Energy Merchants

Capacity Markets Update; Eastern RTO/ISO Conference Notes

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United States

Brian Chin, CPA
+1-212-816-2861
brian.chin@citigroup.com

Greg Gordon, CFA
+1-212-816-2802
greg.gordon@citigroup.com

Humberto Medina
+1-212-816-3366

SUMMARY

- On 5/10/05-5/11/05 we attended the Eastern RTO/ISO conference in Washington D.C.. In attendance were representatives from 21 state commissions, 4 RTO/ISOs and 3 FERC commissioners.
- Key takeaways: the PJM Board is undergoing its due diligence on the PJM capacity markets proposal and whether to submit it to FERC under Section 206. The timeline and ultimate decision remain uncertain.
- In one-on-one discussions each of the three of the FERC commissioners expressed either conceptual support for capacity markets or saw them as long-term useful transition tools to a more competitive market vision.
- Specific criticisms of the PJM capacity markets proposal remain unaddressed. We expect if the PJM Board were to submit the plan to FERC, either a technical conference or a full hearing would be likely, potentially making a final FERC decision possible in late 2005 or early 2006.

OPINION

On 5/10 and 5/11 we attended and presented to the Eastern Regional Transmission Organization/Independent System Operator conference in Washington D.C.. In attendance were commissioners from 21 public utility commissions, three FERC commissioners (Chairman Pat Wood, and Commissioners Suedeen Kelly and Nora Brownell), executives from four regional transmission organizations, and energy companies, consulting firms and legal firms. We were asked to present to the conference to represent a financial community perspective. We presented a summarized opinion of our report, "*Capacity Markets: Capacity Payments For Capacity Reserves*" dated 4/21/05. In that report, we found the largest potential beneficiaries of capacity markets at PJM East could be PSEG (PEG; 1H; $55.55), Constellation (CEG; 1M.; $52.90), PEPCO (POM; NR), Reliant (RRI; 1H; $10.35), and NRG Energy (NRG; 1H; $32.83).

The PJM Board Is Keeping Its Cards Close To Its Vest. At the conference, we met with members of PJM's Board and Management Team, including John McNeely Foster, Scott Miller, and Audrey Zibelman about the PJM's capacity markets proposal. While our conversation yielded neither an indication of the upcoming Board decision or a sense of timing, the PJM team indicated that the Board was conducting its "due diligence." Several PJM (non-Board), NYISO, and ISO New England executives expressed concurrence with our view that capacity markets should help mitigate future reliability issues.

Background: In early summer 2005, PJM's Board may decide to submit a proposed capacity market structure to the Federal Energy Regulatory Commission (FERC) for federal approval. This proposal, called the Reliability Pricing Model (RPM), attempts to create a capacity market auction that incents generators to maintain spare capacity, increasing long-term grid reliability. The proposed structure creates a more robust benchmark price for generation capacity that could result in increased revenues to generators with spare capacity, increased pass-through costs to load serving entities that pay for capacity through Basic Generating

Service auctions, and increased costs to load serving entities that have a rate freeze or are unable to pass through higher capacity payments.

Under PJM rules and the Federal Power Act Section 206, the Board has the flexibility to submit the proposal to FERC without receiving a mandate from the PJM Members Committee. If the proposal is submitted to FERC, FERC will decide whether it is appropriate to review the proposal, and subsequently whether it will approve the proposal. It is highly uncertain whether the PJM Board will submit the proposal, or if FERC will approve it.

FERC Conceptually Sees Capacity Markets As A Useful Mechanism. At the conference we also met with three FERC Commissioners, Chairman Pat Wood (who will depart on June 30th), Cmr. Nora Brownell, and Cmr. Suedeen Kelly. Our one-on-one conversations all yielded similar sentiments from the Commissioners: capacity markets conceptually make sense and are either a useful transition tool towards a more competitive market vision, or are a necessary part of a deregulated market structure that cannot politically tolerate extreme pricing volatility. All three believed current capacity market proposals were not perfect, and that certain criticisms needed to be addressed. If FERC were to receive a proposal from the PJM Board about PJM's capacity markets, FERC would likely take one of three courses of action: 1) make an immediate Order (unlikely), 2) hold a technical conference that suggests FERC largely agrees with the proposal but believes certain issues need addressing (possible), or 3) hold public hearings that would signal material discomfort and would likely significantly extend the decision-making process (possible).

We believe a technical conference is the most likely course of action if FERC were to receive the RPM proposal from the PJM Board, although full hearings remain a possibility. We expect the highly sensitive debate over capacity markets might delay a final FERC decision, if one were to happen, into late 2005 or early 2006. Based on that assumption, the earliest PJM auction could be held in summer 2006 for implementation in 2007.

Although significant debate still exists about the direction of capacity markets, the tone of the conference was pro-competitive market structures. In our view, most participants voiced a pro-market structure sentiment during the discussion of capacity markets. Those most in favor of capacity market structures tended to represent generators and regions seeing potentially short supply, while those most critical tended to represent over-supplied regions. Debate was most vigorous over details of particular capacity market structures.

PJM's Reliability Pricing Model and Other Capacity Market Issues Likely Need Addressing. At the conference we met Denise Goulet, from Miller, Balis and O'Neil, P.C., and Chairman Ken Schisler from the Maryland Public Service Commission, who articulated several issues/concerns about the PJM capacity markets proposal.

- RPM burdens current ratepayers for future generation reliability, but future reliability issues might be met with alternate resources (transmission investment), resulting in an unnecessary penalty borne by current ratepayers.
- RPM does not distinguish enough between inefficient and efficient generation. The proposal as it currently stands might result in lesser retirements of plants that should be retired as a matter of public policy.
- RPM is unnecessarily administrative and complex.
- Capacity markets might lead to inordinate investment in peaker generation rather than baseload generation. The RPM proposal does not make significant differentiation between different types of generation

- Certain parts of PJM have excess capacity – it may not be fair public policy to burden ratepayers in these regions for reliability needs in tight load pockets.
- There remain significant questions among LSEs and state commissions as to whether capacity market revenues would attract investor and result in new generation build. There is concern that a "wealth transfer" would happen between ratepayers/load serving entities and generators/investors without any discernible benefit in the form of additional, efficient generation construction.
- RPM locks in contract terms for 1 year, 4 years in advance. It is not clear whether a one year contract duration is sufficient to send a signal of revenue certainty to investors.
- The current RPM proposal potentially mutes demand response mechanisms for deregulated retail markets. Under the proposal, there is no seasonal adjustment for capacity fees levied to load serving entities, potentially diluting the effectiveness of demand side management mechanisms.

Upcoming Capacity Market Conferences May Indicate Regulatory Directions at FERC, California. We have been invited by Commissioner Brownell to present our views on capacity markets at upcoming ISO/FERC conferences on June 2nd (California) and June 16th (Washington D.C.). Commissioner Brownell and other speakers' comments may illustrate how capacity markets may evolve in the West and at the Federal level.

Other issues included regional emissions trading markets and energy bill legislation.

- The three Northeast RTO/ISOs are planning a regional emissions allowance trading market for implementation in 2009. The program, the Regional Greenhouse Gas Initiative (RGGI), would potentially cover 14.5% of the U.S. economy's greenhouse emissions and 3.5% of global greenhouse gas emissions. The program would be run conjointly with the Environmental Protection Agency's Clean Air Interstate Rules.
- Mark Menezes, Senior Advisor to the Senate Energy Policy Committee in Washington D.C., provided his perspectives on the Federal Energy Bill. The transmission line eminent domain provision of the Energy Bill is still included in the current legislation. Under the current legislation, the federal government can establish national corridors of interest for transmission lines may qualify for accelerated siting authority if regional and local bureaucracies impede construction for too long.

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