

XO ENERGY, LLC
1690 New London Road
Landenberg, PA 19350

June 26, 2017

VIA ELECTRONIC MAIL

Mr. Howard Schneider, Chair
Mr. Andrew Ott, CEO
PJM Interconnection, LLC
P.O. Box 1525
Southeastern, PA 19399-1525

RE: Concerns Regarding the Independence and Neutrality of PJM Interconnection, LLC

Dear Messrs. Schneider and Ott:

XO Energy, LLC (“XO Energy”) is writing to express its concern about the state of competition in the markets administered by PJM Interconnection, LLC (“PJM”) as well as the “independence” and “neutrality” of the ISO. XO Energy has previously expressed its viewpoint that virtual transactions have been under attack - throughout the PJM stakeholder process as well as by physical asset owners, load-serving entities, the Independent Market Monitor and now PJM.

Recently, PJM sponsored two proposals that will severely limit competition in the markets. The first proposal will result in a triple energy deviation charge to the up-to congestion (“UTC”) product, a transmission product without an energy component, which will render the product useless. Subsequently, PJM sponsored a second proposal that will dramatically reduce the number of biddable points available to market participants to support energy and transmission hedging in the Day-Ahead Market. The latest attempt to restrict competition in the PJM markets appears to be a coordinated effort between PJM senior staff and members of the Pennsylvania state legislature that would result in a gross tax on virtual transactions in PJM. On behalf of XO Energy, I am perplexed: how can the actions of PJM be viewed as anything other than biased, discriminatory, abusive, and in clear violation of PJM’s obligation to administer its wholesale power market in an open, fair and competitive manner?



I. Background

On June 14, 2017, XO Energy participated in a conference call with Suzanne Daugherty, the Senior Vice President, Chief Financial Officer and Treasurer of PJM, during which we were informed that the Pennsylvania state legislature was considering a state tax on virtual transactions in PJM. According to Ms. Daugherty, PJM met with members of the Pennsylvania Department of Revenue on at least two occasions to discuss the energy markets. XO Energy understands that, although a determination had been made that physical transactions could not be reasonably taxed, virtual transactions could be subject to a levy because they are allegedly only transacted in Norristown, Pennsylvania and allegedly do not have a direct connection to the physical grid.

Last week, XO Energy met with members of the Pennsylvania state legislature, all of whom discussed the pressure to close Pennsylvania's \$1.2 billion budget deficit by the end of the session/start of the new fiscal year on July 1. Apparently, a number of initiatives were being considered, including a tax on virtual transactions. We were surprised to learn from professional staff that the proposed tax was supported by PJM. There was also some suggestion that a tax on virtual transactions could help fund potential nuclear subsidies.

II. The Flaws of the Proposed Tax

A. PJM's Markets are Subject to the Jurisdiction of the Federal Energy Regulatory Commission

Importantly, PJM's wholesale electricity markets encompass thirteen member states that are subject to the jurisdiction of the Federal Energy Regulatory Commission ("FERC"). In fact, the courts have repeatedly rebuffed attempts by states to intrude on FERC's exclusive domain. In April 2016, the United States Supreme Court held that a Maryland regulatory program that would encourage the development of new in-state energy generation was preempted by the Federal Power Act, which vests exclusive jurisdiction over interstate wholesale electricity rates in FERC. (*Hughes v. Talen Energy Marketing, LLC*, 578 U. S. ____ (2016).)

Furthermore, if the proposed tax is ultimately approved, PJM cannot administer the tax without filing a tariff change, which will require FERC approval. Since the tax will become a part of the cost of engaging in virtual transactions and the only rate which PJM may charge is the duly

filed rate contained in its tariff, the tax will require explicit inclusion in PJM's tariff, any change to which must be approved by FERC.

B. Virtual Transactions Can Impact Unit Commitment and Dispatch

Like physical transactions, virtual transactions are deemed to be a part of interstate commerce. Furthermore, virtual transactions impact physical unit commitment and dispatch of generation resources across PJM's entire footprint (see Figure 1). Virtual transactions together with all transactions in the Day-Ahead Market are explicitly linked to the physical Real-Time Market.

Figure 1: Virtual Transactions Impact Physical Unit Commitment and Dispatch

	12/10/13	12/14/13	12/18/13	12/23/13
Base Case Units Committed	634	565	596	532
Units Decommitted w/o Virtuals	39	10	13	9
Units Committed w/o Virtuals	0	0	0	0
Net Commitment Difference	39	10	13	9

C. The Proposed Tax will be Summarily Challenged

If the proposed tax is adopted, litigation on jurisdictional and commerce clause grounds will ensue. Furthermore, the PJM tariff will require FERC approval and, as in the Talen Energy case, will likely constitute an interference with FERC's statutory power to establish rates for the sale of electric energy in interstate commerce. Under the Federal Power Act, the rates, terms and conditions of PJM's tariff are required to be just and reasonable and not unduly discriminatory or preferential; otherwise, they are deemed to be unlawful.

Federal case law and precedent would not be favorable. The U.S. Supreme Court has repeatedly found unconstitutional state laws that interfere with a federal agency's oversight of regulated markets. Time and again, the Supreme Court has upheld FERC authority to regulate under the Federal Power Act states' attempts to contravene federal policy. *See Maryland v. Louisiana*, 451 U.S. 725, 749-50 (1981); *Northern Natural Gas Co. v. State Corp. Commission of*

Kan., 372 U.S. 84, 91-92 (1963); *Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, 487 U.S. 354, 373 (1988), 476 U.S. 953 (1986).

Maryland v. Louisiana is particularly instructive. There, the Supreme Court struck down a Louisiana law that imposed a tax on the federally regulated natural gas market. The law attempted to impose a “first-use tax” on certain uses of natural gas brought into the state, declaring it a cost of production and requiring that entities transporting the gas either bear the cost of the tax themselves or pass it on to consumers. This proposed tax directly contradicted FERC policy, which typically allocated the costs of production among all owners of the unprocessed natural gas, not just pipeline owners or consumers. The court declared that “Louisiana has attempted a substantial usurpation of the authority of the FERC,” finding that the law contravened FERC policy and had interfered with FERC’s authority under federal law. The court found that while FERC had the authority to permit this kind of allocation, Louisiana could not impose it through state law.

The court also rejected Louisiana’s claims that the commerce was in fact intrastate, rather than interstate, because of purported “breaks” in the nature of the commerce, finding that “we do not agree that the flow of gas from the wellhead to the consumer, even though ‘interrupted’ by certain events, is anything but a continual flow of gas in interstate commerce.” The court then ruled that the tax impermissibly discriminated against interstate commerce by treating in state and out of state entities differently, providing subsidies to in state entities while denying them to out of state entities. The court finally concluded that the tax could not be justified as a compensatory tax because Louisiana had not demonstrated any compensable interest in natural gas harvested from federal lands.

The proposal to tax virtual transactions appears to be exactly the type of state taxation action that the Supreme Court struck down in *Maryland v. Louisiana*. The wholesale price of electricity in PJM’s wholesale electricity markets, both physical and virtual, is established by FERC-approved tariffs. Virtual transactions are inextricably linked to the physical nature of the electricity grid, which the Commodity Futures Trading Commission (“CFTC”) found in exempting such transactions from their jurisdiction. An attempt to segregate such transactions as occurring only in Norristown, and not where the transactions are placed, runs counter to the nature of the transactions, as well as FERC’s and the CFTC’s explicit findings and policy regarding the nature of virtual transactions in wholesale electricity markets.

D. Taxing Flexible, Price Sensitive Transactions is Economically Unfeasible

In 2016, the average profitability of UTCs was less than \$0.11/MWh. Basic economic principles suggest that these virtual transactions cannot simultaneously pay a “tax” of close to \$1.50/MWh and remain profitable. In short order following the implementation of this tax, virtual transaction volume will decrease by 100% resulting in the elimination of any potential tax revenue.

The concept of cost-shifting is not new in PJM. PJM provides “uplift credits” to generation or demand resources in certain situations to ensure that these resources do not operate at a loss when following PJM dispatch instructions. Under current market rules, generation and demand resources are entitled to recover the full value of their energy offers. Uplift credits are then funded by market participants. When financial market participants were notified that there was even a chance that uplift credits would be funded by UTCs, market volume immediately decreased by 80%.

E. The Proposed Tax will Eliminate Competition in the Wholesale Energy Markets

The proposed tax will eliminate competition as financial participants will swiftly exit the wholesale energy markets (see Figure 2). Economists have long touted the benefits associated with the participation of financial traders, namely, that they provide enhanced competition and liquidity to support hedging. The mass exodus of these participants from the PJM markets will lead to distorted market outcomes and inflated wholesale electric prices. This is a dramatic step backward to a vertically integrated structure, proven to be the least efficient and most expensive way to serve retail electricity customers.

Figure 2: Net Profitability of Virtual Transactions in 2016

2016			
Revenue:	Decs:	Dec - Congestion	\$3,300,000
		Dec - Losses	\$3,000,000
		Dec - Energy	(\$14,700,000)
		Gross Dec \$\$	(\$8,400,000)
	Incs:	Inc - Congestion	\$15,900,000
		Inc - Losses	(\$800,000)
		Inc - Energy	\$24,800,000
		Gross Inc \$\$	\$39,900,000
	UTC:	UTC - Congestion	\$13,300,000
		UTC - Losses	\$33,200,000
Gross UTCs \$\$		\$46,500,000	
Charges:	less Inc/Dec fees:	(\$62,824,972)	
	less UTC fees	(\$13,591,803)	
Net:	Net Profit	\$1,583,225	
	of all "Virtuals"		

Source: tables in Section 11 of 2016 SOM

As stated in PJM’s recent white paper on Virtual Transactions:

Overall, virtual trading benefits the efficient operation of the PJM energy markets. It can assist in attaining efficient market outcomes and improve commitment and price convergence between the Day-Ahead and Real-Time Markets.

The participation of financial traders alongside physical asset owners and load-serving entities provides enhanced competition and liquidity to support hedging. Virtual trading generally assists in achieving efficient market outcomes, i.e. Day-Ahead Market outcomes that commit those generation resources that will in fact be needed to serve load in real time.

Messrs. Schneider and Ott

June 26, 2017

Page 7

XO Energy submits this letter to notify the PJM Board of its significant concerns, both about the state of the “competitive” markets in PJM as well as the supposed “independence” and “neutrality” of the ISO.

We appreciate your consideration of this matter and look forward to your response.

Sincerely,

A handwritten signature in blue ink, appearing to read 'SS', with a horizontal line underneath.

Shawn Sheehan
President