COMMENTS OF THE
DEPARTMENT OF THE PUBLIC ADVOCATE
DIVISION OF RATE COUNSEL

Revised Straw Proposal:
New Jersey's Offshore Wind Renewable Energy Certificate ("OREC")

March 26, 2009

1. Introduction

The Department of the Public Advocate, Division of Rate Counsel ("Rate Counsel") would like to thank the Board of Public Utilities ("Board" or "BPU") for the opportunity to present our comments on the Straw Proposal submitted to stakeholders for comment by the Office of Clean Energy ("OCE"), dated March 10, 2009. The purpose of OCE's proposal is to facilitate the goals established in Energy Master Plan ("EMP") released on October 23, 2008 that increases New Jersey's commitment to renewable energy to 30 percent of electricity sales by 2020. An integral part of the EMP has been the call for a minimum of 1,000 megawatts ("MW") of offshore wind capacity to be developed by 2012, and a minimum of 3,000 MW of offshore wind capacity by 2020.

OCE, in its revised straw proposal offered for comment on March 10, 2009, proposes to establish an offshore wind set-aside or "carve-out," within New Jersey's Renewable Portfolio Standard ("RPS"). This carve-out would establish a new tradable credit referred to as an offshore wind renewable energy certification or "OREC." This OREC would have a companion maximum price referred to as an offshore wind alternative compliance payment or "OACP."

Rate Counsel supports what it believes are the overall goals of OCE's proposal: to establish market certainty for the development of offshore wind generation in a challenged financial and economic environment. We do not however, support this specific proposal and find it to be premature since the costs and consequences of this proposal have not been thoroughly addressed. The Straw Proposal includes no estimates of program administrative costs, no estimates of how this approach will reduce the overall costs of delivering offshore wind energy, and most importantly, no estimates of the impact that this proposal will have on rates.

Rate Counsel is particularly concerned that OCE's proposals could have significant implications on Basic Generation Service ("BGS") rates. These issues have not been completely nor thoroughly addressed in the OCE proposal. In the few instances where general proposals have been offered, Rate Counsel believes that OCE's recommendations would result in an immediate increase in rates – driven in large part from the uncertainty associated with this newly-proposed regulation. Rate Counsel is concerned that BGS rates will increase for the following reasons:

(1) OCE's proposal will create a new class of RECs and REC requirements that will increase the cost of RPS compliance.
(2) The creation of a new set of alternative compliance payments will create new uncertainties incenting load serving entities ("LSEs") into "padding" their offers with the maximum offshore wind price ("OACP") to hedge against unexpected offshore wind market outcomes.
(3) OCE's transition proposal to establish a 2013 placeholder value for ORECs will almost certainly result in an increase in rates since no LSE will want to bear the unnecessary risk of under-pricing for this emerging RPS requirement. If LSEs are forced somehow to set prices for their offshore wind requirements at the placeholder value, it sets up the possibility of retroactively re-setting rates to correct for deficiencies in the administratively-determined price.

Rate Counsel is also concerned about the specific proposal to create an entirely new and unneeded framework that sets a troubling precedent and undermines the traditional policy goals of using a RPS to support renewable energy development.

Rate Counsel recommends that the Board utilize an already fully-vetted framework for supporting offshore wind energy development. This framework, established during the course of the Generic Solar Renewable Energy Certificate ("SREC") proceedings, and later expanded in individual electric distribution company ("EDC") filings, could be easily modified to accommodate offshore wind projects.

2. Rate Counsel Opposes Additional Set-Asides

Rate Counsel has opposed establishing new set-asides for renewable energy resources since the advent of the EMP discussion and working group process. Our rationale for opposing these set-asides is quite simple: set-asides result in inefficiencies raising costs to ratepayers. It was Rate Counsel's experience during the course of the EMP working group discussions that the idea of establishing new set-asides was a popular policy proposal for the myriad individual renewable energy developer interests participating in the process. During these discussions, proposals emerged for set-asides for on-shore wind, behind-the-meter wind applications, and bio-fuel generation, to name a few.

Rate Counsel is very concerned that if the Board approves OCE's Straw Proposal it will be moving down a very slippery slope of splitting and balkanizing renewable energy markets into numerous sub-markets with their own tradable credits, their own suppliers, and their own inefficiencies. In such a situation, the state's renewable energy policy digresses into one of various interest groups seeking preferential treatment for their resources at the expense of other renewable energy generation, and ultimately, ratepayers. The Board needs to seek another solution that promotes the efficient development of renewable energy, without compromising the integrity of its own long-term policy.

Rate Counsel is also concerned that by adopting OCE's proposal the Board would inadvertently draw itself into the very trap that has contributed to the current renewable energy underinvestment problem: namely, the regulatory uncertainty resulting from frequent changes in rules and regulations that increases risk for project developers. Adopting OCE's proposal potentially signals to the market that the Board is ready and willing to change or modify its regulatory policies on renewable energy. This creates a moving standard, or set of standards, that challenges renewable energy investment.

While the change in regulatory policy proposed by OCE certainly offers significant benefits to offshore wind developers, it potentially creates adverse impacts on current and potential renewable energy projects that may have been expecting higher REC premiums due to the development of offshore wind energy as the marginal technology setting market prices. Extracting wind energy from the current potential REC resource mix potentially lowers the market clearing price, changing payback and internal rate of return assumptions for existing and emerging projects.

3. OCE's Proposal Would Undermine the Traditional Goals of a RPS

A RPS is typically established to set a renewable energy threshold that all market participants must meet. Suppliers are then required to either develop their own renewable energy production, or purchase renewable energy credits ("RECs") from those qualifying facilities that do not need these credits to meet their own power generation requirements (i.e, those over complying with the standard).

A RPS is commonly thought of as a "market-based" approach for developing renewable energy because it lets the market determine, at the margin, the most cost-effective sources for meeting renewable energy standards. In adopting the RPS, the Board specifically noted:

> New Jersey's RPS proposal for 20 percent renewables by 2020 is not predicated on the development of off-shore wind resources; nor does the RPS, except for the solar set aside dictate what renewable energy technologies are to be developed to meet the RPS requirements. ***The RPS is a market-based rule. It relies on the economic competitiveness of the market in response to the regulation to develop facilities for compliance.***[1]

Under a RPS, a renewable energy supply curve arises in which the least-cost renewable energy resources are developed and deployed first, with higher cost resources either being developed last, or not at all if they are relatively uneconomic. As a result, the least-cost development of renewable energy is thought to be assured through competition.

When the Board modified its RPS in 2006, it established a solar energy set-aside which effectively established a separate solar energy market, and necessitated the

[1] NJ Register, Volume 38, Issue 10, May 15, 2006

development of solar renewable energy credits ("SRECs") for trading purposes for load serving entities ("LSEs"). The Board's approval of the solar set-aside within the RPS created a sub-market which effectively split-off close to 2,000 MW of renewable capacity into its own unique market with its own suppliers and customers. OCE's offshore wind proposal compounds this market segmentation by pulling an additional 3,000 MWs, for a total of 5,000 MW of potential renewable energy capacity away from a traditional RPS approach and into not one – but two separate classes of set-asides.

Competitive markets are defined by a large number of buyers and sellers. Having a large number of buyers and sellers creates competitive pressure for cost reduction and the emergence of substitutes and alternatives. If an LSE, for instance, needs a REC, and finds one offered by an offshore wind facility at $45, while an onshore wind facility is offering RECs at $25, the LSE can choose the lower-cost alternative to meet its RPS requirement.

Creating more and more sub-markets undermines those goals of competitive renewable energy markets by reducing the number of buyers and sellers and creating specific market differentiation. Market differentiation is the first step in moving otherwise competitive markets into those that have the ability to exert various degree of market power since substitutes and alternatives are greatly reduced. Suppliers in these markets become price-makers, not price takers. Competitive pressures to reduce costs are significantly deteriorated, and ultimately consumers (ratepayers) will pay higher rates for projects that may not have existed in a more robust market structure. Rate Counsel cannot support such a mechanism, regardless of how well-intentioned.

4. OCE's Proposal Would Result in New and Potentially Costly Administrative Structure

OCE's proposal creates an entirely new market structure, price discovery institution, and regulatory compliance mechanism that would unnecessarily increase costs to ratepayers. OCE's current proposal would do the following:

- Establish a new offshore wind set-aside within the Board's existing RPS.

- Create a new set of RECs and ACPs, each of which would have their own vintage years. If OCE's proposal is approved, LSEs could have as many as 10 different compliance certificates to manage in order to meet their RPS requirements.[2]

- Create and administer a non-binding price discovery process comprised of a "Request for Pricing Proposals" ("RPP") to set the administrative standard-offer price for ORECs that differs little from a feed-in tariff.

[2]This would include: (1) RECs; (2) ACPs; (3) SRECs; (4) SACPs; (5-7) three different vintage years of ORECs; and (8-10) three different vintage years of OACPs.

- Require the Board to be the supplier administrator that takes title to ORECs and serves as the broker collecting revenues for ORECs from LSEs, and allocating payments to offshore wind developers.

None of these proposals would be necessary if the Board utilized the existing solar contracting approach developed by a broad group of stakeholders for a period now approaching one year. As will be discussed later in our recommendations, by utilizing this approach the Board could:

- Preserve the existing RPS and its market structure without the need for developing a set-aside or new class of RECs and ACPs.

- Leverage the existing competitive bidding process developed by the EDCs for solar energy and what should be lower incremental cost than the stand-alone costs of developing a RPP process proposed by the OCE.

- Leverage the existing solar auction process into a broader renewable energy auction process at what should be a lower incremental cost than the supplier administrative functions included in the OCE proposal.

- Restrict the Board's overall engagement in the mechanics of the renewable energy development process to simply review and approval (and not active participant).

5. OCE's Proposal is Inconsistent with the Board's Past Rejection of Feed-In Tariffs

OCE's Straw Proposal, at its core, is a modified feed-in tariff: a mechanism frequently proposed as a remedy to renewable energy underinvestment, and one just as frequently rejected by the Board due to its inefficiency in determining price. Typically, a feed-in tariff is based upon an administratively-determined standard offer price. Renewable energy developers receive payment for their renewable energy generation at the standard offer price regardless of the fact that their actual costs may be considerably lower than the administratively-determined standard offer price.

The only difference between the OCE proposal and a traditional standard offer is the use of a RPP process to set the appropriate standard offer price. Rate Counsel believes this approach is potentially worse than an administratively-determined price which is at least tempered by regulatory oversight.

OCE's proposal would use a RPP or "indicative offer" approach at discovering price. Under this approach, developers offer non-binding price offers for offshore wind energy.

The approach is non-binding from a price perspective since a high bid does not exclude a developer from later offering ORECs at the lower standard offer price.[3]

Rate Counsel is concerned that this approach may unnecessarily inflate bids, and drive up ratepayer costs, since there is little to no accountability for excessive offers. In such a framework, developers have an incentive to bid-up the price because in doing so, the developer is (a) not excluded from future market participation and (b) can increase profits by inflating its bid, which if followed by all participants, would drive up the OREC supply curve and the market clearing price used to determine the standard offer. If the Board accepts this proposal, some mechanism needs to be included that would reject loosing bids (high offers) from future participation.

OCE's proposal to temper the possibility of inflated bids further highlights the feed-in tariff properties of this approach. By using a consultant, and information from bids in other states and other projects, OCE's proposal digresses into an administratively-determined, regulated price. Thus, ratepayers have the unattractive choice of setting a standard offer price from a faulty bidding system or a potentially inefficient regulatory process. The Board should reject this type of approach much as it has done for solar energy.

6. Rate Counsel is Concerned That The Proposal Could Increase BGS Rates

Rate Counsel is concerned that OCE's proposal will have an unnecessary impact on BGS rates for customers.

First, these BGS rates will increase due to the additional costs for offshore wind energy as well as the compliance and administrative costs included in the OCE proposal. Increases in RPS compliance costs for LSEs, in turn, will be passed along to ratepayers. Unfortunately, the cost of this new compliance standard is unknown since OCE has provided no estimates regarding the administrative costs or the rate impacts of its proposed market design.

Second, the creation of a new set of ACPs ("OACPs") will create an opportunity for LSEs to immediately insulate themselves from risky offshore wind market outcomes. Given market uncertainties about prices, LSEs will have incentives to impute the maximum compliance price for offshore wind to insure against pricing shortfalls.

Third, the transition proposal offered by OCE, for the first round of offshore wind sales in 2013, will result in one of two outcomes. First, it is highly unlikely that OCE will be able to accurately estimate an administratively-determined offshore wind price and some form of *ex post* true-up will likely be required. Second, if OCE sets both OREC and OACP prices, it is highly likely that the OACP price will be selected in order to insure against uncertain market outcomes, and the possibility that LSEs may not be

[3] Assuming that a bidder meets the technical requirements to be a designated facility. There is a binding constraint on the quantity offered by the bidder: they cannot, at a later time, increase the capacity (and energy) from the facility beyond an amount included in the original offer.

reimbursed for choosing some lower price (like the placeholder OREC price) at some later date.

7. OCE's Proposal Excludes A Rate Impact Analysis

A significant shortcoming in OCE's Straw Proposal is the omission of any program cost estimate. It is hard to evaluate the overall merits of this program without reference to program costs. Ultimately, program costs will determine the effectiveness of this program over other alternatives, and most importantly, the rate impacts that will be imposed on ratepayers from this new program.

Rate Counsel would also propose that some form of cost circuit breaker, like that adopted by the Board in the RPS rule modifications for solar, be adopted.

8. Proposals Could Shift Market Risk from Developers to Ratepayers

An earlier version of OCE's straw proposal defined annual OREC prices as the difference between the total OREC price offered by a project and the annualized LMP price for spot (wholesale) market energy. Thus, potential developers would bid an "all-in" price, referred to as a "revenue requirement,"[4] needed to earn a return on their investment. Revenues would include electricity sales revenues and net OREC revenues (presumably the all-in price less electricity sales revenues). The most recent version of the proposal has stricken this formula from the proposal although there are repeated references to "revenue requirements" elsewhere in the OCE proposal, and a statement that "all of the Designated Facility's revenue received from PJM associated with energy produced and delivered (OSW Revenues) will be the property of the BPU." Rate Counsel would request clarification on this pricing proposal to ensure that OREC prices are based only on the additional financial support (i.e., non-electricity sales revenues) needed to develop offshore wind projects.

Rate Counsel would not support a pricing mechanism that includes a true-up for wholesale energy prices. Overall financial support for offshore wind energy comes from a variety of sources that broadly include REC revenues, federal tax incentives, other state and federal incentives, and electricity sales revenues. Rate Counsel believes that wind developers are better suited to bear the risk associated with changes in wholesale energy prices than ratepayers. Including this aspect in any REC pricing proposal does not send strong signals to developers to maximize electricity sales revenues from their facility from non-spot market transactions. The current Straw Proposal notes that OCE will "develop provisions to ensure that the OSW Designated Facilities maximize the sale of electricity to PJM." How OCE intends to make these assurances, and its qualifications to make such assurances, raises exceptional concerns for Rate Counsel.

[4] A revenue requirement is a regulatory construct designed to develop a set of revenues needed to earn a return on a regulated asset and is not a method of financial modeling typically used by competitive, merchant energy assets. This further highlights the feed-in tariff, regulatory-based approach of the Straw Proposal.

Further, including electricity sales revenues into a formula to determine OREC prices is entirely inconsistent with other forms of renewable energy pricing support including solar energy. For instance, SREC prices are not trued up for actual electricity savings (or sales) revenues under the Board's long term SREC contracting approach. Solar developers only bid the additional (not total) financial support needed to ensure project development. Revenue streams associated with electricity savings, incentives, and tax credits are excluded from the SREC determination.

Rate Counsel recommends that if the Board accepts OCE's proposal, OREC prices be bid at levels needed to support the project net of anticipated electricity sales revenues. It should be up to wind developers to find ways to meet or exceed those anticipated electricity sales revenue targets.

9. Excess Revenues Should be Used to Lower Rates

OCE has proposed that any excess OREC revenues be used as a funding source for clean energy programs supported by all retail customers such as the Clean Energy portion within the Societal Benefits Charge ("SBC") or the Universal Services Fund ("USF"). Rate Counsel is opposed to using excess revenues for anything but credits to the already significant commitments ratepayers are making to clean energy initiatives. The Board should be clear that any excess revenues created from this program will be used to reduce rates, and not to expand, or create additional (higher) incentives for existing clean energy programs beyond their budgeted levels.

10. The Use of Non-Price Evaluation Terms Potentially Biases Outcomes

OCE has proposed using other factors in determining its standard offer price such as the potential that a developer can actually complete a project and an undefined range of economic benefits to New Jersey from any individual project/bid. While Rate Counsel supports specific, and pre-defined participation qualifications, we are concerned that the use of such undefined (or loosely defined) non-price terms is highly subjective and arbitrary. The use of these subjective evaluation parameters potentially biases market outcomes by influencing the standard offer, which in turn impacts market entry, wind energy capacity development, and ultimately, rates.

11. Recommendations: The Current SREC Contracting Approach Should be Modified to Support Offshore Wind Energy

Rate Counsel recommends that the Board direct stakeholders to this process, particularly EDCs, to work collaboratively in modifying the current SREC contracting approach to accommodate offshore wind development. Rate Counsel offers the following suggestions for consideration in this process:

- The Board would direct each of the EDCs to support a target amount of offshore wind energy. There would be no specific ORECs nor any other specific "set-aside."

- The Board and other stakeholders would develop a long-run contracting process for RECs generated by offshore wind energy that, as starting point, follows some variation of the schedule offered by OCE in its Straw Proposal. Some share of the EMP's offshore wind goal can be securitized, while the remaining share is left to the bi-lateral market much like the current plans being utilized for solar energy.

- EDCs would be required to enter into long-term REC contracts with offshore wind energy developers only.

- EDCs would conduct a Request for Proposals ("RFP") process, overseen by an independent third-party administrator, preferably the same third party administrator overseeing the solar energy RFP process.

- Offshore wind developers would submit fixed long term bids for the RECs generated from their projects.

- EDCs would award REC contracts to winning (least cost) bids subject to Board approval. Rejected bids would not be allowed to participate (serve as supply sources) until the next RFP process.

- EDC REC contracts would be for the specific price and quantity offered in the bid, not a market clearing price.

- EDCs would auction RECs to the market in a fashion similar to SRECs.

- EDCs would develop mechanisms, including the use of the Clean Energy Budget within the Societal Benefits Charge ("SBC"), to recover the prudently-incurred cost of the program including:

    - Administrative costs associated with the program.

    - Credits for revenues collected from the REC auction that are in excess of those paid under longer-term REC contracts arising from the competitive bidding process.

    - Charges to make up for shortfalls between revenues generated from the REC auction proceeds and the long-term REC contracted amounts from the competitive REC bidding process.

- The Board will establish a circuit breaker that restricts continued progress in developing future offshore wind energy capacity to some absolute cost, or percent cost increase, constraint.

Rate Counsel believes this approach would be more efficient and transparent relative to the proposal offered by OCE.