IN THE MATTER OF THE BOARD'S INVESTIGATION OF CAPACITY PROCUREMENT AND TRANSMISSION PLANNING
DOCKET NO. E011050309

Testimony of Zamir Rauf
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Thank you President Solomon and other Board Members for the opportunity to present the views of Calpine Corporation in this important proceeding. My name is Zamir Rauf and I am Calpine's Executive Vice President and Chief Financial Officer. In that capacity I have direct responsibility for Calpine's corporate and project finance, treasury and debt compliance functions, as well as management of our corporate banking, investment banking and rating agency relationships.

It is with this background and experience that I offer our views on whether or not PJM's capacity market can be effective in supporting the economic requirements associated with building new electric generating capacity.

As you may know, Calpine is the nation's largest independent power producer and owns and operates approximately 28,000 MW of generating capacity consisting of 92 power plants in 20 states and Canada. The majority of our generation is based on natural gas-fired combined cycle technology. Here in New Jersey we own and operate 9 plants with a combined output of 927 MW, and we currently have several active development projects in New Jersey, Delaware and Maryland.

I would like to focus my remarks on Item #6, which addresses the question of whether the RPM can support the development of new baseload and mid-merit generation resources or, in the alternative, whether non-market based long-term contracts will be needed to support such projects. I will also touch on the question of whether there are improvements that can be made to the existing market structure that will result in more generation being built in constrained areas, such as New Jersey.

In sum, Calpine believes that, with some modest changes, the PJM capacity market can and will work to bring forward new generating resources. However, it is critical that we do so in a manner that does not undermine confidence in the market.

Calpine recognizes that knowing whether the "PJM capacity market can get it done" over the next couple of years is critical, especially as the region adapts to expected coal retirements. We believe that natural gas-fired generation will play a substantial role in replacing these assets. This fundamental market dynamic, and the resulting growth opportunity for companies like Calpine was one of the key reasons we made such a large investment in the PJM market last year through the acquisition of the Conectiv Energy fleet.

So, can the capacity market get new resources built? For Calpine at least, the answer is a resounding yes.

This summer we initiated commercial operations at our new 565 MW combined cycle York Energy Center in southeastern Pennsylvania. That plant was developed and financed under a 6-year bilateral capacity sales agreement with another competitive market participant. No governmentally-mandated long-term contract was required.

More importantly, as noted earlier, Calpine is actively developing new projects in Delaware, Maryland, and New Jersey. We are doing this because we foresee that over the next few years, as the result of coal shutdowns and other market factors, capacity prices in the East should start rising, making investments in new gas-fired combined cycle projects economic.

We believe in the benefits of competitive markets and our preference would be to develop this new capacity on a merchant basis. Unfortunately, one of the biggest risks we currently face is the regulatory uncertainties created by various states' interest in trying to jump start the process of developing new capacity via long term contracts.

While we certainly understand the need for states to assure the ongoing reliability of the region's power supply, a) based on PJM's analysis, we do not think we are facing an imminent reliability crisis that requires an emergency response, and b) it will be exceedingly difficult for merchant projects to compete with ratepayer subsidized projects. We therefore urge you to consider the fact that moving toward a bilateral market with long-term ratepayer subsidized contracts is likely a one-way street. Once we start developing new capacity under long-term contracts, all new power projects will expect and require such contracts.

Calpine is confident that some relatively modest changes to the existing RPM structure will maximize the ability of competitive power producers to build new generation when and where it is needed. Our primary recommendation is to allow new generating resources to lock into a medium-term fixed capacity price for a 5 year or so period, compared with the existing tariff which only provides a one-year lock.

In our view, one year is generally too short and represents too much risk for investors who are looking at a 30-40 year asset. At the other extreme, we do not believe state sponsored long term contracts are either necessary or in the best interests of ratepayers and other market participants. A medium term capacity price lock-in provides the right balance of certainty for investors, results in a much more moderate burden on ratepayers, and minimizes any anti-competitive impacts to the market.

Project developers that argue in favor of longer term contracts are generally thinly capitalized and rely disproportionately on project level debt financing to support their projects. Moreover, such entities, the majority of which are either private equity or hedge funds, are often motivated by their financial interests in simply developing a project rather than establishing a long term operational footprint in the market. During times of economic uncertainty, as we are experiencing today, many of the project finance banks that such entities will rely upon to secure debt financing have curtailed their lending, and as we saw back in late 2008 and early 2009, debt financing was difficult to obtain, especially for a thinly capitalized developer.

Conversely, well capitalized companies like Calpine and others are able to rely on their balance sheets to help finance projects, expect to operate the plants for the life of facility, and do not need a long-term deal to finance their project in the PJM market.

Therefore, the key messages I would like to leave with you today are as follows:

- Calpine remains keenly interested in growing its presence in the PJM footprint, and would prefer to do so on a merchant basis.

- We believe a 5 year or so capacity price lock-in period within the existing RPM construct, would more than support our financing requirements and represents the best overall balance between a project's economic needs, ratepayer impacts, and the interests in maintaining a robust and competitive market.

- We do not believe that long-term, state sponsored contracts, are either necessary or appropriate given today's market dynamics.

That concludes my prepared remarks. I appreciate the opportunity to express our views and would be happy to answer any questions you may have.