transmission projects can be bid into the auction and can compete directly with generation resources. While it is the intent of RPM to allow generation and transmission, capacity resources to bid into the auction process, the varying planning horizons and risks for each type of resource does not provide a level playing field for transmission projects to effectively compete with generation solutions.

It is the New Jersey Board of Public Utilities experience that a longer time horizon than four years is needed to site, gain permits, and construct most transmission projects. The siting of transmission lines, whether interstate or intrastate is understandably difficult, involving complex engineering, social, land use considerations, especially in New Jersey. Most importantly from our perspective, it involves a difficult and lengthy regulatory approval process. Many observers and participants in the electricity industry now regard transmission siting and permitting procedures as a major reason why the development of new transmission facilities is not keeping pace with the need to create or enhance the bulk power transmission system. To expect that a transmission line can be sited and constructed, and compete in the RPM process with generation projects, is highly ambitious at best. It is improbable for an entity to consider the development of a transmission solution under RPM because the entity considering the transmission solution must be able to look beyond RPM's four-year auction period, while taking into account the uncertainty of potential generation additions beyond those four years.

Even if the transmission upgrade can be completed within a four-year period, the steps an entity must take to be prepared to offer the transmission upgrade into the RPM Base Residual Auction require that party to begin the transmission process at least several months in advance of the RPM Base Residual Auction. We feel that as currently written, the rules governing a transmission solution participation in the RPM process places transmission projects at a distinct disadvantage when participating in the RPM process. Further, the four year time frame as proposed under RPM highly favors the development of gas-fired peaking generation. This places transmission upgrades at a distinct disadvantage to compete in the Base Residual Auction. The New Jersey Board of Public Utilities believes that RPM or any future capacity construct should allow for the most cost-effective and reliable solutions to be developed, taking into account local characteristics of the transmission system.

Point 3: RPM does not provide an adequate opportunity for demand response

Thirdly, RPM assumes that demand response will be able to compete on a level playing field with generation and transmission solutions to address local deliverability problems, by allowing greater competition among the three types of solutions. It is our belief that, at the current time, the demand side of the electricity market remains severely underdeveloped. We believe that demand response cannot compete with generation and transmission until it becomes fully functional in the electricity market.

A fully functional demand side resource means that all or most customers have the ability to see real-time prices, have the capability to react to those prices in real time, and receive the direct benefits or pay the costs of real-time energy use. This will require the public utility commissions to approve significant changes in current rate designs and to take politically difficult actions to move greater numbers of ratepayers from fixed electricity prices to variable pricing signals. In addition, such changes need to be supported with advanced metering infrastructure, electronic data interchange software and hardware, other technological support, and effective customer outreach and education, all of which require significant time and funding investments. The directives to the states contained in EPACT 05 regarding advanced metering and time of use rates will go a long way towards addressing this issue, but more work needs to be done.

Thus, it is unrealistic to expect that in the near term at least, demand response will be able to compete with generation and transmission. It may be unrealistic to expect such competition in the timeframe suggested by PJM. Before demand response can effectively participate in the RPM Residual Auction, the amount of DSM options must significantly increase in the current market. Until that time, a level playing field will not exist for generation, transmission and demand response to respond to capacity constraints.

Point 4: RPM fails to address embedded cost inequities between states

Fourth, we feel that the current PJM market is experiencing a mismatch between locations of generation and high electricity demand, not insufficient capacity reserves. While certain areas in PJM have excess capacity, other locations experience inadequate

electricity generation to meet their needs. This inequality results from a significant cost differential associated with fuel cost/operating and siting generation facilities within PJM. Although RPM attempts to address the locational factors that undermine the existing capacity market, it does not address the underlying reasons for the current uneven distribution of capacity reserves.

Decisions related to the development of new generation facilities do not rest solely on the identification of load pockets and projected higher revenues from capacity reserves in those locations. Generation development determinations are also directly affected by comparisons in projected facility construction and operation costs. Such costs are significantly greater in states that have adopted rules to implement and enforce strong environmental protections. Although the environmental and health impacts from effective air quality measures and other environmental rules benefit a wide area, the additional costs related to such protection are unfairly shouldered by the energy consumers located in those states that have adopted more stringent standards.

We feel that an initiative like RPM that focuses on a single market factor, such as location, does not address the underlying reasons for the disparity, cannot adequately address these inequities, solve the uneven distribution of capacity, or ensure greater grid reliability. Historically, the additional costs encountered in environmentally sensitive states have led to the siting of less generation facilities and the retirement of older, more inefficient plants. Despite RPM, the New Jersey Board of Public Utilities believes that new generation can continue to be developed in areas where environmental regulations are less stringent and construction and operational costs are correspondingly lower.

Furthermore, RPM will reward all existing generation facilities with windfall profits, including those facilities that emit greater levels of emissions, and have lower production costs because they are located closer to inexpensive fuel sources, such as coal. Currently, the citizens of New Jersey suffer the environmental effects from emissions, carried by prevailing winds, emitted by generation located in states where such facilities are less stringently regulated. With RPM, New Jersey will continue to endure the impacts from the emissions of less-regulated, less expensive fossil-fuel generation, in addition to paying higher costs for capacity reserves located in states with less regulatory requirements.

The solution to the current imbalance of capacity reserves should not rely solely on the placement of an additional cost burden on those states that do not have access to inexpensive fuel sources, such as coal. A more effective and equitable solution requires federal leadership that results in greater parity of generation construction and operational costs resulting from a more uniform protection of our environment. With RPM, we fear that our State will be burdened with higher capacity costs, continued negative air quality impacts, and the costs of siting new transmission infrastructure, necessitated by continued insufficiency of reserves within our State.

Point 5: PJM does not have sufficient time to properly address announced generation retirements

Fifth, electricity restructuring was not only intended to link loads to efficient generation, but also to shift the risk of such generation from the ratepayers to the shareholders. At odds with this basic premise is the idea that generation owners can retire their units with only 90-days notice to PJM. Of course, PJM can request that the generator remain in service until the PJM determines that the reliability issues resulting from the generation retirement are fixed. However, under this scenario, the generation unit is entitled to recover its costs through a cost-of-service type cost recovery or a Deactivation Avoidable Cost Credit formula rate. Allowing generation units cost recovery and guaranteeing them a profit is at loggerheads with generation competition. In a deregulated industry, various returns (and losses) among various types of assets are expected as entities are not entitled to earn an authorized rate of return. Furthermore, although certain generating units may not be earning sufficient revenues, base load and mid-merit generators are obtaining record revenues in the energy market. Such increased revenues in the energy market easily offset the revenue short falls of a few generating units that are needed for reliability.

Providing a new mechanism for generation retirements could provide the predictability that is required to properly plan and install transmission lines to areas that have deliverability problems. The 90-day notice period that the generators are required to provide PJM is clearly not sufficient to allow PJM to remedy a reliability issue that may arise due to the generation retirement. The Commission accepted PJM's proposal to require only 90 days notice before a generator retires, to allow 30 days for PJM to determine if the unit is required for reliability purposes, and 60 days for to allow the generator to file for a cost of service recovery or formula rate recovery. This Commission determined that PJM did not show the authority to require generators to remain in service indefinitely. The New Jersey Board of Public Utilities requests that this 90-day requirement be revisited because it does not allow PJM to correct reliability problems that rise from announced generation retirements and result in cost of service rates or formula rate recovery.

Generating units should be required to notify PJM of the possibility of retiring due to insufficient revenues well in advance of the 90 days currently required. Under the present rule, such units have no incentive to warn PJM if their revenues are decreasing because the regulatory structure allows them to file for recovery. Notifying PJM of the possibility of a generating unit retiring would provide direct and meaningful information that can be used in the RTEPP process. We urge the Commission to begin a proceeding to examine the short 90-day retirement notice requirement before approving RPM.

Point 6: Explicit market power mitigation rules are necessary

Lastly, the explicit market power mitigation rules included in the RPM proposal are absolutely necessary in any approach to remedying the current capacity construct that the Commission approves. The locational aspect of the RPM will increase market power concerns because of the creation of the smaller LDA capacity markets. The market mitigation rules proposed by PJM are narrowly and specifically tailored to address

market conditions in which the potential for the exercising of market power exists. Without the adoption of the market power mitigation rules proposed by PJM, the New Jersey Board of Public Utilities cannot support, and the Commission should not adopt RPM or any other construct that values capacity by location.

While the New Jersey Board of Public Utilities recognizes that locational reliability problems exist in New Jersey and other areas of PJM, we do not believe that RPM as proposed is a solution that will solve these local reliability problems. However, we encourage the Commission to further support additional dialogue to take place to shape the short term and long term needs of our wholesale electricity markets. As part of that process the New Jersey Board of Public Utilities commits to actively participate in this necessary and vital dialog to develop an implementation plan that will guide our markets toward a reliable and viable wholesale energy market. In the interim we are encouraged that PJM is working with the states, utilities, and the Commission to get the best mix of transmission, generation and demand response solutions for identified reliability problems.

Thank you for the opportunity to present these views on behalf of the New Jersey Board of Public Utilities.