

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

PJM Interconnection, LLC

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Docket Nos. ER05-1410-000 and
EL05-108-000

**Remarks of John Judge
Director, Commodity Supply Planning
FirstEnergy Solutions**

**on behalf of
FirstEnergy Service Company**

**Commission Technical Conference
February 3, 2006**

Panel I:

“Whether the current capacity obligation construct within PJM’s market design provides for just and reasonable wholesale power prices in the PJM footprint, at levels that provide adequate assurance that necessary resources will be provided to assure reliability, or whether changes must be made to that capacity obligation construct.”

I. Introduction

I am John Judge, Director of Commodity Supply Planning for FirstEnergy Solutions, an affiliate of FirstEnergy Service Company (“FirstEnergy”) and its parent FirstEnergy Corp.¹ FirstEnergy appreciates the opportunity to participate in this Technical Conference.

FirstEnergy affiliates serve more than 4.5 million customers in Ohio, Pennsylvania and New Jersey, and in two RTOs. Although each of the states in which FirstEnergy operates has adopted retail competition and relies on competitive regional wholesale power markets conducted by an RTO, each has taken a somewhat different approach to electric restructuring. The RTOs in which we participate -- PJM and MISO - - each have different approaches to resource adequacy. And our generation portfolios and load profiles are different in each RTO. In MISO, we have more megawatt hours of owned generation than retail load. In PJM, we have more load than owned generation.

Because “where one stands often depends upon where one sits,” and because FirstEnergy must reconcile these diverse perspectives within our own company, we have worked hard to develop a position on capacity markets that is evenhanded. FirstEnergy not only wants markets to work, we need them to work. And, as Chairman Kelliher has pointed out, electric markets must have a strong overlay of sound and contemporary regulation. Again, as he has noted, the choice is not between markets on the one hand

¹ FirstEnergy Service Company is a service company that is part of a registered holding company system that includes, among other affiliates, FirstEnergy Solutions. FirstEnergy Solutions offers a wide range of energy and related products and services, including the generation and sale of electricity and energy management. FirstEnergy Solutions is a licensed electric supplier in Ohio, Pennsylvania, New Jersey, Delaware, Maryland, Michigan and Washington, D.C. FirstEnergy Solutions is a generator, marketer, and load serving entity within PJM.

and regulation on the other. The challenge is to find the best way for regulation to strengthen markets, balance the interests of customers and investors and, at the same time, enable rather than hinder necessary infrastructure investment.

II. The Current Capacity Obligation Construct Within PJM's Market Design Should be Changed

Before going any further I would like to answer directly the question posed to this panel. The current capacity obligation construct in PJM is not sufficient to provide adequate assurance that the necessary resources will exist for reliability. Changes need to be made.

Among the deficiencies in the current construct previously identified by PJM are: poor long-term price signals, long-term price volatility, dampened investment, and problems of deliverability to load in certain areas.

There are sub-regions within PJM that will need additional generation capacity in the near term -- well within the lead time it takes to develop new capacity. Furthermore, there are generating units that will retire under the current capacity market construct and create additional pressure on reliability levels. We are already seeing increased congestion and pressure on the transmission system as more and more energy moves across the system to meet the demand of these sub-regions. Without significant new investment, these pressures will increase with time across the entire PJM system.

Worse, there are features of the current capacity construct that obscure the problems the market faces. A single, relatively short-term capacity price across the whole PJM system does not reflect the needs of individual sub-regions through the necessary planning horizon. When combined with the properly increased caution of generation owners -- both merchants and utilities -- after the last cycle of capacity boom

and bust, a single regional price results in a lack of infrastructure development activity at a time and in places where it is needed.

The current market is too limited in its scope of participation. Only existing generating units can participate on the supply side of the market. The market fails to incorporate fully the role of transmission and demand side responses. And it provides no way for the developer of a future generating unit to secure capacity revenues for the future. In sum, PJM's current capacity obligation construct is broken and needs to be fixed.

III. PJM's RPM Proposal Should Be Amended to Include, Among Other Things, a Central Role for the States and a Process for Planning and Building the Optimal Mix and Location of Transmission, Generation, and Demand Response Resources

The proposed fix -- RPM -- even though it must be improved, addresses some of the critical deficiencies of the current market structure. RPM is locational. In conjunction with the PJM Regional Transmission Expansion Plan Process, it incorporates transmission and demand response solutions. And RPM adds two critical participants to the market -- the RTO (as administrator of the Variable Resource Requirement curve) and developers (who now have the opportunity to bid in future generation units).

As provided in FirstEnergy's comments in this proceeding, we also have a number of concerns about RPM.² For example, the new capacity market construct *must* recognize the important role States play in assuring that essential reliability-based infrastructure projects are built and "paid for" with adequate revenue streams. States typically have jurisdiction over the siting and permitting of transmission and generation

² FirstEnergy may submit comments for the record in this proceeding after the Technical Conference to elaborate further on the complete set of its concerns outlined in its earlier submission.

facilities. State endorsement of these projects and recovery of their costs in prices paid by ultimate customers are necessary pre-conditions of their being built. In addition, the States can establish mechanisms to provide the capacity revenue guarantees that the builders of new generation will need to secure financing.

Also, four years of price signals will not provide a sufficient incentive to the construction of new generation. As noted previously, after the most recent boom-bust cycle, generation developers and their financing partners are more cautious than in the past. Longer term, guaranteed prices are required.

The fundamental RPM proposal -- with a crucial shift in sequence -- could provide a way forward. In the event of a chronic shortage of generation, the proposed reliability backstop mechanism could allow PJM to request offers for new baseload capacity installation. Each generation project that would be accepted in the backstop auction would be guaranteed to receive its offered price for at least 15 years.

Under RPM as proposed, this mechanism would be activated only after the amount of capacity cleared in the auction is more than one percent below the established Installed Reserved Margin target for *four consecutive years*.³ We believe that this is too long to wait before assuring adequate new resources will be developed. FirstEnergy proposes:

1. A long-term expansion of the existing PJM Regional Transmission Expansion Plan Process in which the RTO, the States and stakeholders develop a plan that proposes the optimal mix and location of resources – transmission, generation, and demand response.

³ Transmittal letter of PJM, August 31, 2005 at page 90.

2. Intense collaboration with affected States in developing the regional plan.
3. A competitive auction process at the State level for projects in specific locales.
4. A residual auction with locational elements similar to RPM into which existing generation would bid and clearing prices would be determined pursuant to an administratively-determined demand curve.
5. The development of a State-level reliability charge to pay for the costs of new projects.

Essentially, we are suggesting that on an annual basis a mechanism similar to the RPM “backstop” be implemented first, followed by a residual auction. This approach allows the RTO and States to decide the type of generation to be built and its location, but leaves ample room for a market mechanism to determine who will build the new facilities and at what price.

IV. Conclusion

Capacity obligation constructs exist to ensure that there are sufficient resources to assure reliability and that those resources are built without customers feeling the pain of price spikes. The existing capacity market construct will not do that. Changes are needed. Through its stakeholder process, PJM has developed many of the necessary changes. Nevertheless, to accomplish objectives as complex and vital as electric reliability and well-functioning capacity markets, a longer term solution is necessary and must include more State involvement and a more directive planning function. Once regulation has laid the foundation, capacity markets will work.