

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

PJM Interconnection, L.L.C.

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Docket No. ER05-1410-000
EL05-148-000

NOTICE OF INTERVENTION, PROTEST AND REQUEST FOR HEARING
OF THE MICHIGAN PUBLIC SERVICE COMMISSION

Pursuant to Rule 211 and 214 of the Commission's Rules of Practice and Procedure, 18 C.F.R. §§ 385.211 and 385.214 (2003), the Michigan Public Service Commission ("MPSC") hereby files a notice of intervention and protest in the above-captioned proceeding. In support of its filing, the MPSC states the following.

I. INTERVENTION

A. Communications

Copies of all pleadings and correspondence in the proceeding should be addressed to:

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B. Basis for Intervention

The MPSC is an agency of the State of Michigan, created by 1939 Pub. Acts 3, Mich. Comp. Laws Ann. § 460.1 *et seq.* As the Michigan regulatory agency having jurisdiction and authority to control and regulate rates, charges, and conditions of service for the retail sale of electricity in the State, the MPSC intervenes in this matter pursuant to the authority conferred by applicable state statutes, rules, and procedures.

C. Description of Filing

On August 31, 2005, PJM Interconnection L.L.C. ("PJM") submitted for filing its new Reliability Pricing Model ("RPM"), modifying the existing capacity rules in PJM's region to address current serious inadequacies.

II. PROTEST

A. Preliminary Statement

By the instant filing PJM has filed its new RPM to replace its current resource adequacy construct. The RPM continues PJM's administration of a centralized capacity market where PJM collects from load and distributes to generators dollars which are intended to ensure adequate generation capacity.¹ While this is a continuation of a capacity market for PJM, the RPM actually has many new and very different features. The RPM construct is also very different from the energy-only market approach currently being considered by the Midwest ISO.² The interaction of PJM with Midwest ISO and other RTOs requires a thorough examination of issues that goes beyond the RPM proposal.

The RPM has been sharply criticized by many and has not been endorsed by the PJM stakeholders. In fact, PJM held several votes in its stakeholder forums, but failed to obtain a majority in support of the RPM. While the MPSC recognizes that PJM did make

¹ Capacity market in the RPM means fixed payments for generation capacity. The capacity market represents a third source of income for generators after the energy market and ancillary services. In contrast, an energy-only market refers to just the energy market and ancillary services.

² See Discussion Paper, Resource Adequacy for the Midwest ISO Energy Markets, September 12, 2005.

some limited progress towards addressing the concerns put forward by stakeholders, by making relatively minor changes to its RPM, PJM does not appear to have considered seriously making significant changes to the RPM or reviewing alternative resource adequacy constructs. With PJM's recent expansion to the west, as well as the creation of the Organization of PJM States, the interests of old and new members, states, and market participants must be more effectively considered. The widespread opposition and PJM's relatively inconsequential response to concerns raised by its stakeholders clearly shows that a resource adequacy solution has not received the full assessment that this important topic deserves.

The importance of resource adequacy requires a careful and complete deliberative process. There is no logical reason for PJM's apparent rush to a solution without adequate consideration of stakeholder concerns. The immense impact that this proposal could have upon all market participants and consumers requires further assessment. There are several ways this can be achieved. At a minimum the FERC should reject the accelerated approval that PJM has requested and set the entire proposal for hearing. With significant concerns regarding numerous defects in PJM's RPM proposal and its potential impact on the development of a joint and common market, MPSC urges FERC to conduct a comprehensive proceeding to include, in addition to a thorough review of RPM, consideration of alternative resource adequacy constructs.

Alternatively, the Commission should consider rejection of the RPM and to return the resource adequacy issues and potential solutions back to the stakeholder process with instructions to consider input from all stakeholders. Under either option, it is important to recognize that there is time to further develop the resource adequacy concept with stakeholders. PJM's overall current reserve margin is more than sufficient for the near term. Other activities that could, and maybe should, affect PJM's result are still under development. These developments along with all viewpoints and alternatives should be more fully evaluated in the stakeholder process.

B. Statement of Position and Summary of MPSC Comments

1. PJM's recent expansion has introduced added complexities that must be addressed, such as the larger area's effect on reserve requirements. The fact that the Midwest ISO is moving toward an energy market resource adequacy plan, as contrasted with PJM's proposed complex capacity market model, raises a serious concern of whether the operation of two divergent resource adequacy models within a common market will be compatible with the PJM/MISO Joint and Common Market.
2. The existing reserve margin in excess of 20 percent provides the Commission with time to establish a process that fully evaluates the deficiencies in the proposed RPM and explores potential solutions.
3. PJM's use of an administratively set Variable Resource Requirement (VRR) curve could result in higher capacity costs.
4. The RPM does not provide specifically for the integration of transmission and demand resource solutions to resource adequacy. PJM has promised to integrate transmission and demand resource solutions, but does not explain how this will be accomplished within the four-year forward period.
5. The RPM does not appear to encourage long term contracts. Some are convinced that it could provide a disincentive to LSEs that have long term contracts or their own capacity.
6. The RPM does not address significant concerns about providing the correct signals so that the right plant gets built in the optimum location. Because this is the very issue that the RPM is supposed to be correcting, it is a serious omission.

C. MPSC Comments

1. Steps must be taken to ensure that the resource adequacy plans adopted by PJM and the Midwest ISO are compatible with the PJM/MISO Joint and Common Market.

The MPSC has, through numerous filings at FERC, demonstrated its staunch support for expeditious development and implementation of the Joint and Common Market throughout the combined PJM/MISO footprint. In accepting the current geographic RTO configuration comprising PJM and MISO, the Commission has identified establishment of the Joint and Common Market as the thread that would knit into a workable market structure what many described as a “crazy quilt”. The commitment by FERC to foster a vibrant joint and common market throughout the PJM/MISO footprint must remain a bedrock principle which cannot be sacrificed or compromised as other changes are considered such as resource adequacy.

The current state of affairs relating to the divergent resource adequacy proposals within the combined PJM/MISO footprint is a major concern to the MPSC. In advancing its RPM proposal, PJM has committed its RTO to a complex capacity market construct. MISO, on the other hand, appears headed towards rejection of an organized capacity market, instead addressing resource adequacy with modifications of existing energy markets to allow for increased price flexibility along with measures to support long-term contracts. Whatever resource adequacy constructs are ultimately adopted by the two RTOs, they must be fully compatible with the successful implementation of a Joint and Common Market between the two RTOs. The Joint and Common Market commitment should be a reminder that this is not a contest among rivals to see who can get its construct in place first. Rather, resource adequacy is a very important objective with a significant impact not only within the individual RTOs, but also jointly as it relates to implementation of the Joint and Common Market.

The MPSC is not satisfied that compatibility between the two RTO approaches has been considered adequately and addressed. Many questions must be answered before the MPSC is comfortable with the current diverse constructs. This is not intended to imply that the two RTOs should necessarily have identical approaches. However, it is imperative that the approaches are compatible and it is the obligation of the RTOs to demonstrate this in fact will occur. No such demonstration has been made. Significant unanswered questions remain, such as how will a less constrained MISO energy market interact with the more constrained PJM energy market? Will the movement of capacity from one market to another be confusing and disruptive as a result of PJM operating a capacity market and MISO not adopting one? How will market monitoring within the RTOs be affected and, if necessary, coordinated between the two RTOs to ensure proper behavior as market participants may have an incentive to game differences between PJM and MISO markets? These and other questions like them must be answered before major structural market changes such as RPM are adopted. A rush to judgment on resource adequacy is ill-advised as the consequences of getting it wrong are huge and could seriously jeopardize establishment of the Joint and Common Market. The MPSC strongly recommends that prior to adoption of any major changes to resource adequacy constructs within PJM or MISO the impact upon development and implementation of the Joint and Common Market be fully vetted to ensure compatibility with the commitment to achieve a robust energy market throughout the consolidated PJM/MISO region.

- 2. The existing reserve margin in excess of 20 percent provides the Commission with time to establish a process that fully evaluates the deficiencies in the proposed RPM and explores potential solutions.**

With a current reserve margin of over 20 percent, PJM's area-wide capacity is more than adequate for several more years. There is no urgency to meet PJM-wide requirements. The potential for local constraints raised by PJM is really a plea to address area-specific reliability problems that may be better

addressed by other means. The adequacy of the current reserve margin, coupled with recent legislation addressing the establishment of an Electric Reliability Organization ("ERO") should have caused PJM to consider the effect of such legislative developments, rather than rushing through the RPM.

Reserve margins are determined by regional reliability organizations. The Energy Policy Act of 2005 ("EPAct") has established that a new organization, an ERO, will be responsible for reliability. FERC has issued a NOPR on the ERO, but it will take time for the ERO to be chosen and to implement standards. At the same time, a new regional reliability organization, Reliability First, has emerged and is proposing to be responsible for standards in the area served by PJM and much of the Midwest ISO. Whether Reliability First will be selected as a regional entity under EPAct and what its duties will be is still unknown. However, if the chosen reliability organization continues to offer reserve standards, as some do now, such standards could require reserves that are not compatible with RPM solutions. One of the many issues that need to be resolved is how these differences will be reconciled. The interface with state-mandated reserve levels will also need to be considered.

Other RTOs and ISOs, such as the Midwest ISO and the ISO of New England, are still in the process of developing their resource adequacy constructs. The Midwest ISO is not scheduled to file its proposal with the Commission until mid-2006. The ongoing review of these other RTOs would allow for additional time for consideration of the PJM's RPM. These other processes may even result in additional methodologies that have not been considered by PJM. It also would allow time for PJM to consider the interaction of its resource adequacy construct with neighboring RTOs, particularly the Midwest ISO where a Joint and Common Market is under development. While PJM's current resource adequacy methodology does not appear to be in need of immediate correction, interim solutions could be considered that address specific current local capacity problems as well as those that arise.

- 3. PJM's use of an administratively set Variable Resource Requirement (VRR) curve results in capacity costs that may be too high. FERC should consider not just the design of the curve, but also alternatives to RPM that may be less costly to ratepayers.**

The VRR curve is an administratively determined matrix of prices that PJM has determined buyers should pay for reserve capacity. As such, it does not directly capture buyer preference in a market for capacity options, rather it is based upon assumptions made by the market administrator attempting to serve as a proxy for buyer demand. PJM's calculation of price is based on the cost of supply as determined by PJM, not demand as expressed by individuals freely interacting in the market place.

Under RPM, load serving entities (LSE) must make yearly commitments to capacity four years in advance. The design of the RPM creates significant new cost exposure to LSEs either directly through the RPM process, or indirectly through its influence on the cost of future bilateral agreements. To reduce volatility, the RPM may require LSEs to pay significantly more in the early years for capacity while PJM still has excess capacity, with an expectation that over time the RPM will cost less than the current construct. The problem with such an approach is that ratepayers are being asked to pay higher rates over the next several years in return for lower rates at some future period without any assurance that the RPM will remain in existence.

The RPM differs from the energy market because it pays more during times of excess capacity and less during times of scarcity (assuming that energy market prices are allowed to rise to scarcity levels). The RPM is therefore like a safe harbor for independent generators with uncontracted capacity. PJM effectively is paying for generation at prices the market is not willing to pay. PJM says that the market is not recognizing the need for this capacity. This is primarily because overall PJM currently has more than adequate capacity. PJM's

apparent justification for the purchase of additional capacity is the potential for future local generation retirements that may result in shortages. If PJM is concerned about possible plant closings in certain areas that will create local capacity shortages, this problem could be better solved by local solutions or a modification to PJM's current capacity market. LSEs with adequate capacity elsewhere in PJM's footprint should not be forced to pay for capacity in a PJM-wide capacity market simply because PJM needs to address a constraint in a portion of its system. This represents a shotgun approach to address a local constraint where a rifle may be more effective.

4. The RPM does not provide specifically for the integration of transmission and demand resource solutions.

The RPM focuses on capacity payments which tend to make the model biased towards building generation rather than transmission or demand response solutions to a shortage. PJM promises eventually to integrate transmission and demand resource solutions, but does not explain how this will be accomplished within the four-year forward period.

The PJM proposal does not appear to effectively integrate generation, transmission and demand resources to produce a least cost solution. For example, the projected problems in the east may be due to lack of transmission capacity. A vague assertion that the RPM will look more carefully at transmission solutions later, while socializing generation costs across the PJM area now, provides no assurance that the RPM will provide a less costly solution.

Transmission and demand resource solutions are an important part of resource adequacy, as they may provide more economic alternatives to new generation capacity. PJM says that it will "bring a neutral long term auction approach that favors only the lowest-cost solution, regardless of whether that is

transmission, generation, or load management.”³ PJM plans to “work with stakeholders to develop a protocol.” However, there is no explanation of how these plans will be carried out, what the end product will be or when it will be delivered.

PJM’s Regional Transmission Expansion Plan only goes out five years, and yet PJM says that “construction of a new 500 kV circuit typically would be expected to take ten years or longer”.⁴ While PJM has agreed to expand the term of the plan, it has not yet done so. And even if the Plan is extended to a longer term, there is no discussion of how this will result in a better integration of other resource options.

The RPM also favors a generation solution for loads that occur only during very brief peak periods by charging for such peak capacity on a seasonal rather than peak basis. This pricing does not reflect the real cost of peak generation, thereby masking short-term price signals for demand response. PJM seems to assume that demand response is not a viable solution. “Various factors, including continued limited demand-side response under retail regulatory frameworks, currently preclude reliance solely on a competitive wholesale energy market to ensure reliability, and require a continuation of a wholesale capacity commitment requirement.”⁵

Whatever resource adequacy constant is ultimately adopted, the Commission should insist that transmission and demand resources are treated as viable alternatives to new generation. The approval of any resource adequacy construct must include specific provisions for achieving the integration of transmission planning and demand resources as well as deadlines for meeting those commitments.

³ See application page 14.

⁴ See Herling affidavit, page 10.

⁵ See application page 35.

5. The RPM does not appear to encourage long term contracts.

PJM states that its RPM proposal will “promote” bilateral contracts and “encourage” long-term contracts.⁶ . The apparent assumption is that the RPM will provide incentives for long-term contracts that include payments for capacity. While the RPM will certainly influence the cost of capacity, it is unclear how it will encourage LSEs to own or contract long term for that capacity. To the contrary, RPM appears to contain many disincentives for long-term contracting. The RPM's treatment of contracted and owned capacity is a critical issue and demonstrates another area where the RPM appears incomplete.

The RPM determines the cost of capacity by the use of a VRR that is designed to almost always establish a reserve level that exceeds PJM's target of 15 percent.⁷ LSEs that own and contract all of their generation capacity must participate in some manner. When the RPM produces a VRR that is greater than what the LSE secured, it must purchase additional capacity which would result in increased costs. Under PJM's “flexible self-scheduling” option, LSEs that self supply may pay more. An LSE that self-schedules will likely have to secure higher capacity reserves in order to ensure they will meet the VRR solution. If the LSE later has “extra” capacity, it may be sold into the RPM, but by then the LSE has lost the opportunity to not purchase the capacity or sell that capacity into other markets at a higher price.

PJM claims that the RPM “includes provisions that will automatically de-emphasize the capacity market as the energy market proves more efficient at incenting adequacy capacity resources.”⁸ The disincentives that the RPM imposes on LSEs that secure their own capacity, however, may instead automatically emphasize the RPM market, making it a permanent and more costly solution.

⁶ Transmittal Letter at 83.

⁷ PJM's Installed Reserve Margin (IRM) is 15%. PJM expects the VRR to clear at or above the IRM 98% of the time (Tab E, Ott Affidavit, page 22).

⁸ Transmittal Letter at 15.

6. The RPM will not necessarily result in the right plant being built in the right place.

The cost of new entry is fixed in the RPM and is based on the cost-based revenue requirements of a natural gas-fired combustion turbine simple cycle peaker power plant addition.⁹ The RPM provides for four-year forward capacity commitments, based on the expected development schedule for a new combustion turbine.¹⁰ Thus, the main ingredient to the RPM assumptions is a combustion turbine. Combustion turbines are peaker units, which are used during peak or emergency periods. The focus on the combustion turbine as the expected new unit does not appear to allow appropriately for other types of generation to set the price for entry. It well may be that baseload plants with longer planning horizons are more appropriate for some areas of PJM, but the RPM may not encourage and may even discourage these plants from bidding into the RPM.

The emphasis on combustion turbines also raises issues regarding fuel diversity. The price of natural gas has risen dramatically over the last several years. The RPM's apparent over-reliance on natural gas does not take into account the volatile gas prices nor does it appear to consider possible gas supply or delivery problems. The recent hurricane-related disruptions in gas supply should encourage the consideration of fuel diversity in order to be less vulnerable to this type of situation in the future.

Over and over, the MPSC has heard PJM's assurance that the right plant will be built in the right place. But the RPM's reliance on the combustion turbine as the standard belies this assurance. Also, the details on the actual implementation of locational pricing do not go much beyond identification of the LDAs. As with other components of the RPM, more work needs to be done if PJM is really going to be able to back the assurances that it is making.

⁹ *Id.*

¹⁰ *Id.* at 75-76.

III. CONCLUSION

The MPSC is convinced that the Commission should reject the accelerated approval of the RPM that PJM has requested and set this case for a comprehensive hearing to examine all of the issues, *inter alia*, including the review of alternative solutions. Most importantly, the Commission should make clear that whatever resource adequacy constructs emerge from the PJM and Midwest ISO, they must be compatible with the PJM/MISO Joint and Common Market. In the alternative, the Commission could return resource adequacy and potential solutions back to the stakeholder process with instructions to collaboratively consider a workable resolution. The importance of determining an appropriate resource adequacy solution merits additional consideration and review.

Respectfully submitted,

**THE MICHIGAN PUBLIC SERVICE
COMMISSION**

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Dated: October 19, 2005

CERTIFICATE OF SERVICE

I hereby certify that I served copy of the foregoing document electronically to all parties listed on the official service list compiled by the Secretary in this proceeding.

Dated at Washington, D.C. this 19th day of October, 2005.

/s/ David D'Alessandro

David D'Alessandro

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