

**UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION**

Centralized Capacity Markets in Regional)
Transmission Organizations and)
Independent System Operators)

Docket No. AD13-7-000

**Prepared Comments of Shahid Malik, President
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FERC Technical Conference on Centralized Capacity Markets in Regional
Transmission Organizations and Independent System Operators
Panel #3: “Adapting to Industry Changes”**

Good afternoon. Thank you for allowing us to participate in this excellent forum. My name is Shahid Malik, and I am the President of PSEG Energy Resources & Trade LLC (“ER&T”). ER&T is the marketing subsidiary of PSEG Power LLC, a wholesale generation company that owns and controls an approximately 13,000 MW deregulated portfolio of installed capacity in PJM, ISO-NE and NYISO. Our portfolio utilizes a diverse mix of fuels: 45% gas, 27% nuclear, 18% coal and 9% oil. We have in-depth knowledge and experience in organized markets with a capacity market structure. We have made substantial investments in our generating fleet in organized markets, including installing approximately \$1.3 billion in back-end technology investments on our coal units, making them among the cleanest coal facilities in the country, and building several new peaking units in PJM. These investments would not have been made without the capacity market income streams that a forward capacity market provides. We also function as a load-serving entity, contracting with electric utility companies to satisfy their respective default service obligations to customers that have not chosen a third party supplier for electricity. Thus, PSEG’s decisions in the market are made through the dual

lens of both a wholesale generator and an entity with contracted commitments to serve load.

My comments today are representative of the views of the PSEG Companies, which include PSEG Power as well as PSE&G, a franchised public utility company in the State of New Jersey. PSE&G has been named America's "Most Reliable Electric Utility" for the 5th time in 8 years and has won regional reliability awards for 11 consecutive years. PSE&G also relies on the capacity market to ensure there is adequate capacity to meet reliability needs and as a source of revenues for certain state-sponsored programs such as demand response and energy efficiency.

The focus of PSEG is very much on reliability and resource adequacy, both present and future, as well as providing service to customers at a reasonable cost. As I will explain, we believe that the capacity markets, particularly PJM's RPM, have generally served to ensure resource adequacy at reasonable cost and have been flexible enough to accommodate changing market conditions and policy goals. However, it is critical that capacity markets (and regulators overseeing them: (i) continue to ensure comparable treatment of all participating resources; and (ii) recognize the challenges facing merchant generation resources in competing with resources receiving subsidies, including ensuring that appropriate buyer-side mitigation measures are in place to reflect the existence of these subsidies.

Capacity markets cannot be viewed in isolation. They are in fact necessary because of the "missing money" problem associated with ISO/RTO mitigation in energy markets, and because the level of capacity procured for reliability is always above the amount required to serve just the energy needs of the system. As such, the industry has

evolved to include as capacity resources less efficient and/or more costly units that rarely have the opportunity to recover energy market revenues or to set price.

An appropriate capacity market design needs to recognize the factors that influence market participants in making investments and should provide them with a reasonable opportunity to recover their investments and earn a competitive return. The risks assumed by merchant generating companies need to be acknowledged by policy makers and we, the generators, must be willing to accept them. In terms of public policy objectives, such as the implementation of new environmental requirements, for example, this means that investors must have assurances that the implementation of those objectives will not interfere with price-setting market mechanisms. So, if capacity markets are well-designed and protected from interference, we can meet resource adequacy requirements in an efficient manner while still helping to meet state and federal policy goals.

As policy makers and governments seek to improve the environment, I would like to note that PSEG, through its subsidiary PSE&G, is investing over \$700 million in approximately 125 MW of renewable solar generation to help meet New Jersey's renewable portfolio standard requirement. These MWs are grid-connected and bid into the capacity market, with revenues credited back to customers under state-approved programs. We believe that clean, green energy should play a role in the generation resource mix in organized markets. At the same time, the fundamental objectives of forward capacity markets must not be undermined in the process, and capacity market design must continue to ensure resource adequacy and system reliability at the lowest long-term cost.

Capacity markets, such as PJM's, have demonstrated that they already have the flexibility to accommodate policy goals for energy and capacity resources. For example, the RPM market design has facilitated the retirement of over 14,000 MWs of coal units driven largely by the MATS rules while still meeting reliability targets. Also, in PJM's most recent BRA, we saw an increase in wind and solar resources that cleared, with approximately 870 MW of wind resources clearing and approximately 90 MW of solar clearing the auction. While the PJM capacity market design is not perfect, these are achievements for which PJM and its RPM should be commended.

Other ISOs, however, have not done as good a job in solving the "missing money" problem. We have deep reservations about the ISO-NE's Forward Capacity Market ("FCM") construct. It has done a poor job of recognizing locational requirements or allowing units to submit offers reflecting their own risk-based costs of participation in the market. Because of these and other flaws, investments for new and existing generation have been chilled, resulting, for example, in the need for a special procurement by ISO-NE of "Winter Reliability" capacity. ISO-NE's plan to implement "performance" based pricing in capacity markets is also poorly conceived and can be expected to result in the premature retirement of viable capacity resources while failing to incentivize new investment.

Overall, the capacity markets have been flexible in responding to changing market circumstances including growth of demand response, energy efficiency and renewables. Yet, specific improvements continue to be needed. These improvements include:

- Avoiding "managing the market." In PJM, for example, over the last year we have seen regular instances of "second-guessing" by the RTO of the economic

Day-Ahead market dispatch. As a result, units that PJM deems to be needed in the Real-Time reliability dispatch are added to the Day-Ahead dispatch even though they are not economic, thereby depressing Day-Ahead prices. While PJM's intentions may have been benign – such as securing uneconomic resources needed for reactive power requirements – the impacts of this course of action reduce the energy market contribution to below competitive levels.

- Ensuring capacity imports are reliable. The market has seen considerable increases in capacity imports into PJM from neighboring control areas. In the last PJM Base Residual Auction (“BRA”), imports of capacity from outside of PJM nearly doubled from last year's auction, totaling approximately 7,500 MW. These capacity imports do not have a “must-offer” capacity market requirement like PJM-domiciled capacity resources. This may ultimately deter investment in PJM and place even more stress on the capacity market to support new entry and to preserve the economic viability of existing resources needed for reliability.
- Eliminating the 2.5% short-term resource procurement target in RPM. This rule, which removes 2.5% of the reliability requirement for RPM from the demand curve, has price suppressive effects and will discourage new entry into the market.

Beyond these specific recommendations, we believe that two fundamental principles need to be followed for the capacity market construct to remain viable in the face of changing public policy choices. First, because capacity is mainly a reliability product that is based upon having sufficient resources to meet future requirements, the

contribution to reliability of capacity from different technology types has to be comparable. “Comparable” does not necessarily mean identical but it does mean that different resource types have to be sufficiently similar to traditional central station generation resources to meet prevailing reliability standards. In the case of some type of non-traditional resources that have been favored by policy makers, such as wind and solar, this comparability can be largely achieved by recognizing the intermittency of the energy source and adjusting the capacity value based on performance of like resources.

We question, however, whether comparability has been adequately achieved for other types of non-traditional resources such as Demand Response. It is simply not the case that 1 MW of Demand Response provides the same reliability contribution to the grid as 1 MW of steel in the ground. In PJM, for example, the predominant type of DR capacity resource (limited DR) can only be deployed ten times over the summer for six hours maximum at a time. In addition, the operational value of this type of DR as an energy resource is very limited because it is not bid into energy markets and is only dispatched during emergencies. In New England, Real Time Emergency Generators can only be called upon coincident with voltage reduction, well down the list of emergency actions after a problem occurs on the system. These resources are not comparable with and undermine resources with more robust reliability and operational characteristics, which sends the wrong market signals and undermines market integrity.

Second, the integrity of capacity markets is directly threatened by the impact of subsidized resources entering the market even if it appears that valid policy goals might be achieved through the subsidies. Market participants investing in merchant generation resources have difficulty competing with resources receiving discriminatory subsidies,

such as state-mandated non-bypassable surcharges or guaranteed investment recovery rate designs for regulated utilities. Government actions such as these effectively pick and choose winners, leaving those who rely on market outcomes as the losers. Over time, this activity will undermine confidence in the markets and discourage new investors by promoting the construction of new subsidized generating plants at the expense of both existing merchant generating plants and other merchant plant developers.

Similarly, buyer-side market power mitigation must be designed to fully account for the bids of these subsidized projects. This requires a robust and comprehensive mitigation scheme that gives merchant investors reasonable assurances they will not be unfairly required to compete with the subsidized projects.

In sum, we are a strong supporter of well-designed and well-functioning capacity markets such as RPM. While no market is perfect, RPM has generally worked well in a competitive and transparent manner in adding capacity resources when and where they have been needed and when they are economic relative to available existing resources. We are also active in trying to shape the capacity design rules in the ISO-NE and the NYISO markets. All of these regions have seen significant entry by renewable resources and by new entrants such as DR, and have adapted to these developments in different ways. At the end of the day, such changes bring important challenges relative to price suppression, resource comparability and reliability impacts. But they can be met if the Commission remains committed to taking the steps necessary to preserve market fundamentals.

Thank you, on behalf of PSEG, for the opportunity to share our perspective on these complex but vital issues that directly affect our nation's electric reliability.