UNITED STATES OF AMERICA

BEFORE THE

FEDERAL ENERGY REGULATORY COMMISSION

PJM Interconnection, L.L.C.) **Dockets Nos. ER05-1410-000 & EL05-148-000**

SUPPLEMENTAL AFFIDAVIT OF JONATHAN F. WALLACH ON BEHALF OF THE MARYLAND OFFICE OF THE PEOPLE'S COUNSEL

OCTOBER 19, 2006

My name is Jonathan F. Wallach. I am Vice President of Resource Insight, Inc., 5 Water Street, Arlington, Massachusetts.

I previously submitted an affidavit in this proceeding on behalf of the Coalition of Consumers for Reliability. In addition, I appeared on behalf of the Maryland Office of the People's Counsel at the Commission's technical conferences on May 30, 2006 in this proceeding and on June 16, 2005 in Docket No. PL05-7.

On September 29, 2006, PJM Interconnection, L.L.C. filed in this proceeding a Settlement Agreement regarding implementation of a Reliability Pricing Model. This supplemental affidavit addresses Section II.K of the Settlement Agreement, which establishes a "New Entry Price Adjustment" for sell offers by new entrants in Locational Deliverability Areas ("LDAs"). Specifically, this supplemental affidavit discusses how the proposed New Entry Price Adjustment artificially raises clearing prices above economically rational and efficient levels, thereby causing undue harm to consumers and distorting true competitive price signals. This supplemental affidavit further describes an alternative mechanism that provides the same revenue certainty to new entry as intended with the New Entry Price Adjustment without the attendant economic harm.

As set forth in Section II.K of the Settlement Agreement, the New Entry Price Adjustment functions as a price-support mechanism in constrained LDAs. Under this provision, a new entrant bidding into an annual LDA auction for the first time is eligible for an adjustment to its sell offer for the subsequent two annual LDA auctions, so long as the following conditions are satisfied in that first auction:

1. The new-entrant's price offer clears in the auction.

2. But for acceptance of that price offer, the amount of capacity cleared in the LDA auction would be less than the LDA reliability requirement.

3. Acceptance of that price offer increases the amount of capacity cleared in the LDA auction to the quantity amount on the applicable demand curve where the price on the curve is no more than 40% of the net cost of new entry ("Net CONE").

If these conditions are satisfied in the first annual LDA auction that the new entrant submits a price offer, then in the two subsequent annual auctions the new entrant will be permitted to submit price offers up to the lesser of: (1) 90% of Net CONE; or (2) its price offer in the first annual auction. Thus, if the above conditions are met under this settlement provision, sell offers in the succeeding two auctions would be capped not at the avoidable-cost level that would normally be imposed under market-mitigation rules, but at the substantially greater value of 90% of Net CONE. In other words, the New Entry Price Adjustment provides an opportunity for a pivotal supplier to affect market price by setting its offer price above incremental cost.

The New Entry Price Adjustment provision will not affect clearing prices in the first annual LDA auction that the new entrant submits a price offer. If the new entrant's offer clears, then prices should clear in that first auction at the new entrant's price offer with or without this settlement provision.

In the two succeeding auctions, however, the New Entry Price Adjustment will artificially increase clearing prices above competitive-market values. In a competitive market, rational bidding strategy for the new entrant would be to bid full cost in the first auction and to bid at avoidable going-forward cost in subsequent auctions.[1] As a result, in a competitive market, prices in subsequent auctions should clear at the new entrant's avoidable cost, reflecting surplus conditions in the LDA.[2] In contrast, under the New Entry Price Adjustment provision, prices in the second and third auctions should clear at either 90% of Net CONE or the new entrant's first-year offer at full cost, well in excess of competitive levels.[3]

In the Southwest MAAC LDA, the New Entry Price Adjustment could act as a floor on clearing prices, forcing prices to clear at a minimum of 90% of Net CONE in every year. Under equilibrium conditions, a new entrant of about 600 MW will trigger the New Entry Price Adjustment in an LDA the size of Southwest MAAC.[4]

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[1] In fact, in his simulation modeling of the settlement demand curve, Dr. Benjamin Hobbs assumes that existing resources bid into the RPM auction at zero avoidable cost.

[2] Prices could clear above the new entrant's avoidable cost if more-expensive existing resources also clear in the auction. Even so, it is likely that such prices – reflecting the avoidable cost of the marginal existing resource – will be significantly lower than prices set at either 90% of Net CONE or the new entrant's full cost.

[3]Prices could clear above both 90% of Net CONE or the new entrant's first-year offer if a more-expensive new entrant participates and clears in the second or third annual LDA auction, in which case the settlement provision would have no effect on price clearing. However, it is unlikely that additional new entry would clear in the second or third auction, since a new entrant in the first auction that triggers this settlement provision would create a substantial capacity surplus in the two subsequent auctions.

[4] Even if new entry is too small to trigger the New Entry Price Adjustment, load growth will likely result in prices in the next year's auction clearing at or above 90% of Net CONE. Although

Assuming that this new entrant offers into its first LDA auction at Net CONE, prices will clear at this value in the first year. New entry of 600 MW is equivalent to about two years of load growth in Southwest MAAC.[5] Consequently, the new entrant, priced at 90% of Net CONE in accordance with the New Entry Price Adjustment, will clear at the margin in the succeeding two auctions, forcing prices in those auctions to clear at 90% of Net CONE.

By the fourth auction, load growth will eliminate the surplus created by this 600 MW new entrant. At that point, additional new entry will lead to another three-year cycle of price supports under the New Entry Price Adjustment. In the absence of new entry, the demand curve will force prices to clear at or above Net CONE.[6] In either case, the combination of the demand curve and the New Entry Price Adjustment will ensure that prices clear at a minimum of 90% of Net CONE.

The New Entry Price Adjustment will substantially increase costs to consumers in the Southwest MAAC LDA. Assuming that a new entrant's avoidable going-forward cost is about 40% of Net CONE, the New Entry Price Adjustment will increase costs to load in Southwest MAAC by more than $500 million in the two years of price support.[7]

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this entrant's offers would be capped at avoidable cost in the next year's auction, the demand curve would force prices to clear at or above 90% of Net CONE.

[5] PJM's Regional Transmission Expansion Plan of February 22, 2006 forecasts load growth of about 1.6% per year in Southwest MAAC.

[6] In the absence of new entry, the supply curve will fall short of the demand curve, i.e., the supply curve will end before intersecting with the demand curve. In this case, the clearing price will be set by the point on the demand curve that lies directly above the end of the supply curve.

[7] This estimate does not include the additional cost associated with any make-whole payment to the new entrant receiving the New Entry Price Adjustment. This settlement provision provides a make-whole payment to the new entrant to the extent that clearing prices in the second- and third-year LDA auctions are less than the new entrant's first-year price offer. For example, if the new entrant bids at 100% of Net Cone in the first year and prices clear at 90% of Net Cone in the

This settlement provision may also cause harm to the generation market in LDAs. The New Entry Price Adjustment distorts price signals by forcing prices to clear well above competitive levels. These elevated prices misleadingly signal a tightening market when in fact the market is in surplus, and may consequently lead to inefficient investment decisions by merchant developers.

The New Entry Price Adjustment is designed to provide a measure of revenue certainty to new entry in LDAs, but does so at an unreasonable cost to consumers and the marketplace. This trade-off is not only unreasonable, but also unnecessary, since new entry can be provided the same measure of revenue certainty without artificially raising prices above rational and efficient levels. This revenue certainty is achievable simply by providing to eligible new entry a make-whole payment to cover the difference between its first-year offer price and clearing prices in the second- or third-year auctions. With revenue certainty assured through the make-whole payment, there is no need to force prices to in the second- or third-year auctions to clear at other than competitive levels.

As noted above, the settlement's New Entry Price Adjustment increases second- and third-year auction prices to 90% of Net CONE, pays this elevated price to all cleared capacity, and then provides a make-whole payment to the new entrant to cover the difference between its first-year offer price and the second- and third-year auction prices. A more reasonable, less harmful approach would be to eliminate the provision that allows eligible new entry to offer into the second- and third-year auctions at levels exceeding avoidable going-forward costs, while maintaining the provision for a make-whole payment. This alternative approach will provide the same measure of revenue certainty to new entry as the New Entry Price Adjustment.

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second and third years, the new entrant will receive a make-whole payment equivalent to the product of 10% of Net Cone and the new entrant's UCAP rating.

However, unlike the New Entry Price Adjustment, this alternative mechanism will not distort price signals or needlessly increase costs to consumers.

For Southwest MAAC consumers, the benefits from this alternative approach could be dramatic. Assuming that a 600 MW new entrant's first-year offer is priced at 100% of Net CONE and that its avoidable going-forward cost is about 40% of Net CONE, two years of make-whole payment would increase costs to load in Southwest MAAC by less than $50 million, or less than 10% of the increase associated with the New Entry Price Adjustment.

This concludes my affidavit.

AFFIDAVIT OF JONATHAN F. WALLACH

Jonathan F. Wallach, being first duly sworn, deposes and says that he has read the foregoing "Supplemental Affidavit of Jonathan F. Wallach on behalf of the Maryland Office of the People's Counsel," that he is familiar with the contents thereof, and that the matters and things set forth therein are true and correct to the best of his knowledge, information, and belief.

/s/ ________________________
Jonathan F. Wallach

Subscribed and sworn to before me this 18th day of October, 2006.

/s/ ________________________
Notary Public

My commission expires: MARCO
Notary Public
Commonwealth of Massachusetts
My Commission Expires
September 27, 2013