STATE OF NEW JERSEY
BOARD OF PUBLIC UTILITIES

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NEW JERSEY CAPACITY ISSUES -	**: BPU DOCKET NO.:**
TECHNICAL CONFERENCE	**: EO09110920**
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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	**:**
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INITIAL COMMENTS
OF PSEG ENERGY RESOURCES & TRADE LLC
AND PUBLIC SERVICE ELECTRIC SERVICE
AND GAS COMPANY ON TECHNICAL CONFERENCE

Pursuant to the procedures adopted at the June 24, 2010 technical conference in the above captioned matter, PSEG Energy Resources & Trade LLC and Public Service Electric and Gas Company (the "PSEG Companies") hereby file their initial comments in this proceeding. As shown below, the Board of Public Utilities ("BPU") should not undertake any action that would disrupt the operation of the successful Basic Generation Service procurement or the operation of the well-functioning markets administered by the PJM Interconnection, L.L.C.[1] In support whereof, the PSEG Companies hereby respectfully show as follows:

I. INTRODUCTION

The PSEG Companies commend the BPU and its staff for conducting the June 21, 2010 technical conference in a manner that allowed a thorough exploration of issues in connection with the development of new generation in New Jersey and the other states comprising the PJM region. The PSEG Companies submit that, given the diversity of voices that participated in the proceedings, the BPU should feel confident that it has a proper foundation upon which to deliberate regarding these matters.

Consideration of matters such as the adequacy of generation resources to meet New Jersey's energy needs and the obstacles that may be preventing construction of new generators is certainly within the purview of this Board. The provision of safe, fairly priced and reliable

[1] The PSEG Companies respectfully reserve the right to file supplemental comments. At the request of the PSEG Companies, Professor William Hogan is in the process of preparing an affidavit concerning the matters that are the subject of the technical conference. Due to the short time allowed for submission of comments under the procedures adopted at the June 24, 2010 technical conference, Dr. Hogan has not yet completed his analysis. The PSEG Companies intend to submit the document being prepared by Dr. Hogan as soon as it becomes available.

energy to New Jersey consumers is part of the core mission of the BPU. Further, under the provisions of the Electric Discount and Energy Competition Act, the BPU is directed to consider the availability of energy supplies in available markets.

The PSEG Companies respectfully submit that, given its mandate, the BPU should be pleased with the predominant message of the technical conference: PJM energy and capacity markets are working as designed and reliability requirements for New Jersey are being satisfied through these mechanisms. As stated at the technical conference by Mr. Meehan from NERA and confirmed by the remarks of Mr. Chin from Citigroup Global Markets, a major shift in the planning paradigm has occurred in which generation adequacy is being determined by market forces. Under this new paradigm, generators assume much of the risk associated with constructing new generating plants thus insulating customers from above-market costs such as occurred with respect to mandates that required purchases of "non-utility generation" in the past. Thus, to the extent that economic incentives do not support the construction of certain types of generators or of particular generating plants, the discipline of market forces should be allowed to apply.

It would be unnecessary and, indeed, counterproductive to make any major change to the current energy procurement structure. The Basic Generation Service ("BGS") auction process used by the BPU to meet default service requirements has worked very efficiently to secure electricity supplies consistent with market forces and has minimized the price volatility experienced by residential and small commercial customers in the State. In these circumstances, the BPU should proceed with extreme caution before taking any steps that would undermine the operation of this mechanism or the underlying PJM markets.

If the BPU does decide that additional incentives for new generation are required, the PSEG Companies stress that any actions taken by the Board should preserve the current market design framework. Thus, for example, in the event the BPU decides to promote new generation through use of the BGS mechanism, it should retain the fundamental elements of the BGS procurement design. Also, should the Board decide it advisable to foster particular types of generators, it could utilize the PJM Reliability Pricing Model to achieve its goals. Other measures such as improvements to the generation permitting process in New Jersey could also be considered.

II. COMMENTS

A. New Jersey Consumers Will Realize Optimal Benefits By Allowing The Development of New Generating Plants To Be Driven By Market Forces

As noted by Mr. Meehan at the technical conference, a paradigm shift has occurred in which generation adequacy and the construction of new generating plants are driven by market forces.[2] Indeed, the PJM capacity and energy markets provide the foundation for meeting electricity supply needs in New Jersey and throughout the rest of PJM. The breadth and strength of the PJM markets provides substantial benefits to New Jersey consumers.

[2] *See* Transcript of June 24, 2010 technical conference ("Transcript") at p. 26..

The development of new capacity resources in response to market signals provides the most efficient outcome for consumers. Intervening into markets by subsidizing the construction of generation resources before they are needed will result in sub-optimal deployment of capital and ultimately require consumers to pay higher prices. Generation resources to meet basic supply requirements should only be constructed when economic forces adequately support their development.[3]

The ability to import cheaper power from other portions of PJM and other regions saves New Jersey consumers hundreds of millions of dollars annually in comparison to what it would cost to supply electricity only from New Jersey sources. New Jersey also benefits in terms of it ability to achieve reliability at a lower cost by being able to share resources with other regions and benefits from being able to socialize a significant share of the costs of transmission projects that benefit the State. It thus needs to be recognized that overzealous efforts to pursue development of new generation in New Jersey that is not supported by the market could significantly undermine these benefits and efficiencies. While possible enhancements to any market design should be considered, generation development should be a response to market forces. It would be unrealistic and counterproductive to pursue generation projects as the vehicle for industrial development in the absence of market demand especially given the presence of the robust PJM market that already exists.

In fact, direct government intervention in the form of long-term contracts to support specific new fossil generation construction projects will drive out other forms of investment or, at least, cause developers to demand premiums before deploying capital. Commercial entities will not be willing to commit capital that will be subject to market forces if they perceive that a risk-free arrangement will be offered in the future. Similarly, developers will not be willing to commit capital based on a forecast of market prices if they perceive that the government may take out-of-market actions intended to suppress those prices. As also stated by Mr. Meehan at the technical conference: "Investors are going to be much more hesitant to make those type of investments [in new capacity resources] if preferential treatment is given to just one or two resources."[4] At best, projects will only get built after extreme shortage conditions emerge that will enable developers to demand premiums to offset the perceived risks.

Moreover, under current market conditions, the economic incentives for fossil generation projects that are not replacements for retiring plants in constrained areas do not appear to be sufficient to support new construction. Based upon recent transactions in the United States, existing generation is available at a cost of 30% to 40% of new construction. For example, Calpine has publicly stated that it has recently acquired existing generating plants at an

[3] This is not to say that the State should not adopt measures to pursue particular energy policy goals. For example, incentives for wind and solar projects could be provided due to their nascent technologies and desirable environmental attributes. Potential market impacts associated with such projects should not be ignored but they should be manageable.
[4] Transcript at p. 29.

average cost of $381 per kW.[5] This compares with a cost estimate based upon engineering studies prepared by independent consultants retained by PJM of $1,165 per kW to construct a combustion turbine generating unit in eastern PJM.[6] Given the current market climate, therefore, out of market procurements of new generation will require significant subsidies of above-market contributions.

Because of the level of subsidies that would be needed in order to support new generation construction under current market conditions, out-of-market procurements would not appear to be the most cost-effective way to foster job growth in New Jersey. It must also be recognized that adding new generating capacity in New Jersey that lacks sufficient economic support from the market could precipitate the premature retirement of other generating plants.

Ultimately, governmental intervention in the form of mandated long-term contracts for new generation effectively replaces the market's determination of need and the assignment of risks to developers with a governmental determination of need and the assignment of risks to consumers. The PSEG Companies would urge the BPU not to take this path.

B. The Current BGS Procurement Mechanism Has Worked Well For New Jersey Customers And Should Not Be Significantly Modified

The BPU has approved statewide auctions for the procurement of full requirements services in each of the last nine years for BGS. This mechanism has worked very well and should not be significantly modified.

The BPU approved auction design allows potential suppliers to bid for the right to supply two types of products: first, for BGS—Commercial Industrial Energy Pricing ("BGS-CIEP"), a variable hourly-priced product for industrial and larger commercial customers supported by one-year supply contracts, and, second, BGS—Fixed Energy Pricing ("BGS-FP"), a seasonally fixed-price product for small commercial and residential customers supported by "laddered" three year supply contracts. The BPU auction utilizes a "descending clock" design in which all participants bid on the identical "load following" product supplied under a standard form contract. The BGS supply is a fully delivered and full requirements product that addresses all of the complexities of the energy industry and simply provides electricity to customers when and in the quantities that the customers choose to use that electricity. In the BGS auction, accordingly, the only variable considered in selecting winners from the eligible bidders is the price offered.

Economic evaluations of the BGS process have concluded that its design provides a very efficient methodology for procuring electric power at the lowest cost consistent with prevailing market conditions. As Commissioner (then President) Fox stated in 2004:

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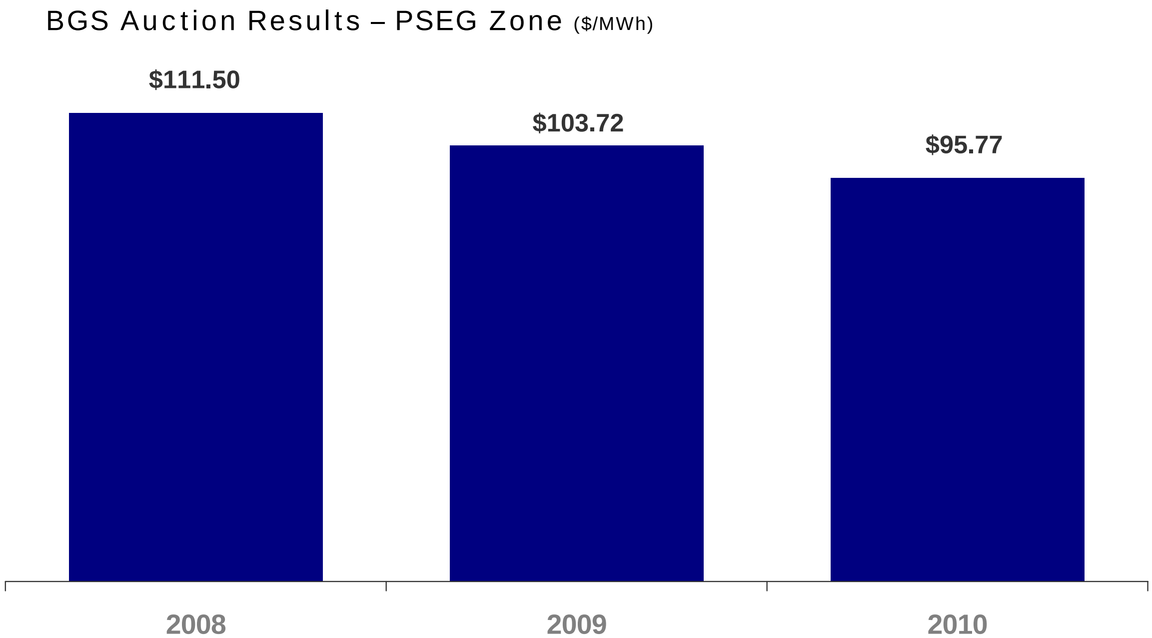
[5] *See* "CALPINE CORPORATION Strategic Transactions Overview: Acquisition of Conectiv Fleet & Sale of Colorado Plants" dated April 21, 2010 (available at http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9Mjk5MjQyOXxDaGlsZElEPTM3NzgxMHxUeXBlPTI=&t=1).

[6] *See* "2012/2013 CONE Update with PJM Member Base Assumptions – August 25, 2008," p. 2 (available at http://www.pjm.com/~/media/committees-groups/committees/mrc/postings/ppm-cone-ct-update.ashx).

New Jersey is the only state in the country to secure its entire electric needs with an auction. We have once again been able to take advantage of a very robust and active energy market at the wholesale level and get the best possible electric prices for our homes and businesses.[7]

Indeed, given the existence of these "very robust and active" PJM markets, many of the BGS winners have consisted of companies that do not own generation assets in New Jersey or even in the PJM region.

The following chart illustrates BGS auction results over the last three years in the PSE&G Zone.



The BGS auction process has resulted in prices that appropriately respond to changes in market conditions by reducing the commodity portion of customer payments during periods of declining demand as has occurred over the last several years.[8]

At the same time, the BGS pricing mechanism has provided price stability. The three-year rolling procurement structure of BGS supply for residential and smaller commercial and industrial customers insulates these customers from the price shocks resulting from short-

[7] *See* "Power Points," March 2004 (available at http://www.pseg.com/media_center/pdf/bgs3final.pdf).

[8] Because BGS prices reflect a three year commitment on behalf of the suppliers, BGS prices necessarily reflect the risk premium that competitive suppliers have assessed as to future conditions. As a result, BGS prices do not track short-term wholesale market prices. In addition, BGS prices include all components associated with full requirements service, e.g., capacity, ancillary services and congestion charges. The BGS prices thus reflect the fully delivered price of electricity hedged over the BGS period.

term energy price volatility. For example, in the aftermath of Hurricanes Katrina and Rita electric prices in other nearby states rose over 50 percent, while BGS prices in New Jersey rose only 13 percent. Conversely, when prices are moderating, the BGS design allows customers to switch freely to third party suppliers thus providing a "free option" for circumstances in which the BGS price is higher than the current market price available to a particular customer. The value of this free option is shown by the significant migration to third-party energy supply which has occurred with respect to the residential and small commercial class of customers, and the recent entry of several energy marketers that are targeting New Jersey's residential customers.

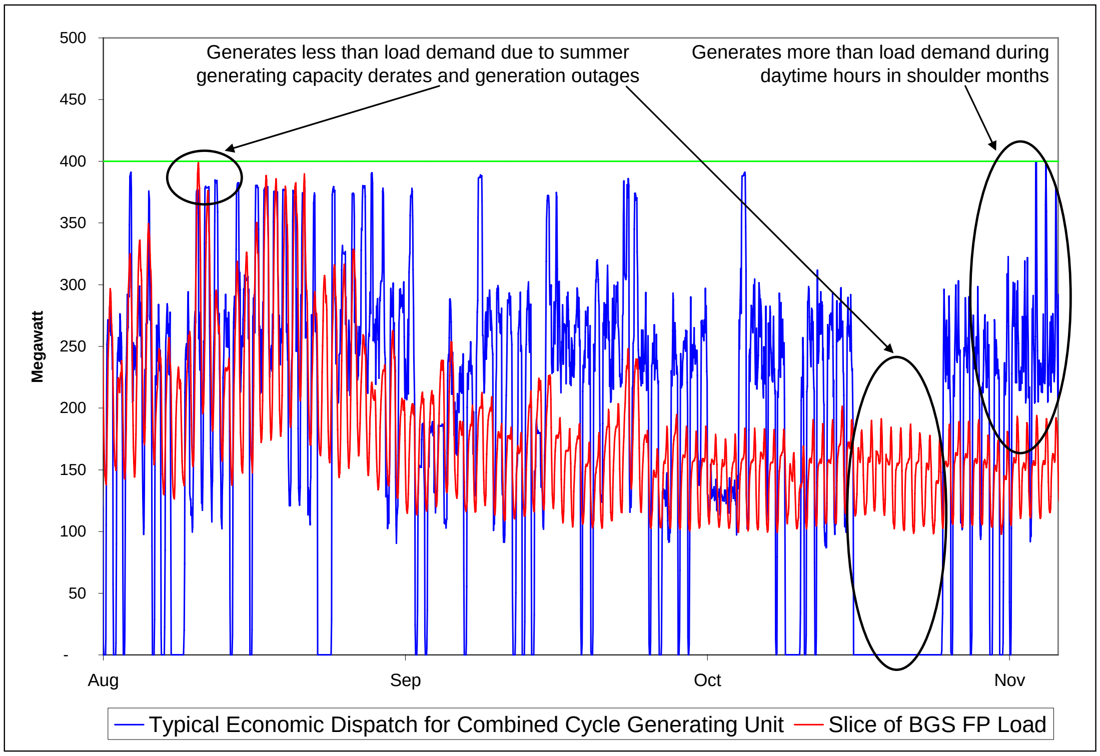
Any changes to the BGS auction therefore should be carefully considered so as not to adversely impact these key characteristics. The use of BGS to procure the output of a specific new generating plant, however, would, as described below, undoubtedly have such adverse impacts.

C. Contracts For Single Plant Procurements Would be Incompatible With the Current BGS Construct

Requiring utilities to enter into contracts for the purchase of the output of a particular generating plant would undermine the efficiency of the current BGS procurement mechanism. Much of the benefit of the existing BGS procurement mechanism would be lost if this were to be required.

Generation plants are not capable of providing the full requirements of a consumer's electricity demand nor are they capable of providing the same fully delivered product that is offered by BGS. Contracts to buy power from specific generation plants are written in terms of delivering output from that generator in block periods and in block quantities. In contrast, BGS suppliers have a far more complex contractual commitment to follow and meet electricity demand of customers as it changes throughout the day and throughout the year. BGS suppliers most efficiently rely upon a mix of generation sources and other electricity products provided through the marketplace to meet their contractual obligations to customers. The following chart illustrates the mismatch between a typical generation unit output and a typical customer electricity demand:

Typical combined cycle generation output is not a very good match to BGS–FP load



Further, using the BGS mechanism to support the construction and operation of a specific generating plant in the State would place additional risks and costs on other BGS suppliers and on New Jersey consumers. For example, if a specific generating plant were procured to operate "for BGS" so that its output when operating offset other BGS supply obligations, the other BGS suppliers would be required to assume responsibility for load following duties associated with that unit's unavailability. Thus if a 500 MW plant whose output was acquired exclusively "for BGS" were operating at a time when load was 5,000 MW and then dropped by 600 MWs, the other BGS suppliers would have full financial responsibility for the entire 600 MW reduction. Similarly, if the 500 MW plant experienced a forced outage, the other BGS suppliers would have full financial responsibility to make up the entirety of the 500 MWs of abruptly discontinued supply. While the other BGS suppliers could certainly perform these functions, the increased load variability in their supply commitment would come at a cost that would be included in BGS bids and ultimately be imposed on consumers.

D. Long-term Contracts Expose Customers to Potential Out-of-Market Costs

The use of long-term BGS contracts to obtain supply from a particular generator would also impose long-term supply risks on BGS customers from which they are currently insulated under the BGS construct. Even assuming that a particular long-term contract with a new generating plant looked attractive when entered into, it could result in high out-of-market rates at a remote future date. The adverse impacts on customers, moreover, would likely fall disproportionately on those least able to bear them. If the 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 class 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.

There are many industry examples of efforts by government entities to engage in such long-term unit specific procurement. While these efforts were well-intentioned, the results have often been harmful to customers:

- Long term contracts under the Public Utility Regulatory Policies Act of 1978 (PURPA) that utilities were forced to enter into under the direction in the 1980s and 1990s ended up being well above market in most cases thereby resulting in out-of-market costs that are still being paid by consumers to this day. PSE&G's PURPA contracts would have resulted in about $2.026 Billion in above market payments over the period 1995 to 2009 had the largest of those contracts not been reformed by PSE&G. Restructuring resulted in $935 Million in savings over that time – still resulting in net overpayments of about $1.1 Billion in above-market amounts actually paid by consumers.

- 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 filing at the Federal Energy Regulatory Commission in February 2002. The filing alleged that the above market portion of 44 mostly long-term transactions equaled about $18.7 Billion.[9] A significant share of these above market costs were ultimately borne by consumers.

Long-term contracts that would be limited only to new units, moreover, would impose even more price risk on consumers. If generation adequacy were to become a concern, the procurement of needed supplies should come from as large and diverse a base of potential resources as possible. The level of competition, if existing resources are allowed to participate with new generation, should provide consumers with the lowest possible price available. There would no rational basis to exclude existing resources.

Indeed, the cost of obtaining power from new generating assets is well above the current market price for electricity. For example, PSEG Power was recently the winner of a competitive procurement in the State of Connecticut for construction of three peaking generating units with a total output of about 130 MWs. The amount that will be paid to the project under a cost of service contract arrangement with a Connecticut utility is the equivalent of about a $398 per MW-day capacity payment for a 20 year term. The payment level is well above the most recently determined forward price for capacity in New Jersey

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[9] *See Public Utility Commission of California v. Allegheny Energy et al,* FERC Docket No EL02-60-000, February 25, 2002 Complaint, p. 29.

of $245 MW-day.[10] Connecticut ratepayers will be committed to pay these out of market costs for this generation for the length of the contract. Thus, even assuming that the Connecticut Department of Utility Control has a valid policy rationale for directing utilities to enter into these arrangements at this time, its actions clearly expose ratepayers to potential "stranded costs" at a future date if markets do not react as the Commission anticipates.[11]

Finally, it must be recognized that there is no "free lunch" and that financing a new generation facility must be supported by a creditworthy entity somewhere in the transactional chain. Ultimately, for construction supported by a long-term contract, this entity will likely need to be the utility counterparty. Credit rating agencies are well-aware of this fact and frequently have determined that utility obligations under long-term supply contracts are the equivalent of debt. As such, these obligations may be factored into the utilities' credit metrics and could place pressure on the utilities' credit rating. While regulators may not factor in these obligations against the utilities' capital structure, a lower rating will cause higher borrowing costs for affected utilities in order to fund their ongoing investments to benefit customers. This will result in greater need for rate relief, essentially resulting in customers sharing the burden of the increased risk caused by this long term commitment.

E. PJM Markets Are Working As Designed

New Jersey currently benefits very significantly from being part of a large energy market and control area. The PJM energy and capacity markets, in conjunction with the BGS procurement auction, are resulting in demand being met in a reliable and economically rational manner. A total of 4,831.9 MW (unforced capacity) of incrementally new capacity in PJM was made available for the 2013/2014 Delivery Year in the May 2010 Base Residual Auction (BRA) held under the Reliability Pricing Model ("RPM") framework. This incrementally new capacity includes new generation capacity resources, capacity upgrades to existing generation capacity resources, new demand resources, upgrades to existing demand resources, and new energy efficiency resources.[12]

As shown by PJM's presentation at the June 24, 2010 technical conference, a substantial portion of these new capacity additions have occurred in New Jersey. Since the advent of RPM, 848.4 MWs of new generation have cleared in New Jersey.[13] This includes peaking

[10] This is the rate for the 2013/2014 Delivery Year as determined in the May 2010 auction. Capacity rates for prior years have been lower. Further, it should be noted that this comparison provides only a rough equivalency because market revenues other than capacity payments have not been considered. However, the comparison is generally valid in the case of peakers which derive most of their revenues from capacity payments.

[11] Attempts by state commissions in the 80s and 90s to foresee market prices was the precise reason why many utilities were directed to enter into long term contracts with co-generation plants that eventually forced those utilities to seek stranded cost recovery payments from ratepayers.

[12] *See* 2013/2014 RPM Base Residual Auction Results, p. 14 http://www.pjm.com/markets-and-operations/rpm/~/media/markets-ops/rpm/rpm-auction-info/2013-2014-base-residual-auction-report.ashx.

[13] *See* "New Jersey Power Supply, Load and Capacity Data," presented by Mike Kormos and Steve Herling, PJM Interconnection, L.L.C., p. 14-15.

facilities cleared in the Northern PSE&G Zone that will be constructed by PSEG Power. Moreover, Load Management resources that have cleared as capacity resources in RPM have increased dramatically from below 200 MWs statewide in 2007 to well over 600 MWs in 2010.[14] Further, in the PSE&G zone, the quantity of demand resources cleared grew from 472.9 MW for 2012/2013 BRA to 1,119.2 MW for the 2013/2014 BRA, an increase of 646.3 MW (137%).[15]

The success of RPM moreover has not been lost on the financial community. As stated in Mr. Brian Chin's written comments filed in this proceeding:

- Is RPM Working Enough:
    - In our [Citigroup Global Markets'] opinion, yes. Capital markets are attuned to capacity price auctions. Capacity prices increasingly affect asset valuations (Calpine/Connectiv (sic)). Mothballing of capacity has been prevented.[16]

This recognition of RPM's role in financial evaluation confirms the increasing important function of this market.

F. Enabling New Jersey to Compete With Other States for New Generation Siting.

While the conditions of the current economic environment do not support new fossil generation construction in New Jersey or in the region, this will not always be the case. If energy demand increases or existing generation supply is reduced either by environmental policy changes or other economic factors there may be a need for new generation supply. The question is whether developers of new generation supply would elect to build their new generation facilities in New Jersey or elsewhere. To the extent New Jersey wants to prepare itself to compete with other states for such generation supply it is particularly important that steps be taken to streamline environmental permitting. [17] These steps include:

- *Nonattainment area offsets*: One of the significant hurdles in permitting new generation in New Jersey is the acquisition of offsetting emission reductions such that the increases in emissions from the new source are offset by an equal or greater reduction in actual emissions from the same source or from other sources

[14] *Id.*, p. 16.
[15] *See* 2013/2014 RPM Base Residual Auction Results, p. 7 http://www.pjm.com/markets-and-operations/rpm/~/media/markets-ops/rpm/rpm-auction-info/2013-2014-base-residual-auction-report.ashx.
[16] "Capacity Issues Technical Conference, State of New Jersey," presented by Brian Chin, Citigroup Global Markets, p. 7.
[17] New Jersey has accepted a leading role in demonstrating to the nation that action must be taken to minimize the impacts of climate change. Unfortunately, this leadership comes at a cost to electric generators in NJ who are required to participate in the Regional Greenhouse Gas Initiative (RGGI). These operating costs are also an important market power consideration for developers of new generation in NJ especially since PA is not a participant (PJM). The situation is exacerbated by the continuing delay in federal climate legislation that NJ may consider appropriate to sunset the state's participation in RGGI.

in the area. Most importantly, fine particulate matter (PM2.5) offsets are extremely rare and may be a significant impediment to new generation siting in the future. This situation is exacerbated by a New Jersey specific "shelf-life" provision that decreases usable shutdown emission reductions by 50% after 5 years and 100% after 10 years. This is not a federal requirement but a New Jersey specific requirement. In summary, New Jersey has ownership of shutdown offsets that could be used to decrease the significance of this hurdle for new generation. New Jersey could improve this permitting process by for each megawatt of environmentally high emitting generation capacity shut down by an owner, New Jersey could provide sufficient offsets (if available) to this owner for building new generation equal to the same megawatt capacity.

- *Reduce fees:* Allocate environmental permitting fees on a more equitable basis and develop a formula for the operation of the self-funded programs and charge the user accordingly.

- *Reduce time for permits:* Allow for DEP staff augmentation by contracted personnel. Afford applicants the option of funding fees directly and create a one stop permit review team for major projects that meet certain criteria and expand the use of licensed professionals to oversee the stack testing would allow a more efficient scheduling of the units. The cost savings are passed back to customers in lower rates.

G. If Additional Enhancements Are Deemed to Be Necessary They Should Be Integrated Into the Current Market Structures As Much As Possible.

If the state of New Jersey determines to provide incentives to develop specific new generation facilities within the State, it should pursue options that will build upon the existing market construct and minimize inefficient market outcomes to the greatest extent possible. Efficient markets provide electric energy consumers the best prices over the long-run. Specifically, the State should work within the existing RPM and BGS frameworks, and utilize the capabilities of those constructs to support and attain particular policy objectives. Improvements in open access to New York markets may also help support new generation developments.

1. Features of The RPM Mechanism Could be Used to Support New Generation Development

One of the features of the RPM model is its ability to model any type of constraint – including both the type of resource, as well as the specific characteristics of a resource. When it is deemed appropriate to have a certain type of resource, the model can be employed as an optimization tool to achieve the results desired. Thus, if the State wishes to insure that a certain amount of generation is located within its borders, or that a particular type of technology is represented in a certain quantity in New Jersey, those targets can be established as parameters, and can be met by the RPM market mechanism. This allows the cost of procuring resources with special characteristics or within certain regions to be revealed in a transparent manner, while still allowing the rest of the market to see an appropriate price signal. Using the RPM construct instead of special out-of-market mechanisms maintains the market-based price signal for all generation and allows a clear view of the additional costs associated with acquiring capacity with the desired characteristics.

To be more specific, consider the following example: The State determines that it wants to have 5,000 MWs of additional generating capacity supplied from combined cycle generation. It works with PJM to establish this as a parameter within the four (4) electric distribution companies Locational Deliverability Areas ("LDAs") within New Jersey. Specific RPM parameters, consistent with this request, can be employed, and the market can be used to meet this limitation, while the remaining New Jersey capacity would be procured within the traditional RPM construct. In this example, assume the price needs to reach $500 / MW-day to incentivize enough combined cycle investment to reach the appropriate level, and the RPM auction for the remaining 15,000 MWs of obligation within New Jersey clears at $100 / MW-day. The market construct will have been preserved, the objective met, and the cost of capacity for load would equal $200 / MW-day ([$500 * 5,000 + $100 * 15,000] / 20,000 MWs). This approach is similar to a smaller LDA, such as the Northern PSE&G zone, clearing at a different price within a larger, nested LDA, like EMAAC.

This construct would work within the existing PJM framework and not impact the New Jersey BGS structure. Suppliers would know the cost of capacity associated with serving the load as they do today, and incorporate it directly into their bids.

An example of this approach currently exists within the New York capacity market. New York City is focused on the generation adequacy within the city itself, and as such, requires that 80% of its capacity needs be met by generation sources directly within the city limits. The New York Independent System Operator ("NYISO") meets those obligations with in-city resources, and then solves the reliability equation for the balance of the ISO. This results in higher costs for New York City customers, off-set by slightly lower costs throughout the rest of the State, and the attainment of the New York City target of 80% of resources located within the city.

This approach provides the advantage of a market-based solution within the existing framework, while satisfying other policy based objectives. As it is administered by PJM, it will have the usual level of oversight, and will help insure that the "lowest cost" and "best-fit" resources are selected to meet the various needs. This methodology, however, will not work as a one-time event, and the policy objective sought needs to endure over time to provide some degree of confidence around the future earnings potential of the special assets. Market forces and actions may cause the constraint not to bind in the future, but the limitation needs to remain within the model.

Additional support for new generation could come from enhancements to the general RPM market design. Notably, it would assist in developing new combined cycle generation if the current forward procurement period were increased from three years in advance to five years in advance. A more transparent and predictable process for coordinating transmission planning and RPM auction parameters would also help developers in evaluating and financing potential projects.

2. BGS Could Be Modified To Include Longer-Term Trenches That Would Help Support New Generation Development

The State could also consider an extended term BGS tranche of sufficient size to provide a partial hedge for new construction. While it does not appear that this innovation would be enough to support new entry of generation under current market conditions, adopting this feature at a time when new generation is more financially viable would help support the commitment of the necessary capital expenditures.

The extended term BGS tranche could provide for a commitment of up to 10 years at a fixed price. To minimize the impact of the special long term procurement on other BGS suppliers as much as possible, the type of service offered should be "full requirements" service as is currently provided under the BGS procurement. Because as shown earlier, the "full requirements" service obligation does not closely correlate with the normal operating cycle of a combined cycle plant, this condition would lessen the value of the long-term contract as a hedge. The contract nonetheless would still provide a degree of financial support to a plant capable of operating with a high availability factor. In addition, eligibility for the tranche should be open to both existing and new generation to reduce market impacts and to assure that customers receive the lowest cost alternative.

The pricing for a long-term tranche would likely include a premium reflecting the lack of price discovery in the "out" years and the risk assumed under the arrangement. This is because at present, while gas contracts may go out for five years, there is no liquid market for load following contracts beyond an approximately three year period. Thus a premium – much like the premium paid under an insurance contract – will be added out of necessity because of the lack of liquidity in these longer term contracts. And, like an insurance policy, the arrangement ultimately may pay off in a beneficial manner to consumers but it must be recognized that bidders will not price this type of offering to the advantage of the "policy holders."

3. Improvements in Access to New York Markets May Also Provide Support to New Generation Development

Finally, new generation construction could also be supported though increasing access to higher cost electricity markets such as New York City in order to facilitate exports to NYISO from PJM. Enhancements in interregional planning and operations between PJM and NYISO would have the potential to unlock new markets for New Jersey generation output. Because of the proximity between New York City and northern New Jersey, generation in New Jersey would be in a uniquely advantageous position to utilize increased transfer capacity between the two regions and thus provide the opportunity for exports of power from New Jersey plants. It is important to note that under the current market structures, New Jersey has the benefit of having power plants located in the State which pay taxes to the State and provide employment opportunities, yet at times export power to neighboring areas that are willing to pay higher premiums for such power.

H. The BPU Would Face a Risk of Legal Challenges If It Directed Electric Public Utilities To Enter Into Long Term Contracts for New Generation

1. Under EDECA, the BPU Appears To Lacks The Authority to Direct the EDCs to Enter Into Supply Arrangements Which Can Not Be Evaluated In Light of Market Conditions

Under the EDECA, the BPU appears to lack the statutory authority to order utilities to enter into long-term contracts whose duration exceeds the period over which power is generally traded. EDECA generally provides for retail open access by end users in the state of New Jersey. It also requires utilities to offer BGS, *i.e*, "provider of last resort" service for customers that cannot or prefer not to select a third party supplier.

The mechanism for the procurement of supplies to meet BGS requirements is found in EDECA and imposes parameters on how utilities may secure their electric power needs and the prices that may pay. N.J.S.A. 48:3-58(d) specifies that "[p]ower procured by an electric power supplier shall be purchased at prices consistent with market conditions. The charges to consumers . . . shall . . . include[e] the cost of power purchased at prices consistent with market conditions, by the supplier in the competitive wholesale marketplace." This provision evinces an intention that prices to consumers should be in line with "the market." This reading, moreover, is further supported by the policy findings stated in the legislation which include adoption of a policy to "[p]lace greater reliance on competitive markets, *where such markets exist*, to deliver energy services to consumers . . ." (emphasis added).

The longest period over which prices are generally available at this time would be, at most, five years into the future, and even after three years there is a decline in liquidity for such contracts.[18] Because there would be no way to determine "prices consistent with market conditions" beyond this period, the BPU would be found to lack authority to order purchases of a longer duration under the statute.[19] Further, the statute does not contemplate that the BPU will create its own market by holding an RFP procedure. The reference to "the competitive wholesale market" in the legislation and the reference to "competitive markets, where such markets exist" in the legislative policy findings demonstrates that the legislature's intention was that supplies be procured in the markets that have developed organically. While the BPU could develop a competitive procurement process for new generating plants, such action would not constitute a "market" for new generation within the

[18] Even five years would be stretch. The current three year procurement for BGS is more consistent with actual energy trading patterns and available products offered by market participants in reasonable quantities.
[19] *See e.g., E.S. v. Division Of Medical Assistance And Health Services,* 990 A.2d 701, 710 (N.J. Super, App. Div. 2010) (finding that New Jersey administrative agency correctly determined that arrangement had no "fair market value" in circumstances in which "few would enter into a contract" due to unacceptable risks and obligations.); *In re Rochester Urban Renewal Agency,* 45 N.Y.2d 1, 8-9 (1978). ("[W]hen the property is of a kind seldom traded, it lacks a market price and there must accordingly be recourse to some other method of evaluation.")

meaning of the legislation. Such a procurement does not represent how energy supply is normally obtained, *i.e*, the "competitive markets [that] exist" as specified in EDECA.

This reading is also consistent with the goals of retail open access in New Jersey, which are to foster customer choice but also to retain provider of last resort service as a reasonable alternative. If utilities are directed to enter into contracts that cannot be determined to be in line with market conditions, there is a risk that prices will be significantly higher or lower than the prevailing market prices. If prices in the BGS procurement are significantly lower than market, the ability of third party supplies to compete with BGS will be affected adversely. Conversely, if prices are much higher than the market, customers that do not (or cannot) switch to third party suppliers will be penalized.

Finally, even if the length of the commitment period were not a factor, there is nothing to indicate that there is any "marketplace" for new generation as a separate electricity product. Electricity trading, aside from requirements for particular environmental characteristics in some cases, does not distinguish between "new" and "old" generating sources. Accordingly, there is no established "market" for new construction of generating plants. A contract that targeted new generation ordered by the BPU under auspices of the BGS procurement would be *ultra vires* under EDECA and thus a nullity.

2. No Other Statutory Authority Has Been Identified That Would Enable the BPU To Direct Utilities To Enter Into Long-Term Contracts for Electricity Supply

No party to this proceeding nor the BPU itself has identified any other statutory enactment that is claimed to provide authorization to direct public utilities under its oversight to enter into long term contracts for supplies of electricity from particular companies. Further, the structure of EDECA makes clear that no such authority exists.

Prior to EDECA, the BPU had broad authority over supply arrangements. This was changed when EDECA became law. Provisions concerning the procurement of electric supplies – with the exception of special legislation related to solar power not relevant here – are found *exclusively* in N.J.S.A. 48:3-58 of EDECA related to BGS. Accordingly, unless such authority was provided in EDECA (which we have shown above is not the case), the BPU lacks any statutory entitlement to order utilities to enter into long-term contracts with specific suppliers.

3. Attempts To Order Utilities to Procure Supply Exclusively From In-State New Jersey Resources Would Violate the Commerce Clause of the United States Constitution.

New Jersey cannot, consistent with constitutional norms, mandate that New Jersey utilities procure power only from in-state facilities. The Commerce Clause to the United States Constitution provides that "[t]he Congress shall have power . . . [t]o regulate commerce . . . among the several States." U.S. Const. art. I, § 8, cl. 3. "It is long established that, while a literal reading evinces a grant of power to Congress, the Commerce Clause also directly limits the power of the States . . ..” *Wyoming v. Oklahoma*, 502 U.S. 437, 454 (1992). When a state statute discriminates against out-of-state economic interests to the benefit of in-state competitors, a “virtually *per se* rule of invalidity” is applied. *Wyoming* v. *Oklahoma*, 502 U.S. at 454 (quoting *Philadelphia* v. *New Jersey*, 437 U.S. 617, 624 (1978)).

A procurement limited only to in-state generating facilities would constitute such blatant discrimination, by precluding out of state generators even from competing for the business. Under well-established Supreme Court precedents, this would be unconstitutional. *See, e.g.*, *Wyoming v. Oklahoma* (unconstitutional for Oklahoma to require that Oklahoma utilities use coal produced in Oklahoma to generate electricity); *Pennsylvania v. West Virginia*, 262 U.S. 553 (1923) (state may not require West Virginia natural gas producers to give first preference to their local customers); *Philadelphia v. New Jersey* (state may not limit use of in-state landfills to waste produced in-state); *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269 (1988) (state may not limit tax credit to ethanol produced in-state).

III. CONCLUSION

Adopting a program of out-of-market procurements would be poor policy because of misalignment with the PJM markets and its resultant impact on customers. These competitive markets – both for capacity and energy – have worked efficiently and have resulted in millions of dollars in savings for New Jersey residents. The PJM capacity market, moreover, has provided the necessary incentives for hundreds of MWs of new generation and well over 1,500 MW of new demand response resources in the State.

Out of market procurements have the potential to undermine crucial market signals as well as to impose out-of-market subsidizes on consumers. If the BPU does decide to go down the road of offering out-of-market incentives to construct new generation, the willingness of developers to build new generating plants without such inducements will be greatly eroded. This road is really a “one way street” and will likely commit the BPU to making all generation development decisions in the State for the foreseeable future.

Further, changing the current BGS construct would harm New Jersey consumers. BGS has worked extremely well and has resulted in millions of dollars in savings to New Jersey customers though the efficiencies achieved in energy procurements. Given the success of the BGS procurement, we would suggest that the BPU exercise extreme caution before making changes to the BGS process. Indeed, as shown by past experience, long-term procurements have frequently resulted in consumers becoming saddled with above-market costs for many years.

If the BPU does believe that modifications are necessary, as much as possible, they should be consistent with the current market construct. One possible avenue would be to include constraining parameters into the RPM auction for the New Jersey transmission zones that would require the procurement of particular types of generators. This mechanism would not be disruptive of RPM as a whole or disruptive of the BGS construct. An extended term tranche in the BGS procurement could also be considered. If the BPU does adopt such measures, however, they should not be limited to new generation construction. The market is the most efficient mechanism to determine whether existing plants, upgrades, operational improvements or new build is the optimal outcome.

Streamlining the permitting process in New Jersey would also clearly be a significant positive change that could be made. New Jersey should take steps to grant nonattainment offsets, to reduce fees and to cut down on permit review periods. New Jersey's current requirements are unnecessarily stringent and place it at a disadvantage compared with other states in the region.

Wholesale market participants compete to build new power plants today. Restructuring has made for a vibrant and competitive marketplace in which new generation is being constructed. Given these facts, it follows that generation projects for which financing is not available are not supported by the forward price curve or the fundamentals of supply and demand. Contracted new build for energy thus would require payment of above market rates – resulting in customers paying more than is necessary to supply safe, clean, reliable energy. We urge the BPU not to take this path.

Respectfully submitted,

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