

September 9, 2016

PJM Board of Managers

PJM Interconnection, LLC (“PJM”) is seeking to increase its stated rates for administrative cost recovery under its Open Access Transmission Tariff (“Tariff”) Schedules 9-1 through 9-5 and to eliminate the formulaic Advanced Control Center (“AC<sup>2</sup>”) cost recovery rates under Tariff Schedule 9 – 6 Advanced Second Control Center. This letter reflects the Finance Committee’s activities related to this topic and the recommendation from the sector-elected representatives to the Finance Committee.

### **Finance Committee Responsibilities**

The Finance Committee Financial Review, Reporting and Communications Protocol (the “Protocol”) specifies the responsibilities of PJM in reviewing proposed administrative rate changes with the Finance Committee to allow the Finance Committee to provide recommendations to the PJM Board of Managers prior to making regulatory filings to revise its administrative rates. The applicable excerpts from the Protocol are provided below for reference.

“The purpose of the PJM Finance Committee is ... (b) to make recommendations to the PJM Board on matters pertaining to the appropriate level of PJM’s rates ...”

“13. PJM shall give the Finance Committee advance notice of proposed regulatory filings to modify PJM’s administrative rate structure so as to permit the Committee to review and provide comment on the proposed modifications. The Finance Committee, in an advisory capacity, shall provide recommendations to the PJM Board regarding such proposed changes to PJM’s administrative rates. In emergency situations, PJM shall provide such notice as feasible to the Finance Committee and the Finance Committee shall provide such recommendations as feasible under the circumstances.”

## **Finance Committee Meetings and Conference Calls**

The Finance Committee has met with PJM management via in-person meetings and conference calls on the following dates during 2016 to discuss PJM's administrative rates:

<b>Date</b>	<b>Discussion Topics</b>
March 30, 2016	Stated Rate History 2006-2015 Cost Drivers Members' Rate Objectives
May 17, 2016	Members' Rate Objectives 2016-2026 Projections Initial Prospective Rate Options
July 7, 2016	Prospective Rate Options
August 24, 2016	Prospective Rate Options
September 9, 2016	Prospective Rate Options and Recommendation Letter to Board of Managers

### **Stated Rate History**

PJM established stated rate Tariff Schedules 9-1 through 9-3 and the AC<sup>2</sup> formula rate Tariff Schedule 9-6 effective June 1, 2006. In 2008, PJM revised the refund mechanism to be on a one-quarter lag basis instead of the original one-year lag basis. Additionally, in 2011, PJM voluntarily reduced the stated rates by 3% to reflect economies of scale achieved with a larger PJM geographic region.

PJM's 2015 net expenses were consistent with the original ten-year projections discussed when stated rates were proposed in 2005. This reflects PJM's ongoing commitment to cost management even in the context of significant transaction volume increases and new responsibilities arising in the past decade, particularly for compliance, cyber security and interregional coordination.

### **Drivers / Problem Definition**

PJM provided the Finance Committee with the financial and regulatory details supporting the following drivers of the need to address PJM's prospective administrative rates at this time.

1. PJM's voluntary stated rate reduction filing in 2011 indicated an expectation that the lower 29 cent composite rate per megawatt hour would accommodate PJM's anticipated expenses for approximately five years at which time PJM would engage its members in a discussion of PJM's future rate levels and likely need to submit an updated rate filing. This year (2016) is the completion of that five-year expectation.
2. The Stated Rate Reserve has been underfunded with a declining balance for over two years with no expectations to become fully funded prospectively without revisions to PJM's future rates.

- a. There was a \$10 million unfavorable variance in the 2015 year-end reserve balance projection due to mild weather.
  - b. PJM projects a \$5 million financial reserve balance at the end of 2016. PJM’s 2017 projected expenses exceed its 2017 projected revenues under the current rates in Tariff Schedules 9-1 through 9-6 by \$17 million. So, absent changes in PJM’s rates effective January 1, 2017, PJM will likely deplete its reserve early in 2017 and have insufficient revenues plus reserves to fund its 2017 expenses.
3. The AC<sup>2</sup> Rider expires in 2018. Projected revenues would then be insufficient to fund projected ongoing AC<sup>2</sup> expenses of approximately 3 – 4 cents per megawatt hour beyond the expiration of the AC<sup>2</sup> Rider. Further, much of the technology investment during the AC<sup>2</sup> Program needs updating, scaling and enhancements for which no rate recovery mechanism exists currently.

**Objectives**

The Finance Committee discussed the following objectives for PJM’s next rate filing based on a draft prepared by PJM management that also references the objectives of the 2005 stated rate filing and the Finance Committee’s 2010 assessment of the ongoing value of those objectives. These objectives were shared with all PJM members for comment before being adopted by the Finance Committee as the framework for evaluating rate options considered.

Original 2005 Stated Rate Structure Filing Objectives	2010 Finance Committee Assessment	Objectives for Next PJM Rate Filing
1. Reduce rate volatility and provide multi-year service fee certainty	Original objectives still of value to members and being achieved with the current rate structure and PJM’s Finance Committee Financial Review, Reporting and Communications Protocol.	1. Maintain low rate volatility and provide multi-year service fee certainty for 5-10 years
2. Deploy effective operation and capital cost management		2. Deploy effective operation and capital cost management
3. Increase rate and cost transparency to members		3. Maintain enhanced rate and cost transparency to members
4. Establish cost recovery for second control center investment		4. Establish cost recovery for post-AC <sup>2</sup> Rider ongoing costs of second control center
5. Maintain creditworthiness for cost-effective borrowing purposes		5. Maintain creditworthiness for cost-effective borrowing purposes

**2017 – 2026 Net Expense / Composite Rate Projections**

PJM reviewed in detail with the Finance Committee its ten-year expense assumptions by cost category as well as its load assumptions which then result in PJM’s projected composite rates for the next decade. For that period, PJM projects its expense will increase at an annual average change of 2.9%. In order to fund its projected resource requirements and the deferred regulatory liability (financial reserve), PJM projects a composite rate requirement of 36 cents in 2017 rising to 41 cents in 2026.

## **Future Rate Options Considered**

During the May 17, 2016, the Finance Committee and PJM management developed five future rate options to be modeled and discussed at the July 7, 2016 Finance Committee meeting.

1. Option 1 – No changes to Tariff Schedules 9-1 through 9-6 or the 2006 Stated Rate Settlement Agreement;
2. Option 2 – Composite stated rate changes in a single step increase to 41 cents per megawatt hour effective January 1, 2017;
3. Option 3 – Composite stated rate changes to 36 cents per megawatt hour effective January 1, 2017 and then escalates 2.5% annually from January 1, 2018 until reaching a maximum composite rate of 41 cents per megawatt hour effective January 1, 2023;
4. Option 4 – Composite stated rate changes to 36 cents per megawatt hour effective January 1, 2017 and then escalates 1 cent per megawatt hour annually from January 1, 2018 until reaching a maximum composite rate of 41 cents per megawatt hour effective January 1, 2022; and
5. Option 5 – PJM reverts to formula rates effective January 1, 2017.

After review and discussion of the ten-year modeling of these five options at the July 7, 2016 Finance Committee meeting, a subset of the member-elected representatives to the Finance Committee requested PJM model an additional option intended to address some of the points made during the July 7, 2016 Finance Committee meeting.

- 3.a. Composite stated rate changes to 36 cents per megawatt hour effective January 1, 2017 through December 31, 2018 and then escalates 2.5% annually from January 1, 2019 until reaching a maximum composite rate of 41 cents per megawatt hour effective January 1, 2024.

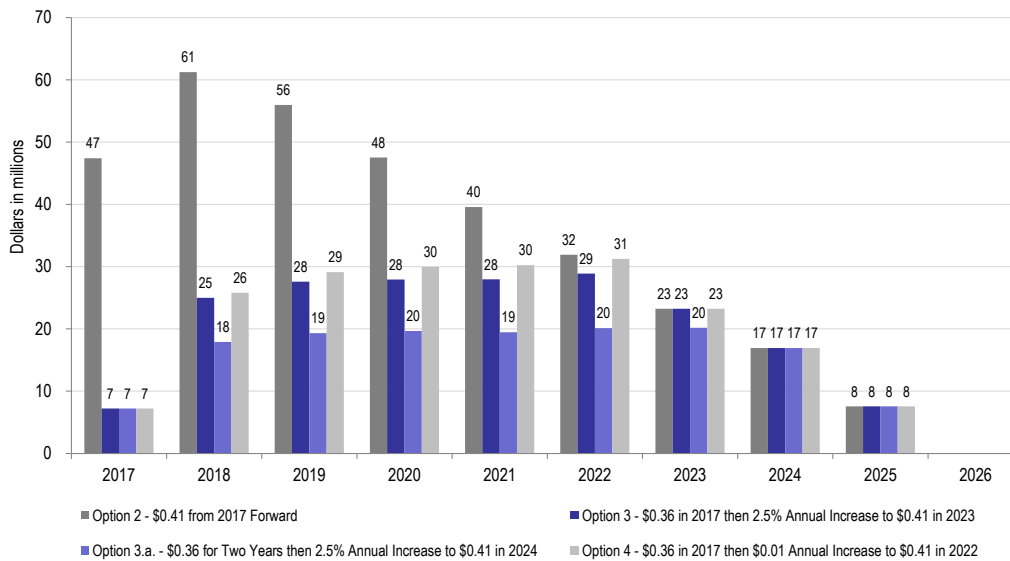
## **Evaluation of Options**

PJM proposes to continue refunding to members on a one-quarter lag basis stated rate revenues in excess of actual expenses when the financial reserve is fully funded. The Finance Committee members determined that options should be evaluated (a) against the established objectives and (b) considering the balance between reasonable projected refund levels and the potential risk of reserve depletion.

Objectives for Next PJM Rate Filing	Option 1 – No Changes	Option 2 – Single Step Change	Option 3 – 2.5% Annual Change Through 2023	Option 3.a. – 36 Cents in 2017 and 2018 then 2.5% Annual Change Until 41 Cents in 2024	Option 4 – 1 Cent Annual Change Through 2022	Option 5 – Formula Rates
1. Maintain low rate volatility and provide multi-year service fee certainty for 5-10 years	< 1 year until reserve is fully depleted and expenses exceed revenues <b>X</b>	10 years with \$0.01 - \$0.07 annual refunds ✓	10 years with \$0.01 - \$0.03 annual refunds ✓	10 years with \$0.01 - \$0.02 annual refunds ✓	10 years with \$0.01 - \$0.03 annual refunds ✓	Multi-year reference projections would be provided; annual and monthly rates would vary <b>X</b>
2. Deploy effective operation and capital cost management	<b>X</b>	✓	✓	✓	✓	✓
3. Maintain enhanced rate and cost transparency to members	✓	✓	✓	✓	✓	✓
4. Establish cost recovery for post-AC <sup>2</sup> Rider ongoing costs of second control center	<b>X</b>	✓	✓	✓	✓	✓
5. Maintain creditworthiness for cost-effective borrowing purposes	<b>X</b>	✓	✓	✓	✓	✓

Options 1 and 5 were removed from further consideration after the July 7, 2016 Finance Committee meeting based on the table above that highlights how these options do not achieve all the established objectives, in particular the ability for members to know the maximum transaction rate they will be charged for a multi-year period.

To continue narrowing the options to a recommendation, the Finance Committee then looked to a comparison of the projected refunds under each option.



PJM agreed to remove Option 2 from further consideration based on member feedback regarding concerns with the associated refund projections for this option highlighted in the refund projections chart above.

## **Recommendation**

The member-elected representatives to the Finance Committee recommend the Members Committee endorse and the PJM Board of Managers approve PJM management making a section 205 filing with FERC that reflects the principles of Option 3.a. which includes a reasonable annual rate escalator that commences after two years (i.e., starting in 2019) and ends in 2024 while balancing projected refunds with a realistic expectation of maintaining the financial reserve funding. This proposal will require PJM to continue to exercise cost management to ensure its expenses remain below the revenues resulting from the proposed capped stated rates.

Specific elements of recommendation:

1. The composite stated rate will be 36 cents per megawatt hour effective January 1, 2017 through December 31, 2018 and then increase 2.5% annually until being capped at 41 cents per megawatt hour effective January 1, 2024 as reflected in the table below for the next ten years discussed in the Finance Committee:

Effective January 1,	Composite Stated Rate	Annual Change
2017	\$0.3600	7.5% <i>(includes approximately 5% increase to fund currently underfunded financial reserve)</i>
2018	\$0.3600	0.0%
2019	\$0.3690	2.5%
2020	\$0.3782	2.5%
2021	\$0.3877	2.5%
2022	\$0.3974	2.5%
2023	\$0.4073	2.5%
2024	\$0.4100	0.7%
2025	\$0.4100	0.0%
2026	\$0.4100	0.0%
Average Annual Change <i>(with reserve funding)</i>		2.1%
Average Annual Change <i>(without impact of reserve funding)</i>		1.6%

2. The formula rate Tariff Schedule 9 – 6 Advanced Second Control Center will be retired simultaneous with the revised stated rates becoming effective as the ongoing AC<sup>2</sup> expenses will be recovered through the revised stated rates; and
3. PJM will commit to a Finance Committee review of actual results and updated revenue, expense, reserve and refund projections after the first five years of the revised stated rates.

Specific elements that are recommended to remain as they function today without any revisions:

1. PJM will continue to be authorized to accumulate a deferred regulatory liability (financial reserve) up to 6% of annual stated rate revenues (with a reduction to 2% in every third year for income tax expense management purposes);
2. PJM will remain obligated to provide refunds of accumulated stated rate revenues in excess of actual expenses on a one-quarter lag basis when the financial reserve is fully funded;
3. The Finance Committee will retain its written recommendation authority over PJM’s annual expense budget, which is a key component of the projected refund calculations; and
4. The Finance Committee Financial Review, Reporting and Communications Protocol shall remain in effect to define the financial transparency and coordination framework for the Finance Committee with PJM management, including but not limited to (a) PJM’s ongoing commitment to report no less than quarterly to the Finance Committee on PJM’s actual stated rate revenues, expenses, refunds and financial reserve balance and how these actual results compare to previous projections, and (b) the Finance Committee’s continuing authority to provide recommendations to the PJM Board of Managers on PJM’s stated rate levels.

Sincerely,

Member-elected Representatives to the PJM Finance Committee

Member-elected Representative	Sector
Charlie Bayless, North Carolina Electric Membership Corporation	Electric Distributor
Steve Lieberman, Old Dominion Electric Cooperative	Electric Distributor
Dave Evrard, Pennsylvania Office of Consumer Advocate	End Use Customer
George Waidelich, Safeway, Inc.	End Use Customer
Michelle Greening, Raven Power Marketing LLC	Generation Owner
Joe Kerecman, Calpine Energy Services, L.P.	Generation Owner
Marguerite Miller, Credit Suisse (USA), Inc.	Other Supplier
Marji Philips, Direct Energy Business Marketing, LLC	Other Supplier
Jim Benchek, FirstEnergy Solutions Corporation	Transmission Owner
Gary Greiner, Public Service Electric & Gas Company	Transmission Owner