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**IN THE MATTER OF THE NEW  
JERSEY BOARD OF PUBLIC  
UTILITIES REVIEW OF THE  
STATE'S ELECTRIC POWER  
AND CAPACITY NEEDS**

**STATE OF NEW JERSEY  
BOARD OF PUBLIC UTILITIES  
DOCKET NO. EO09110920**

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**Joint Comments by**

**Public Service Electric and Gas Company  
Jersey Central Power & Light Company  
Atlantic City Electric Company and  
Rockland Electric Company**

**July 2, 2010**

## **Background**

The Board of Public Utilities (the “Board “ or “BPU”) held a Technical Conference on June 24, 2010, In the Matter of the New Jersey Board of Public Utilities Review of the State’s Electric Power and Capacity Needs, BPU Docket No. EO09110920. The purpose of the conference was to seek information regarding additional electric generation and capacity needs of New Jersey, with written comments submitted under this docket due on July 2, 2010. Public Service Electric and Gas Company (“PSE&G”), Jersey Central Power & Light Company (“JCP&L”), Atlantic City Electric Company and Rockland Electric Company, the electric distribution companies (“EDCs”), welcome the opportunity to submit the following observations and comments below on this subject.

## **The Electric Discount and Energy Competition Act (“EDECA”) Has Resulted in a Major Shift in the Planning Paradigm**

The EDCs believe that EDECA has resulted in a major shift in the planning paradigm for electric generation and capacity. With the implementation of EDECA, the EDCs have directed their efforts toward making a market-based solution to generation supply work. In conjunction with the Board, they have developed and implemented a Basic Generation Service (“BGS”) process that works to efficiently obtain market-based supply for customers not served by third party suppliers. For large customers this is an hourly priced supply (BGS-CIEP). For small and medium-sized customers, this is a rolling three-year fixed price supply (BGS-FP) that balances the need for reflecting market prices as required by EDECA with protecting these customers from undue volatility.

A basic principle of BGS is that it takes the wholesale market as it is and reflects market prices. Generators build capacity based on market signals and customers pay market prices as they evolve over time. Under this new planning paradigm, generators, not customers, bear the risk of the economics of new capacity; and PJM plans transmission as required to maintain reliability and enhance economics through the Regional Transmission Expansion Plan (“RTEP”) process.

## *The New Planning Paradigm Is Working Well*

The new planning paradigm is working well and the decision regarding when, where, and what generation to build is now a market decision. New capacity has been added and is keeping pace with load requirements. From 1999 to 2008, over 4500 MW of new capacity was added in New Jersey.<sup>1</sup> System reliability has been maintained throughout PJM and in New Jersey. For the first time since the 1980s, major high voltage transmission is being added as a result of PJM's RTEP process that should further enhance reliability and have the ancillary effect of lowering energy prices (LMPs) and reducing congestion. Furthermore, PJM analyses show that generating capacity is adequate through 2013-2014 (the latest period for which an RPM auction has been conducted); and the RPM provides price signals that will encourage further additions at the right locations when economic to do so. Although the new planning paradigm is not producing large excesses of generating capacity, this is *efficient*. Excess capacity is costly and inefficient. The fact that New Jersey is a net importer of energy is also an efficient market solution. This allows New Jersey customers to import lower cost out-of-state energy and results in lower prices for customers.

Generating capacity additions under the central planning paradigm prior to the implementation of EDECA, including non-utility generator ("NUG") contracts, thought to be economic at the time, in retrospect proved to be expensive and a burden on customers because their costs turned out to be higher than prevailing market prices. In fact, NUG Transition Charges ("NTCs") continue to this day more than ten years after restructuring. Using JCP&L as an example, over \$1.5 billion of over-market NTCs have been borne by customers since 2003, and this amount would be significantly higher save for the restructuring of many of these contracts by JCP&L.

The use of long-term BGS contracts to obtain supply from a particular generator would impose long-term supply risks on BGS customers. These are precisely the risks from which they are currently insulated under EDECA and the current BGS construct. The adverse impacts on customers, moreover, would likely fall disproportionately on those least able to bear them. If the

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<sup>1</sup> Mike Kormos and Steve Herling, *New Jersey Power Supply – Load and Capacity Data*, PJM Presentation at BPU Technical Conference, June 24, 2010, slide 4.

BGS procurement mechanism results in a supply portfolio that includes significant quantities of long-term, above market contracts, customer switching can be expected to increase. In turn, this will further reduce the size of the BGS customer group, thus increasing the adverse rate impact of any high cost long-term contracts. Ultimately, those customers that are poor credit risks or for some other reason are unable to switch could end up bearing the brunt of any stranded cost amounts. As will be explained later, it would, in fact, not be feasible for only BGS customers to support long-term contracts.

Long-term contracts may also impose additional costs on customers by having adverse impacts on utility balance sheets. In some cases, long-term contracts have been treated in a manner similar to credit obligations. In the publication entitled “Standard and Poor’s Methodology for Imputing Debt for US Utilities’ Power Purchase Agreements”, Standard & Poor’s notes that they view long-term power contracts as creating financial obligations that are incorporated into their assessment of a utility’s credit worthiness. Ultimately, the burden of such obligations will be visited on the utilities’ customers.<sup>2</sup>

Concerns were expressed by several parties at the technical conference over RPM price levels.<sup>3</sup> However, as implemented by PJM and as confirmed by PJM’s independent market monitor (“IMM”) Monitoring Analytics, LLC, all existing capacity market sellers are subject to mitigation and, therefore, there is no exercise of market power in the RPM auctions. There have been seven RPM auctions and all have cleared near, or below, the calculated new entry costs. In addition, RPM prices have elicited a significant amount of demand response (“DR”) resources and energy efficiency (“EE”) resources that also help meet reliability needs and are a check on

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<sup>2</sup> There are many industry examples of efforts by government entities to engage in long-term procurement. While these efforts were well-intentioned, the results have often been harmful to customers. In addition to JCP&L’s NTC charges discussed above, Niagara Mohawk securitized over \$3 billion to restructure NUG obligations and PSE&G’s PURPA contracts would have resulted in roughly \$2 billion in above-market payments had the largest of those contracts not been restructured by PSE&G. As with JCP&L, restructuring resulted in substantial savings and PSE&G was able to significantly reduce above-market amounts actually paid by consumers. In California, contracts entered into by the California Department of Water Resources in the Spring of 2001 to stabilize prices during an energy crisis were severely out of market only a few months later, resulting in a complaint being filed at the Federal Energy Regulatory Commission in February 2002 alleging that the contracts the state had entered into just several months earlier were not just and reasonable. Much earlier, as early as 1985, California had suspended expensive PURPA standard offer contracts, showing that short memories can lead to repeat problems.

<sup>3</sup> Transcripts from the BPU Technical Conference held on June 24, 2010, page 140, lines 1-10.

prices. LS Power did not indicate a willingness to accept a lower price, but did indicate a desire to lock the RPM price in for a longer term.<sup>4</sup> Under the RPM construct, if the RPM price falls, customer prices will fall. Under the contract paradigm, developers will lock in to high prices. If Rate Counsel believes RPM prices are too high, it is reasonable to wonder why it would make sense to lock in those prices. Efficient and competitive markets take time to develop and react. As Mr. Chin of Citi noted in his presentation, financiers are now recognizing capacity revenue in their lending determinations.<sup>5</sup> As this occurs, there will be greater support from the financial community to provide the financial needs of generation developers.

**The EDCs Believe That a Move to Long-Term Contracts Is Ill-advised at This Time**

There may well be improvements that can be made to RPM. Mr. Weishaar of the PJM Industrial Customer Coalition noted that the best solution is not a one-off solution but one that improves the market.<sup>6</sup> The EDCs fully concur. To the extent that the Board sees reliability as a looming problem -- or sees a need for enhanced generation in New Jersey that the market is not filling -- the EDCs believe that the preferred course of action is to work with PJM and FERC to develop a market solution; and only resort to a non-market solution if all else fails. Unjustified preemptory market intervention will impede market solutions. For example, would the DR that has come forth have been developed if regulators had intervened to create new capacity, capacity that ultimately would not have been needed, to be built under long-term contracts?

The EDCs have a significant concern that state activities designed to affect – as opposed to reinforce – the competitive wholesale electricity markets are ill-advised at this time and likely to have unintended consequences. The EDCs urge the Board to proceed cautiously on this issue as it potentially can lock in significant changes for long periods of time. Long-term capacity contracts, especially contracts targeted at only new and only in-state resources, not only do not take the wholesale market as found, but are an activity that will likely distort the market. The EDCs are concerned that introducing long-term contracts at this time would destroy price signals

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<sup>4</sup> Transcripts from the BPU Technical Conference held on June 24, 2010, page 149, lines 8-9 and page 150 lines 1-6.

<sup>5</sup> Transcripts from the BPU Technical Conference held on June 24, 2010, page 77, lines 1-7.

<sup>6</sup> Transcripts from the BPU Technical Conference held on June 24, 2010, page 131, lines 9-25 and page 132, lines 1-5.

and undermine the progress made to date in the development of competitive markets. The implementation of EDECA has resulted in competitive markets and retail choice and the EDCs contend that the introduction of long-term contracts would be inconsistent with market pricing and competitive markets.

Long-term contracted capacity supported by customers may lower the RPM price in the short-term. However, to the extent such contracts make competitive generators reluctant to add capacity on a merchant basis; the intermediate to longer-term effect could be to distort the market by reducing reliability and increasing RPM prices. Market forces will wither if there are ratepayer-supported new capacity additions that are perceived to be interfering with market price signals and receiving preferential treatment. If new capacity is added via long-term customer-supported contracts, eventually the only viable entry will be entry that is underwritten by customers.

Board-mandated entry of new capacity under a long-term contract would need to be underwritten by *all* customers, not just BGS customers. BGS customers have the option to leave. This means that BGS rates cannot be used to support cost recovery of the long-term capacity contracts. In the event that BGS rates were used to support cost recovery and contracts do not reflect market fundamentals, then the Board risks letting the burden of those contracts fall increasingly on those BGS customers who may well have no effective alternative due to income or credit levels, as over time the base of BGS customers that can be used to support cost recovery will shrink.

Market intervention is a complicated process that can yield unintended consequences. The EDCs are concerned that, should the Board start directing long-term capacity contracts and interfering with the market solution, this will start a process that cannot be stopped. It is possible that investors will not build new capacity if the state directs long-term capacity contracts and this, in turn, may require continued contracting. Market failure in this case will be a self-fulfilling prophecy. Furthermore, BGS will move away from market pricing. Ex-post prices determined via long-term contracts may be too high or too low, and either case is harmful. If prices are too low, this undermines competition and third party suppliers will leave the market. If prices are too high, customers will bear the cost of this mistake through higher rates.

## Summary

Over the past decade, New Jersey has moved away from a centrally planned approach to capacity and reliability to a market-based approach. The market approach, combined with PJM's RTEP, is working: capacity has been more than adequate and RPM prices are below the calculated cost of new entry. Over time, the market-based approach protects customers from acting as guarantors on generator financing and can be expected to produce a more *efficient and lower cost* solution. A retreat from a market approach will result in a chronic shift of generation investment risk back to customers.

To the extent that the Board sees a need for enhanced reliability and additional capacity in New Jersey that is not currently being met by the market, the EDCs respectfully submit that the Board should work with PJM and FERC to improve the market-based solution. Only after all this is done and the Board still believes that there is a problem, which is unlikely, should long-term contracts even be considered. The introduction of long-term contracts is extremely premature and ill-advised at this time.