

INVESTIGATION OF RESOURCE ADEQUACY ALTERNATIVES

BPU DOCKET NO. EO20030203

POST-TECHNICAL CONFERENCE COMMENTS

NEW JERSEY LARGE ENERGY USERS COALITION

The New Jersey Large Energy Users Coalition (“NJLEUC”) appreciates the opportunity to offer these further comments regarding the Board’s investigation of resource adequacy in response to the Minimum Offer Price Rule (“MOPR”) Order issued by the Federal Energy Regulatory Commission (“FERC”) and to the separate proposal offered by PSEG and Exelon Generation for the integrated procurement of capacity and the environmental attributes associated with clean generation. We welcome the opportunity to participate in this proceeding, as its outcome could have profound implications regarding future energy procurements and the continuing viability of the utility regulatory paradigm that has existed since the restructuring of the electric industry more than two decades ago.

These comments will address certain of the issues addressed by the speakers at the Board’s September 18, 2020 Technical Conference. Our failure to address other issues or opinions addressed during the Technical Conference should not be interpreted as agreement with those issues or opinions. NJLEUC incorporates by reference our Initial and Reply Comments in this docket and will not repeat the arguments set forth in those comments.

Given the extraordinary stakes involved, the state cannot afford to hurry this decision

Although PSEG and Exelon Generation again suggest that the state should quickly adopt their preferred method of procuring capacity and the environmental attributes associated with clean generation, there are many compelling reasons not to do so. First and foremost, the enormity of the changes that would result from adoption of the FRR alternative, as intensified by the

companies' "integrated" procurement proposal, and the extraordinary financial and regulatory risks associated with them, must be fully examined and weighed against the actual costs and policy implications of the FERC MOPR. It is critical that the Board carefully assess the potential for adverse, long term consequences that could flow from a faulty decision reached in undue haste.

While NJLEUC shares the state's frustration with federal policies that could impede the accomplishment of the state's clean energy goals, we again underscore that the PSEG/Exelon proposal clearly evidences that the companies are not motivated by higher public purpose, but by greed. In light of all that has preceded this matter, it should be abundantly clear to all that the potential for windfall profits inherent in the companies' proposal is so substantial that the companies *volunteered* to give up \$300 million annually in ZECs to secure this new deal. The deal they seek would, among other things, lead to the partial re-regulation of the nuclear plants using a largely untested device that would likely be fraught with unknown and unintended consequences and huge potential financial risks to ratepayers. These financial risks, which are now properly assumed by the companies' shareholders, would instead be shifted to unsuspecting ratepayers, potentially for extended periods, at a most inconvenient time when many lives have been disrupted by a global pandemic. Some of these issues will be addressed below.

Given the extraordinary stakes involved, most panelists agreed there is no reason for the Board to be bullied into taking precipitous action, particularly given the potential for FRR to cause significant financial and regulatory consequences that the state would have to tolerate for extended periods of time, without an ability to alter course as the consequences become known. This is particularly so given that in a month, there could be a change in administration in Washington, which would bring personnel changes at FERC and with them, adoption of policies that will emphasize renewable energy, and likely rescind the MOPR Order. There is also an ongoing appeal

of the MOPR Order which, if successful, would likewise lead to its rescission. In addition, the harsher impacts of the MOPR Order could be mitigated by PJM through its compliance filing and ongoing collaborative processes. These processes should be allowed to run their course.

As a practical matter, most panelists agreed that FRR would not ripen as an issue until 2024, when the first tranche of offshore wind is scheduled to become operational. Under the MOPR, all existing renewable resources are grandfathered and the nuclear units are expected to clear the PJM auction. Further, the panelists, including Dr. Bowring and renewable energy developers directly impacted by the MOPR, agreed that all other clean energy resources are competitive and should also clear the PJM auction. All agreed that due to their high costs, the offshore wind facilities would not be expected to clear in the PJM auction, thus implicating the MOPR for the first time.

A discussion regarding the need to quickly implement FRR would not be complete without properly taking into account the minimal capacity revenues that would be lost from the failure of the offshore wind generators to clear the auction, particularly when compared to the extraordinary risks and costs associated with FRR and the companies' integrated procurement proposal. The earlier comments filed by NJLEUC, the PJM IMM, P3, Orsted and several renewable energy companies and groups clearly established that the range of such lost capacity revenues is between \$14 million and \$40 million annually. While not insignificant, when compared with the potential rate increases and windfall profits associated with FRR and exercises of market power, and the potential assessment of crushing PJM performance penalties if FRR does not go smoothly, these potential capacity losses represent little more than a rounding error.

The offshore wind lost capacity revenue calculation is a simple one. Because offshore wind facilities are intermittent resources, PJM discounts their faceplate capacity value. Here the

1100MW faceplate value for the Orsted Ocean Wind project would be reduced to approximately 286MW. This figure is then multiplied by the current PJM capacity clearing price and the calculation yields a lost revenue figure in the range described above. *Contrary to the statements made by several panelists, the record is devoid of any support for the claim that, over time, hundreds of millions of dollars in capacity revenues would be lost under the MOPR.* Rather, most stakeholders agree that renewable resources are currently competitive and will become increasingly more so with the passage of time, thus obviating any concern that these resources would not clear the auction, even under the MOPR.

Therefore, as we previously noted, the MOPR is expected to have minimal effects that may appropriately be addressed in other, far less draconian ways than adoption of an FRR alternative whose benefits are questionable and potential costs astronomical. While not insignificant, compared to the billions of dollars that are spent by utility ratepayers supporting a myriad of energy programs each year, the lost offshore wind lost capacity revenues pale in significance. It makes little sense to completely upset the regulatory apple cart to “cure” such a minor “disease”, particularly if done in haste and without exhaustive consideration of all potential ramifications of the decision.

It is also appropriate to recall that the restructuring of the electric industry took *seven years* to accomplish. Despite this substantial expenditure of time and resources, substantial mistakes were made in the process—including the irrevocable award of \$3 billion in stranded costs to PSEG’s power plants. Despite the company’s dire projections of doom at the time, the plants proved to be enormously profitable in the competitive markets. Despite this, ratepayers remained saddled with the payment of fictitious stranded costs for fifteen long years. We must learn from the mistakes of the past or we are doomed to repeat them. There is no need for haste. The Board

should abide the events occurring at the federal level and in the marketplace and not be bullied into making a decision in haste that could cause longstanding and potentially irreparable harm to ratepayers, the competitive markets, and the Board itself.

The companies' market power is real and would be exacerbated by FRR and the companies' integrated procurement proposal

What is market power and why is it a concern? In a word, market power in this context represents the ability of generators to artificially raise the cost of energy above competitive levels. Therefore, it is understandable that PSEG and Exelon continue to ignore the subject or suggest that market power is not an issue. However, despite the companies' protestations to the contrary, market power is very much an issue in this proceeding and is likely the motivating force behind the companies' support for FRR and their integrated procurement proposal. As NJLEUC's prior comments reveal, the companies' proposals are completely one-sided propositions that are designed to leverage their considerable market power, market power that would be magnified under an FRR regime, to extract windfall profits from unsuspecting ratepayers.

Any suggestion that the companies' considerable market power is not a primary consideration in this proceeding is refuted by a long succession of annual PJM IMM State of the Market Reports. These reports have consistently determined that "structural market power" is "endemic" in the PJM capacity markets and that New Jersey markets are "highly concentrated" and dominated by PSEG and Exelon as "pivotal suppliers" whose output must be acquired by the state to meet our capacity requirements. Market power provided the basis for the state's justifiable refusal to authorize the companies' proposed merger in 2005 and it remains an issue to this day. To deny this is to deny a well-documented reality. It is an issue that the state ignores at its peril.

PJM protects against exercises of market power through application of a suite of market power mitigation measures to its capacity auctions. These measures include numerous rules regarding the permitted behaviors of bidders in the PJM capacity auctions including, among others, offer caps on sell orders by suppliers found to be pivotal (to protect clearing prices), “must offer” and mandatory participation requirements for existing generation (to prevent the strategic withholding of generation as PSEG threatened to do with its nuclear plants), and performance incentives.

The PJM IMM also has broad authority to actively monitor and report on the competitiveness of the various PJM markets, including exercises of market power, and to make recommendations regarding the conduct of the markets to make them more efficient. Thus, to avoid exercises of market power, PJM employs an expansive system of rules and measures designed to assure that market participants, including those with recognized market power, behave in a competitive manner. It has been through the adoption and active enforcement of these market power mitigation measures that competitive auction outcomes have been assured.

Under FRR, these market power mitigation responsibilities would fall on the Board. The Board’s job would be made more difficult by the fact that FRR would increase the potential for exercises of market power. As discussed in our initial comments, under FRR, the state would be compelled to procure the capacity needed to fulfill its long-term capacity plans through bilateral contract negotiations with a limited pool of generators that would be dominated by PSEG and Exelon, who would be able to exercise significant market power within local delivery areas (LDA) in which they own the majority of generation resources. Unlike the broad-based PJM markets which tap generation sources located in multiple states, the FRR Minimum Internal Resource Requirements would mandate that the state procure a portion of its capacity requirements from

within the LDA, thereby substantially limiting the number of generators from which capacity could be purchased and increasing the potential for exercises of market power. We also demonstrated in our Reply Comments that under the companies' integrated procurement proposal, the companies would control the overwhelming majority of the clean energy resources that would be eligible for their proposed Tier I procurement.

Thus, under FRR the state would have no alternative but to negotiate bilateral power agreements with PSEG and Exelon. It would be up to the Board to adopt and effectively enforce market power mitigation measures similar to PJM's sufficient to control the companies' market power, to assure that ratepayers only pay rates that are consistent with the competitive markets. This would be a considerable undertaking in the circumstances, so it is important for the Board to objectively assess whether it has adequate available resources to perform these important tasks, as well as the critical resource planning and other functions that would be required under FRR.

Does the Board have the technical expertise and resources to effectively regulate FRR?

This proceeding will require the Board to honestly and realistically appraise its available resources and whether they will be up to the huge challenges associated with adoption of FRR and the companies' integrated procurement proposal. It bears repeating that FRR is a largely untested regulatory device that was not intended or designed to be an attractive alternative to the PJM markets, and has never been successfully implemented in a deregulated state like New Jersey. All stakeholders agree that adoption of FRR would cause a seismic shift in the state's regulation of the electric industry, resource planning, reliability and future capacity procurements, and will require legislation, expansive rulemaking, a multiplicity of policy decisions and active, informed oversight.

As was the case in the restructuring proceedings, many FRR implementation issues will likely be addressed in contested proceedings, with litigation challenging Board decisions likely to occur. Significant resources and expertise will be required to establish and enforce the new regulatory framework to assure that the Board's resource planning, regulation and oversight responsibilities are effective and adequately protect the interests of ratepayers. The Board must be confident in its ability to accurately project its capacity requirements several years in advance, a daunting task made more onerous by the threat of substantial performance penalties if the projects prove to be inaccurate. Ratepayer protection will also be a critical consideration given the likelihood that unrestrained exercises of market power will increase energy costs, and because the companies' procurement proposal would shift to ratepayers many financial, business and operational risks associated with FRR and the nuclear plants that have assumed by utility shareholders since the resolution of the restructuring proceedings.

An objective appraisal of the Board's resources necessarily begins with the fact that the Board has been out of the generation oversight and capacity procurement business for more than two decades. None of the Commissioners and likely only a handful of staffers were even at the Board when the electric industry was restructured. Even fewer staffers, if any, played a direct role in the regulation of the utilities as vertically integrated monopolies, cost of service regulation of generation assets, or the integrated resource planning needed to assure the reliable supply of power to the state. The only time the Board directly addressed the issue of the companies' market power was in the PSEG/Exelon merger proceeding, in which the decision to deny the merger was largely based on the multiplicity of detailed market power studies prepared by the PJM Market Monitor, rather than the Board.

An objective appraisal should also acknowledge that the ranks of the Board's energy staff have recently been depleted and are in transition. The new personnel who have recently been added, while clearly talented and promising, would not be expected to have the in-depth energy background and requisite expertise in generation resource planning and the power markets that FRR regulation would clearly demand.

Further, despite the suggestion by some, the Board's experience overseeing the Basic Generation Service auction is not analogous to the expansive and active role it would be required to assume under FRR, and provides none of the tools that would be required for it to do so. The demands on the Board would be orders of magnitude broader if the state were to adopt the companies' proposal to jointly procure capacity needed for reliability purposes and the environmental attributes associated with clean energy.

It can be fairly stated that the Board's role in the BGS auction process is, for the most part, a passive one. While the Board annually addresses structural and policy issues regarding BGS procurements--such as the current issues regarding the treatment of transmission--it has outsourced much of the responsibility for the actual conduct of the auctions to an auction manager, with the Board's role largely limited to approval of auction results. It is also important to underscore that the BGS auction is a retail procurement of default service for non-switching customers, and that it incorporates as direct inputs into BGS pricing the outcomes of the PJM capacity and energy wholesale auctions—outcomes that are protected by PJM's rules and active oversight.

Under FRR, there would be no PJM capacity input into the BGS price. It would fall upon the Board to not only construct an alternative procurement framework that replicates PJM's, but to develop a viable procurement program that would enable the Board to accurately forecast and procure the state's long term capacity requirements to avoid the imposition of the PJM

performance penalties and assure reasonable BGS prices that, by statute, must be purchased at prices consistent with market conditions. N.J.S.A. 48:3-57. For reference, the FRR procurement requirements and potential penalties are discussed at length in NJLEUC's initial comments in this proceeding.

The stakes therefore could not be higher. Given the incredible financial and regulatory risks associated with FRR, particularly those that would fall on ratepayers in this COVID environment, it is fair for the Board to objectively determine for itself whether it has available to it sufficient technical expertise and ability to assume this demanding role. For example, what staff or experts are available to the Board who could accurately project, up to eight years in advance, the capacity requirements of the selected FRR zone(s), knowing that inaccuracies would subject ratepayers to onerous performance penalties? The difficulty of such projections is underscored by the likelihood that a projection made this past December, could not have anticipated the COVID pandemic or the current economic environment that has reduced electric demand? What resources are available to the Board to enable it to step into the shoes of PJM and assume PJM's critical role in mitigating market power, promoting competitive outcomes, protecting ratepayers and assuring the reliable supply of power? Who would be the Board's Joe Bowring?

These consideration underscore the need for the state to take a deep breath before acting. We need to objectively assess our current and available resources, and carefully consider whether the substantial challenges and risks that all agree are associated with FRR could be effectively assumed and addressed by these resources. If, following a realistic and objective assessment the state is unable to conclude with confidence that it is up to this daunting task, the state would be well-advised to take a pass on FRR and the companies' proposal.

Competitive markets are preferable to adoption of a weak form of cost of service regulation

Apparently in response to the significant pushback it has received from stakeholders regarding its initial proposal, PSEG now argues that there are “many FRR designs” that can be adopted by the Board, including the company’s new and unexplained proposal for “RPM derivative pricing”.

However, despite PSEG’s assertions regarding FRR’s flexibility, the fact remains that the fundamental rules that define FRR are wholly inflexible, and they underscore that moving to FRR would be a very big deal for the state that should not be undertaken lightly. As noted, adoption of FRR would involve the abandonment of viable PJM competitive markets in favor of a largely untested nonmarket regulatory paradigm that is projected to raise capacity prices (as it has done in regulated states like Virginia that have adopted FRR) and expose ratepayers to potential exercises of market power that could result in unjustified financial windfalls to the companies.

In his May 2020 report “Potential Impacts of the Creation of New Jersey FRRs”, the PJM IMM noted:

. . . the fundamental point about the FRR approach is that the FRR approach is a nonmarket approach. In the FRR approach, there is no PJM market monitoring of offer behavior by generation owners, there are no market rules governing offers, and there are no market rules requiring competitive behavior. In the absence of a competitive market that includes the FRR area(s), there is no competitive market reference point to define what a competitive offer would be from the FRR generation owners in a bilateral negotiation or what the competitive market price would be. Prior market results do not define a competitive outcome in subsequent periods because market dynamics and market outcomes may change significantly. As a result, even the higher estimates of the cost impact to the customers of New Jersey from the creation of an FRR are likely to be conservatively low. If New Jersey were to subsidize any generating units, the subsidy costs would be in addition to the direct FRR costs. (Report at 4)

Similar concerns were recently articulated by Illinois Governor JB Pritzker in response to a similar proposal by Exelon to subsidize its nuclear plants through FRR. Governor Pritzker noted that as proposed, Exelon’s version of FRR would “annually pay each of Exelon’s nuclear plants an amount equal to *three times* the current taxpayer subsidy that two Exelon plants already receive without any strings attached and without Exelon showing us their math why this is necessary....they are asking us to take their word for it without providing the relevant financial statements for each plant.” (“Putting Consumers and Climate First: Governor Pritzker’s Eight Principles for a Clean and Renewable Illinois Economy”, August 20, 2020, at page 7). (emphasis in the original). The Pritzker Report observed that given this state of affairs--when viewed against the backdrop of the federal bribery charges that were recently brought against Exelon arising out of its pursuit of legislation authorizing the nuclear subsidies in the Illinois Legislature--the public “rightfully questions” whether such initiatives were “inevitably tainted by the political power of utility companies that have used their excessive clout and political contributions to corrupt the political process for their own profits, and whose practices have led to criminal investigations and charges. Their days of outsized influence on the process are ending”. (Report at 2).

Consistent with the IMM Report, the Pritzker Report advanced additional reasons to reject FRR:

Further, the FRR construct promoted by current legislative proposals does not provide the same benefits as a market construct. It may bring problems with market power concentration in Exelon, and it does not guarantee the environmental generation mix that we are working toward. Finally, there would be significant time and costs involved in establishing an FRR, presenting significant pragmatic challenges to effectively implementing an FRR. This may result in delaying participation from new renewable energy generation. The better approach is to explore all means to set up a clean energy framework, and to compare their costs and benefits. FRR is not the only option. (Report at 7).

The Pritzker Report also acknowledged that “taxpayer and ratepayer financial support for these plants cannot be a blank check” and that Illinois could not “afford to increase costs to consumers in the wake of COVID-19.” Governor Pritzker therefore concluded that rather than pursuing FRR, he would support proposals to establish a market-based program that incorporates the social cost of carbon. (Report at 7).

Ironically, PSEG’s own experts in this proceeding fully share the view that market-based structures like the PJM capacity markets are superior to nonmarket, regulatory constructs like FRR. The Joint Comments filed by PSEG and Exelon in this proceeding were supported by an expert report by The Northbridge Group entitled “Evaluation of the PJM IMM’s Potential Impacts of the Creation of New Jersey FRRs, May 2020” The report was prepared in part by Frank Huntowski, a Northbridge partner, whose attached biography touts his involvement in the restructuring of the U.S. electric industry and assisting clients with wholesale market design and regulated power supply procurement issues. The report took issue with the PJM IMM’s May, 2020 report and, in particular, its projections regarding the cost consequences of FRR for New Jersey customers.

It is noteworthy that nowhere in his report did Mr. Huntowski express the view that FRR is a construct that is superior to the PJM competitive capacity markets. This is not surprising given Mr. Huntowski’s longstanding advocacy regarding the many advantages of competitive markets over regulated command and control constructs like FRR. Mr. Huntowski’s strong belief in competitive markets was on full display in a 2008 Northbridge Group report that he authored entitled “Embrace Electric Competition Or Its Déjà Vu All Over Again”. https://hepg.hks.harvard.edu/files/hepg/files/embrace_electric_competition_or_its_deja_vu_all_over_again.pdf?m=1523368520 . This report indicated that it was issued in response to criticisms

of electric industry deregulation and energy competition, and efforts to return to a regulated model, a potential outcome that the report roundly rejected.

There are many sections of the report that, when viewed through the prism of this proceeding, provide compelling arguments against the implementation of FRR. Indeed, the 75 page report is replete with statements of support for competitive markets and hostility to governmental command and control-type solutions to a wide spectrum of issues. The section entitled “Competition Will Provide a Better Path to Confront the Enormous Challenges Ahead” includes a subsection entitled “Re-Regulation Will Not Fix the Perceived Problems” that provides a good summary of the report’s arguments espousing the merits of competitive markets over nonmarket solutions:

. . . Some of this backpedaling, like re-regulation bills, is very direct. Other actions are more subtle: there are new efforts to pick the “right” generation technologies, to mix cost-of-service and market-based new construction to establish “vintage pricing” with special higher pricing for new builds, and to rely on rate-funded, customer-guaranteed long term contracts using an integrated resource planning process in an effort to stimulate new capital investment. All of these actions are forms of re-regulation that are not only intended to “fix” competitive pricing issues but also ensure that “enough” investment in new generation is made on a timely basis. Proponents of these initiatives argue that they are necessary to ensure adequate reliability, environmental compliance, fuel diversity, and even national security.

Some policymakers likely will try to characterize these efforts as a new, better form of regulation or a mix between regulation and competition. But these actions are nothing more than a return to the central planning of the past—the same central planning that tried to select the right amount and the right mix of technologies in the 1970s and failed. There is no reason to believe that this “new” least-cost planning approach will be more successful today. The inherent flaws, especially the underestimation and misallocation of risks, are still present. And, as before, customers will be responsible for inefficient choices and significant risks inherent in future electricity markets. Re-entry of regulated utilities into the generation business, whether through direct utility ownership or allowing utilities to enter into long-term contracts with new generators, is risky for customers.

Either action is a centrally planned, taxpayer-funded approach to new generation that transfers risk from the developer and utility to the retail customer. Long-term contracts and/or investments increase the risk that costs will be above market, potentially for significant periods of time. (Northbridge Report at 72).

The section argues further that competitive markets should remain the desired end-state because “relying on markets to make investment decisions, rather than on central planning backed by ratepayer guarantees, is sound public policy”. Citing the adage that those who cannot learn from history are doomed to repeat it, the report concludes with the following thoughts:

Either policymakers will take steps to facilitate competitive markets or they may find themselves—consciously or not—back in the 1970s. Under the latter scenario, we will be entrenched in a regulated model that requires utilities and regulators to make billions of dollars of resource choices in a centrally-planned manner supported by ratepayer money, while confronted with tremendous uncertainty about technology, carbon control, fuel prices, and demand levels. Poised now at a point where generation supply must accommodate higher natural gas prices on the one hand and the need for carbon control on the other, it is critical to rely on the market to make choices about fuel type and technology for new investments and actively manage the associated risks. We do not need another round of regulated investments that later prove to be uneconomic and cost customers billions of dollars. (Northbridge Report at 75).

While the Northbridge report primarily addressed new investment in generation rather than FRR or the form of “integrated” procurement of capacity and environmental attributes the companies advocate, its arguments and conclusions regarding the superiority of competitive markets over nonmarket, command and control approaches like FRR apply with equal force here. Among other things, FRR would result in the partial re-regulation of the generation resources, requiring ratepayers to financially support the nuclear plants. This “Frankenstein-like” form of re-regulation would be a lose/lose proposition for ratepayers that completely flies in the face of the resolution of electric industry restructuring, whose primary purpose was to foster the development of competitive markets.

Among other things, FRR would require the Board to create a command and control system in which the Board would be responsible for administrative determinations regarding generation resource planning, the value of capacity and the environmental attributes of clean generation, and for making accurate long-term projections regarding the state's capacity requirements. FRR would require the state to enter into five year or longer bilateral contracts with utility generation affiliates having significant market power. Ratepayers would be required to assume the operational and business risks associated with the "deregulated" nuclear plants and for the draconian FRR performance penalties that would be imposed if the state fails to accurately project the state's capacity requirements. These are the precisely the types of problems that Northbridge correctly argued render nonmarket solutions inferior to competitive markets.

Indeed, the Northbridge Report makes compelling arguments that fully support the state's rejection of FRR and is replete with references to the superiority of market solutions over regulated models like FRR. These conclusions of the report are particularly instructive:

Market prices provide the right price signals: In a competitive market, market prices are a function of marginal costs...Over long time cycles, marginal cost pricing produces a more efficient and ultimately lower-cost outcome relative to regulated average cost pricing because it provides the correct price signal for the efficient allocation of new and existing generation and demand response resources. The level of market prices seen today are appropriate in that they provide the correct price signal and incentive for investment in the different types of low carbon resources that will be needed in the future.

Competition promotes efficiency improvements in existing plant operations: Competitive markets provide strong incentives to improve plant performance and administration in the short-term. Empirical evidence suggests that restructuring has improved the efficiency of power plant dispatch, extended the benefits of pooling and coordination across broader markets, reduced plant operating costs, increased baseload capacity factors, and reduced plant heat rates. Since 1999, nuclear plants operated by competitive generators have had an average capacity factor that is about two percent higher

than that of regulated plants, producing savings of about \$350 million per year.

Plant investment and retirement: One of the most significant areas of potential savings from restructuring is more efficient long-term investments...Unlike the 1970s and 1980s, uneconomic investments did not adversely impact customers in non-regulated states since unregulated investors—not ratepayers—bore the risk of these investments. (Report at 3-4)(Bold type in the original).

The Report's analysis of "the four inherent flaws of regulation" is also instructive regarding some of the perils of FRR. Briefly summarized, these flaws are:

--Lack of clear price signals, that "were the result of internal forecasts of a regulated entity subject to political influence and negotiation with the regulator during the ratemaking process";

--Perverse capital incentives, under which "regulated utilities continued to develop coal and nuclear plants long after those plants were clearly uneconomic in forward-looking terms."

--Improper allocation of risks, involving the improper allocation of risks to consumers rather than to investors. "Not surprisingly, the regulatory process significantly underestimated these risks when making long-term commitments. There are many examples of customer-funded commitments that turned out to be uneconomic."

--Tendency for regulatory "fixes" to overcompensate. "Political and regulatory reactions to fix perceived problems tended to overcompensate with unintended consequences which further increased costs and inefficiencies."

The section concludes with the thought that going forward, "the decision to support regulation or competition should not depend on the effects of external shocks [such as the FERC MOPR here], but instead on whether a competitive or regulated model will foster more efficient decisions and ultimately better price and reliability outcomes over a sustained period of time and varying market conditions. In spite of recent criticisms, the case for competition in the electric industry is still compelling, supported by economic theory and examination of empirical

evidence....Decades of experience in the electric industry suggest that regulation is not well-equipped to meet (future) challenges. But recent experience in restructured electricity markets and significant experience from other competitive industries suggests that competitive markets are. We should learn from this history rather than repeat the regulatory mistakes of the past. By embracing competition, we can avoid “déjà vu all over again”. (Report at 3-5).

As noted, these well-considered conclusions of PSEG’s own expert apply with equal force to FRR and the companies’ integrated procurement proposal. Here, the Board must decide whether to continue to rely on the PJM competitive markets for capacity procurements or to adopt a bastardized form of re-regulation that is fraught with danger to ratepayers, competitors and the Board itself. While NJLEUC has advanced arguments against FRR that are similar to those described above, in this instance we are content to rely on PSEG’s FRR expert to make the arguments for us.

PSEG’s FRR Proposal is a Moving Target

During the technical conference, PSEG’s representative, Lathrop Craig, espoused a new FRR design that he referred to as “RPM derivative pricing”. The methodology would be tied in some undescribed way to the outcome of the PJM capacity auctions, with the Board’s role in the procurement described as similar to its role in approving BGS auction results. Mr. Craig offered scant details regarding the proposal and indicated that it was one of many potential FRR designs that could be adopted by the Board. Other participants indicated that they were unfamiliar with this so-called pricing methodology and therefore could not comment on it, perhaps other than to question why the mechanism would be necessary if it is simply tethered to the PJM auctions. NJLEUC reserves the right to comment further if and when additional details of the PSEG proposal are revealed.

The fact that PSEG is amending its proposal is noteworthy. It is likely a response to the significant stakeholder opposition to FRR and the companies' proposal that is due in part to concerns regarding the financial implications of the companies' offer to abandon ZECs if their FRR proposal is accepted. However, regardless of the reason for this apparent change in direction, the comments by PSEG and others regarding the purported "flexibility" of FRR design warrant comment.

While there may exist the potential for some design flexibility in the FRR alternative, the rules established by PJM are not flexible and were designed to make FRR an unattractive alternative. These rules, as set forth in the PJM tariff and Section 8.1 of the PJM Reliability Assurance Agreement, are described at length in NJLEUC's initial comments. Among the rules that are inflexible are those that require an FRR entity to accurately forecast its unforced capacity obligation for all load in the local delivery area (LDA) three years before the initial delivery year and for a minimum contractual term commitment of five years. Also inflexible are the severe performance penalties for erroneous forecasts. If insufficient capacity is committed for a delivery year, the FRR entity would be assessed an onerous Commitment Insufficiency Charge (calculated at twice the established cost of new entry) for the shortfall that occurs during the remainder of the contract term. A significant Capacity Resource Deficiency Charge would be assessed for any shortfall of resources needed to satisfy the internal resources required in an LDA.

It is unlikely that an FRR entity will be able to accurately forecast its long-term load requirements as the FRR rules would require, so it is likely that ratepayers will be exposed to the mandated, draconian performance penalties. In past circumstances, similar long-term projections have considerably missed the mark, including PSEG's projections of its long-term stranded costs in the restructuring proceeding and the projections of energy pricing included in non-utility

generation agreements. There is no reason to believe that an FRR entity or the Board would fare any better with long-term projections required to be made as part of FRR procurements.

The Minimum Internal Resource Requirements discussed above are likewise inflexible and would require that a portion of capacity be procured from within the LDA. In the FRR context, the MIRR requirements dramatically increase the potential for the companies to exercise market power because the requirements reduce the number of eligible generators from which an FRR entity may procure capacity. Here, the FRR entity would have no alternative but to purchase capacity from the companies, which the PJM IMM determined to be pivotal suppliers in areas found to be moderately or highly concentrated and, therefore, could exercise considerable leverage in procurement negotiations.

FRR would also require the Board to fill the substantial regulatory void created by the withdrawal from the PJM capacity market, compelling the Board to replicate PJM's significant role in avoiding unchecked exercises of market power and to establish a comprehensive regulatory framework for FRR procurements. Thus, any suggestion that FRR would be an easy alternative to PJM.

These rules are not "flexible" and would be very much a part of any FRR regime that is adopted, regardless of its design. As they currently exist, these rules would interpose substantial legal, policy and administrative hurdles that the Board would have to clear to effectively conduct capacity procurements, program oversight and integrated resource planning. Taken together, these inflexible FRR rules would cause a seismic shift in longstanding state energy policies, with the potential to significantly increase energy costs if the implementation is not handled properly.

It also bears noting that adoption of FRR does not mean that the state would no longer part of PJM and free of federal regulation. Rather, FRR only involves a partial withdrawal by the state,

limited to the PJM capacity markets, leaving the state very much under the continuing jurisdiction of PJM and federal regulation. It should be noted that their regulatory authority permits PJM and FERC the ability to change their rules at any time and they have done so in the past. Thus, if FERC and PJM were to be confronted with a state action—such as a “flexible” FRR regime that incorporates PJM auction outcomes--that is perceived to undermine the interstate wholesale markets, there is nothing to prevent FERC and PJM from changing the rules of the road to derail the initiative. This is what occurred to thwart the state’s LCAPP initiative to subsidize the development of new generation facilities and it could easily happen again if it is perceived that New Jersey has modified FRR in a manner that FERC and PJM do not approve.

In sum, even if FRR is interpreted to be sufficiently “flexible” to incorporate the evolving iterations of PSEG’s proposal, and to provide a level of comfort that would encourage the state to take this huge leap of faith, the fundamental elements of FRR, which were designed to be unattractive, will remain intact, or could be further “adjusted” by FERC or PJM to discourage or prevent actions taken by the state. It is difficult to conceive of any variation of FRR that could objectively be viewed as favorable to the interests of ratepayers, competitors and the state. We urge the state to recognize the FRR alternative for the poison pill that it is and avoid its adoption at all costs.

NJLEUC appreciates the opportunity to provide these additional comments and looks

forward to continuing involvement in this proceeding.

Respectfully submitted,

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