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Director

October 22, 2014

Via Hand Delivery
Kristi Izzo, Secretary
New Jersey Board of Public Utilities
44 South Clinton Avenue, 9th Floor
Post Office Box 350
Trenton NJ 08625-0350

Re: In the Matter of the Provision of Basic Generation Service for the Period Beginning June 1, 2015
BPU Docket No. ER14040376

Dear Secretary Izzo:

Enclosed for filing please find an original and ten copies of the Division of Rate Counsel's Supplemental Comments regarding Section XIII of PJM's Capacity Performance Updated Proposal dated October 7, 2014. These comments are being submitted pursuant to the Board Staff's request for comments dated October 8, 2014. These comments will also be circulated electronically to the email list server used by the Board for this filing.

We have also enclosed one additional copy of the materials transmitted. Please stamp and date the copy as "filed" and return to our courier. Thank you for your consideration and attention to this matter.

Respectfully submitted,
STEFANIE A. BRAND
DIRECTOR, DIVISION OF RATE COUNSEL

By: *s/ Diane Schulze*
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I/M/O the Provision of Basic Generation Service
(BGS) For the Period Beginning June 1, 2015
BPU Docket No. ER14040376

Supplemental Comments of the Division of Rate Counsel

October 22, 2014

Introduction

The Division of Rate Counsel ("Rate Counsel") is pleased to provide these supplemental comments on the possible impact on BGS of Section XIII of the PJM Capacity Performance ("CP") Updated Proposal ("PJM Capacity Proposal") dated October 7, 2014 pursuant to the October 8, 2014 email from Board Staff.

Section XIII of the PJM Capacity Proposal focuses on the "transition mechanism," a mechanism to provide "incremental improvements . . . while recognizing the need to allow time for investment, transition of contracts and transition cost management." [1] The proposed transition period encompasses delivery years 2015/2016, 2016/2017 and 2017/2018.

For the 2015/2016 delivery year, the PJM has recognized that "it may not be feasible to begin implementation of Capacity Performance transition due to the short time available for investment in winterization, dual-fuel capability, firm fuel contracts, etc"[2]. Accordingly, PJM proposes, *inter alia*, to "incrementally procure up to 10,000 MW of additional Capacity Resources for the winter season (December 2015 – March 2016)."[3] Rate Counsel believes that although PJM's proposal for the 2015/2016 may increase

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[1] PJM Capacity Proposal, Section XIII, page 33.

[2] Id.

[3] Id. at 34.

capacity costs by some amount, it will not materially affect total costs for BGS-FP suppliers and therefore no changes are necessary to the BGS auction or to TPS contracts for this energy year.

For energy years 2016/2017 and 2017/2018, PJM proposes to hold incremental auctions to "procure a sufficient amount of capacity that adheres to a transitional version of the performance standards and requirements of the Capacity Performance product"[4] In addressing the "transition period," the Board must determine what, if any, action to take (1) with respect to existing BGS and Third Party Suppliers ("TPS") contracts and (2) with respect to the upcoming 2015 BGS auction.

Discussion

In both filed comments and at the Legislative-type hearing held on September 29, 2014, NextEra and RESA commented on anticipated changes to the PJM Reliability Pricing Model (RPM) that could affect future PJM capacity prices. In addition, at the Legislative-type hearing held on September 29, IEPNJ commented on this issue. All three of these entities argued that the New Jersey ratepayers should insulate BGS providers and TPS from potential price increases in the PJM capacity market. Suggestions were made for the creation of a non-bypassable charge or the modification of the Supplier Master Agreement ("SMA") as possible mechanisms to pass capacity price increases through to some or all New Jersey ratepayers. Rate Counsel strongly opposes these proposals.

[4] Id.

Existing BGS-FP contracts for Energy Years 2015/2016 and 2016 /2017

Rate Counsel believes that underlying this entire discussion is the fact that BGS-FP is sold as a "fixed price" product. Under the "fixed price" construct of the BGS auction, it is the suppliers' obligation to manage market risk, not the Board's and certainly not BGS-FP customers'. Competitive energy suppliers are sophisticated financial entities who regularly participate in the PJM stakeholder process. As such, they have all of the risk management tools, knowledge, experience and capital necessary to manage changes in the marketplace. While additional risk may cause competitive suppliers to raise their offer prices in the BGS auction, one of the purposes of the auction is to maintain competition among potential suppliers such that competitive suppliers are managing risk to offer the lowest price at which they can still expect to make a profit.

Because BGS-FP is a fixed price product and because bidders in the BGS auctions are sophisticated players in the energy markets, the Board should take no action with regard to current BGS-FP contracts that extend into energy years 2015-2016 and 2016-2017. These contracts entered into by BGS-FP suppliers and the Electric Distribution Companies ("EDC") to supply electric power for BGS-FP customers are standardized contracts unique to the BGS procurement process, known as Supplier Master Agreements ("SMAs"). BGS-FP ratepayers, largely residential and small commercial electric utility customers, are explicitly recognized as third party beneficiaries of the BGS-FP SMAs:

> This agreement is intended solely for the benefit of the Parties hereto including Customers for which the Company is executing this agreement as agent.[5]

[5] SMA, Section 15.6

If the Board were to allow 2014 and 2015 BGS providers to recover the costs associated with the changes in capacity prices, whether through a change in the SMA or through a non-bypassable charge, the Board would be effectively, and retroactively, altering the SMAs and shifting responsibility for changes in the capacity market from BGS-FP suppliers to BGS-FP ratepayers. A risk assumed by the BGS-FP provider at the time the SMA was executed and explicitly acknowledged in the SMA:

> Each BGS-FP Supplier hereby represents, warrants and covenants to the Company as follows:…
>
> > g) it has entered into this agreement [SMA] with a full understanding of the material terms and risks of the same, and it is capable of assuming those risks;….[6]

Moreover, it would be difficult, if not impossible for the Board to determine the financial impact of a change in capacity price on BGS-FP providers. There is no price transparency in the BGS-FP winners bid. As previously noted by Morgan Stanley in response to Rate Counsel's proposal for price/supply transparency in the BGS price:

> MSCG, for example, manages a firm-wide portfolio of energy-related contracts, both physical and financial. The portfolio consists of both physical purchases and sales of power and other commodities and financial hedges of risk including but not limited to price risk, associated with those commodities. MSCG does not earmark specific purchases to meet the requirements of specific sales. Instead, MSCG buckets all of its contractual obligations – including physical supply purchases and sales, financially-settled energy contracts and BGS-like contracts – and examines its resulting portfolio position on a net basis. Portfolio trading is conducted on a continuous basis to manage risk within that portfolio. As

[6] SMA Section 3.1(g).

> part of this risk management function, the portfolio components change continuously as traders initiate and liquidate positions as market conditions change. Physically-delivered or financially-settled positions may be purchased or sold in order to manage the portfolio so that the resulting net position in the portfolio is within the risk limits of the firm.
>
> There is no correlation matching a particular wholesale load obligation like BGS with a particular physical source of supply or hedging contracts.[7]

Thus, to accomplish the "pass through" the Board would have the obligation to review power purchases and financial hedges used by BGS-FP providers to determine the actual financial loss experienced by the BGS-FP provider resulting from changes in the PJM capacity market due to the implementation of CP. This would be an incredibly complex, if not impossible, undertaking.

Existing TPS contracts for Energy Years 2015/2016 and 2016 /2017

In addition, allowing the pass through of costs by BGS-FP providers gives those suppliers a competitive advantage over third party providers who may have entered into long term fixed price contracts with private customers opting out of BGS-FP. While a non-bypassable charge has been proposed to compensate both the BGS-FP providers and the TPS providers for increases in capacity prices on existing contracts, Rate Counsel suggests that this is an un-workable solution. Presumably, like BGS providers, TPS providers are sophisticated financial entities with large, diverse portfolios which are constantly being adjusted. As with BGS-FP providers, TPSs presumably hedge their portfolio and may self-supply or may enter into bilateral contracts to meet their capacity

[7] Final Comments of Morgan Stanley Capital Group Inc., BPU Docket No. EO06020119, September 22, 2006. See also, Reply comments of Constellation Energy Commodities Group, BPU Docket No. ER07060379, p.11 (bidders may manage all of their positions as a single obligations, constantly entering into a number of transactions to meet a total portfolio goal, not necessarily to manage a single position.); Comments of the PJM Providers Group ("P3"); BPU Docket No. EO09050351(BGS suppliers typically use a mixed portfolio of resources to satisfy their load servicing requirements.)

obligations. The creation of a non-bypassable pass-through mechanism would require the Board to monitor all third party contracts to determine which contracts, if any, were materially affected by any increase in the PJM capacity market price resulting from PJM's creation of performance capacity.

Rate Counsel urges the Board not to modify the SMA or to establish a non-bypassable charge to cover any increase in capacity costs for existing contracts. Ratepayers rely on the price stability of the fixed price service and presumably are already paying both a risk premium and a profit to the entities providing this service. It is unfair to ratepayers to collect from them a risk premium for the fourteen years that the BGS-FP auction has been held and then to seek to have ratepayers bear the costs when there is a risk that prices may go up. Furthermore, if the Board allows these suppliers to pass through increased costs imposed on them by PJM and/or FERC, there is absolutely no incentive for these large entities to participate at PJM and to ensure that prices remain reasonable. If these sophisticated financial entities are truly unable to anticipate any of these costs, and these costs are large enough to undermine the BGS auction, then BGS providers and TPS should provide significantly more evidence to support their claim. Merely stating that they do not want to account for these costs in their bids is not sufficient. They should further explain why end-use customers should bear these risks even though they have paid for a "fixed-price" product.

Given that BGS providers and TPSs have the risk management tools, knowledge, experience and capital necessary to manage changes in the marketplace, the suppliers' proposals to pass costs onto ratepayers should be rejected. It is not necessary, and even harmful to shift the risk of PJM charges onto New Jersey ratepayers. As discussed above, it is Rate Counsel's position that none of these costs should be passed through to BGS customers but should be included in the BGS bid price. While the assumption of additional risk may cause competitive suppliers to raise their offer prices in the BGS auction, one of the purposes of the auction is to maintain competition among potential suppliers such that competitive suppliers are managing risk to offer the lowest price at which they can still expect to make a profit. Thus, rather than burdening ratepayers with additional non-bypassable charges, Rate Counsel believes that none of these costs should be directly passed through to ratepayers but should be integrated into the cost of supply as part of a full requirements fixed price product.

The upcoming BGS auction

Rate Counsel believes that the Board should not rush to action. The PJM Capacity Proposal is too ill-defined at this stage to trigger radical changes in the BGS auction that has been running smoothly for 14 years. PJM's October 7, 2014 Updated Proposal is just that, a proposal. The procedural schedule before PJM's Enhanced Liaison Committee allows stakeholders to present written comments to the PJM Board by October 28, 2014, and to make oral presentations to the Board on November 4, 2014. Some time thereafter, the PJM Board will vote as to what it wants to do, which could include adopting the proposal, amending the proposal or nothing. In any event, a filing will be made to FERC in early December. At that time the BGS bidders will know what it is that PJM is truly proposing. A decision by FERC, however, would likely be by February 1, 2015. Only then will the parties truly know what the proposal is, and only then could the true impact of this change be calculated. This is in fact no different than any other RPM change made by PJM before the BGS Auction.

It is likely that PJM will have a fully detailed proposal that has been approved by the FERC before the BGS auction occurs, but at a minimum, we anticipate that by the time the BGS auction occurs in February 2015, there will be more information available to potential BGS bidders that will allow them to calculate their bids. Indeed, PJM changes the rules of RPM on an annual basis and bidders are able to work these changes into their bids each year. As noted earlier, they are in the best position to determine the effect of these RPM changes on their portfolio of supply sources.

As currently proposed by PJM. for the 2015/16 delivery year, PJM will be holding incremental auctions to procure additional capacity if needed, but it will not require changes to the base capacity procured in the Base Residual auction (BRA) for that year.[8] This should therefore not impact the ability of BGS Suppliers or TPSs to formulate their bids for that year. For the 2016/17, 2017/18 delivery years, PJM also proposes to conduct incremental auctions but will allow resources to bid in as CP resources. Presumably, by the time the BGS Suppliers bid into the BGS auction in February 2015, they have secured some of their portfolio and have a sense of how they will meet their entire BGS obligation. They should therefore be able to account for much of the risk for those years. They are certainly in a better position to do so than ratepayers.

[8] PJM Capacity Proposal, Section XIII, p. 34.