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September 29, 1997

Joel I. Klein, Esq.
Assistant Attorney General
Antitrust Division
Main Justice Building
10th and Constitution Ave.
Washington, D.C. 20530

Re: Request for Statement of Enforcement Intentions Pursuant to Business Review Procedures

Dear Mr. Klein:

On behalf of the Joint Venture that constructed and operates the Keystone-Conemaugh coal-fired electric power plants (the "Project"), this letter requests a statement of the Antitrust Division's present enforcement intention with respect to the proposed plan of operation set forth below.

Summary

The Joint Venture, through operation of the Project, has a capacity of 3,400 megawatts and, for the past 25 years, has generated low-cost power for distribution through the transmission grid controlled by the Pennsylvania-New Jersey-Maryland Interconnection Association ("PJM"). The Project accounts for less than 6% of the total capacity of PJM (including reserves), and less than 10% of its average weekly peak demand. Accordingly, the Joint Venture has no market power. See Baltimore Gas & Electric Company and Potomac Electric Power Company, 79 FERC ¶61,027 (1997).

To date, the four units of the Project have been dispatched at the direction of PJM to meet the native retail electrical loads of the joint owners of the Project. Under the prevailing regulatory regime, the owners have each recovered their portion of costs for the energy generated by the Project through tariffs and fuel adjustment clauses determined by their respective state public utility commissions.

Recent and proposed changes to PJM (and its governing regulations) will alter the mechanisms used by PJM in dispatching generating resources and distributing power. Under PJM's proposed "open market" procedures, PJM will serve as an

independent clearing house for purchases and sales of electricity and use prices submitted by plant owners, rather than costs, as the basis for determining the order of dispatch for its generating resources. This new procedure will facilitate wholesale sales and purchases of electricity among all utility and non-utility market participants, including power marketers, independent power producers, and utilities outside PJM's region. Among other benefits, the new procedures will allow for more efficient operation of the Project by enabling it to make low-cost energy available to purchasers whenever its output exceeds the requirements of the joint owners' native load.

The changing operating environment for the Joint Venture will require changes in the Project's operations. Most significantly, the Joint Venture will be required for the first time to submit a "bid" to PJM that reflects the price levels at which each unit will be available for dispatch.

The Joint Venture has developed a plan of operation for the Project that will enable the Venture to continue its history of supplying low-cost power to the Mid-Atlantic region. As explained more fully below, the plan provides (i) that the Project Office of the Joint Venture will prepare and submit for each generating unit any bid required by PJM, without participation of the owners; (ii) the Project Office will provide the joint owners with delayed information about these bids; and (iii) the Joint Venture will adopt certain antitrust safeguards to protect against any possibility that the communications among the parties to the Joint Venture could "spill over" into other business activities.

Background

A. The Joint Venture

In the late 1960's, 10 electric utilities formed the Joint Venture to share the costs, risks and know-how needed to finance, construct and operate the Project, which includes four coal-fired, steam electric generation units in Western Pennsylvania with a total capacity of 3,400 megawatts. The Keystone and Conemaugh units were developed near sites of coal production to avoid the need to transport coal to more distant locations. The purpose of the Project was, in effect, to provide low-cost power by transporting coal by wire.

The Keystone and Conemaugh plants (each with two generating units) are located west of Johnstown, Pennsylvania

about 30 miles apart. The plants were built in the late 1960's and early 1970's, pursuant to joint venture agreements (attached as Exhibit A) among seven owners for Keystone and nine owners for Conemaugh.

The joint venture agreements provide that the Project will be owned as "tenants in common" by the participating utilities, and that no owner may partition or divide the Project in any respect. At present, the Joint Venture has 10 different utility owners, who have undivided interests in either Keystone or Conemaugh ranging from the 1.11% held by UGI, to the 22.84% held by Public Service Electric & Gas Co, as set forth in Exhibit A. The operating agreement for the Project requires it to be operated by an independent contractor "in accordance with good utility practices."

Although the Project provides low-cost energy, none of the owners of the Project would have built it alone. The costs and risks of the Project were too great for any single utility. The joint owners of the Project originally invested $390 million for its construction in the late 1960's and early 1970's. Through 1996, the owners have made additional investments in the Project for capital improvements that total nearly $1 billion. At today's prices, replacement costs for the Project would likely exceed $3 billion.

The Project has successfully operated to provide low-cost electricity for more than 25 years. The Project is expected to continue operating for another 25 years, with proper maintenance and additional capital investment. At present, the budget for the Project estimates the joint owners will be required to make additional capital investments for the years 1997 through 2002, totaling approximately $182 million, or $30 million on average each year.

While providing low-cost energy for the owning utilities and their customers, the Joint Venture poses no threat to competition through the exercise of market power. In terms of incremental energy costs, the Project units are among the lowest cost units in the PJM grid. Economical and reliable operation of the units requires generation at levels of at least 500

megawatts, and the units require minimum lead times for start-up of at least 8 to 12 hours. The total capacity of the Project constitutes less than 6% of PJM's total capacity. Similarly, its maximum energy output amounts to less than 10% of PJM's average weekly peak load of approximately 36,000 megawatts.[1] Because of the size, efficiency, reliability, and low cost of the units, they generally operate as "base load" units in the PJM grid.

In short, the Joint Venture has provided substantial benefits to consumers by increasing the availability of low-cost power, while posing no detriments to competition.

B. Regulatory Changes and the Restructuring of PJM

The owners of the Project are all members of PJM, which operates as a regional power pool (the "Pool") regulated by the Federal Energy Regulatory Commission ("FERC"). PJM functions as a "regional economic dispatch" center with its dispatchers selecting, on an hourly basis, the cheapest source of energy available from any Pool member or other Pool participant to serve the next increment of demand for electricity. When electricity produced by a generating unit owned by one Pool participant is dispatched by PJM to supply the customers of another participant, those participants are said to have sold and purchased energy in "Pool interchange." PJM administers a settlement and billing process to collect and distribute payment for Pool interchange after the fact.

PJM members can also designate the output of generating units they own for the benefit of their own customers. Pool interchange thus functions as a residual market, under which energy needs that Pool participants have not arranged to satisfy from their own generating resources or from contract energy

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1 If it were to become necessary to define a relevant antitrust market, the appropriate market would include significant sellers and generation capacity outside of PJM. In light of the low percentages recited in the text, there appears to be no need to go through that exercise here.

purchases are met through the most economic generating resources of any PJM participant that has not previously been committed.

Currently, as it has for many years, PJM determines which generating unit constitutes the least expensive resource available to meet energy needs of the Pool on the basis of the variable costs of the generating units. Until recently, Pool interchange was priced on the basis of "split savings." That is, PJM members whose generating units provided energy to the Pool for dispatch received a portion of the difference between their variable cost of producing that energy and the amount it would have cost the PJM member whose customers consumed the energy to produce the energy using its own resources. PJM members purchasing Pool interchange paid a portion of that difference. As a result, sellers and purchasers of energy through Pool interchange split the savings resulting from regional economic dispatch.

In 1996, FERC adopted comprehensive changes in the way in which power pools like PJM would operate in the future. See FERC Order No. 888. Pursuant to this new regulatory regime, PJM is in the process of restructuring itself, under FERC supervision, to develop an Independent System Operator ("ISO") to conduct PJM energy purchase, sale and dispatch functions. Under this new structure, the ISO will begin receiving proposals to buy and sell wholesale energy from all utility and non-utility market participants, including power marketers, independent power producers and other utilities outside the PJM region. This restructured market will be open for bids from participants submitted one day in advance to supply energy to meet PJM's projected demand for the next day.

Under a revision of the PJM Agreement that was approved by FERC on February 28, 1997, and which took effect April 1, 1997, the pricing of Pool interchange has been modified. Now, Pool interchange is priced on the basis of hourly "market clearing" prices. The market clearing price is the reported variable cost of the most expensive resource that the ISO calls upon in an hour to satisfy demand for Pool interchange in that hour. Any PJM Pool participant whose generating units supply Pool interchange in a given hour receives the market clearing price for that hour and any PJM Pool participant whose customers consumed Pool interchange in the hour pays that same market clearing price, regardless of their actual bid amount. Issues remain to be resolved by the FERC over whether this "market clearing" price should vary based on the location on the transmission grid where the energy is delivered or consumed.

As noted above, Pool interchange serves as a market for residual energy available within the PJM grid. Accordingly, the bid price for a generating resource has only a limited effect on actual transaction prices for electricity. First, the bid price generally determines the order in which a plant is dispatched, not the market clearing price. Second, the bidding mechanism is not used at all with respect to units, or portions of unit capacity, that are self-scheduled -- i.e, schedule by an operator rather than dispatched through the PJM cost-based bidding method. Third, the pricing mechanism is not used in connection with energy generation that is used to meet native load. (Under such circumstances, there is no sale of the energy and, therefore, the pricing mechanism is irrelevant.)

On July 14, 1997, PJM members proposed a further modification of pricing for Pool interchange to permit each PJM Pool participant to bid to supply energy to PJM at any price that Pool participant deems appropriate, rather than at cost. PJM's current dispatch method - the use of member bids to determine order of dispatch and a market clearing price - would then apply to such discretionary bids. Such a change would require a determination by the FERC that the Pool members either lack market power over the sale of electric energy in Pool interchange or have adequately mitigated any market power they may possess. See, e.g., Southwestern Public Services Co., 72 FERC ¶ 61,208 (1995).

In short, the additional restructuring of PJM would, for the first time, allow the Joint Venture (like any participant in PJM) to submit discretionary, or "open market," bids for the output of the Joint Venture (as opposed to bids capped by costs determined in accordance with PJM's guidelines). The Joint Venture, therefore, is seeking guidance from the Antitrust Division to confirm that its proposed plan of operations for these new market conditions conform with the antitrust laws.

The Proposed Plan of Operation

A. Without Participation of the Owners, The Joint Venture Will Submit a Single Bid To PJM For Each of the Project's Units

As a result of the changes and proposed changes in PJM's operations, the Joint Venture must, for the first time, develop a "bid" or offer price for the output of the Project units. As discussed below, a single bid for the output of the

Joint Venture is reasonably ancillary to the venture's legitimate purposes and poses no threat to competition, even if PJM restructures further to provide for "open market" (rather than "cost-based") bids.

Indeed, the Joint Venture has no practical alternative to the submission of a single bid.

First, the agreements that have governed operation of the Joint Venture for 25 years provide no mechanism for divided operation of the plants and/or separate bids by individual owners. Those agreements provide that owners will operate the units as "tenant-in-common" with "undivided interests." Accordingly, none of the owners have independent control over portions of the capacity and output of the unit that would allow them to submit separate bids.

Second, the Joint Venture's costs and output cannot be allocated among the owners in any manner that would allow for separate bids by the owners. Each unit of energy produced by the Joint Venture has a different cost that depends on the degree to which each generator is fully or partially loaded.

With respect to costs, for example, the first 500 megawatts of output of each of the Project's four units is far more expensive per megawatt than the remaining output, because the units operate at low efficiency levels. Above 500 megawatts, incremental costs vary with each additional increment of output and increase sharply as the unit is dispatched close to its upper limit. These characteristics of the Project prevent any workable allocation of costs or output among the owners in a manner that would allow for division of plant operations or separate bids.

Third, efficient operation of the Joint Venture is inconsistent with multiple bids. High cost, for example, discourages operation of any of the Project's four units at levels less than 500 megawatts. Indeed, safe operation of the units requires generation at levels greater than 400 megawatts. Accordingly, the Joint Venture generally bids the first 500 megawatts of production of each unit as a block.

Finally, efficient operation of PJM appears to require submission of a single bid for each unit by the Joint Venture. PJM has stated:

> PJM anticipates that as we move to a priced energy market, jointly owned units such as Keystone and

Conemaugh will continue to be represented as a single unit for all operational purposes. This will include submitting only one monotonically increasing price curve for each unit. Letter dated November 1, 1996, from Kenneth W. Laughlin, PJM Transitional Project Manager, to Fred Humphrey, KCP Administration Manager. (Exhibit B.)

While necessary for efficiency, a single bid would not impede competition:

- Under PJM's bidding methodology, a bid submitted for the Joint Venture will rarely, if ever, determine the market clearing price. The Joint Venture's bid would determine the market clearing price only for the limited periods of time that the Project's units (i) operate as the high cost units in the PJM grid and (ii) are available for open market transactions.[2]

- Information about the bids or costs of output of the Joint Venture has little potential to facilitate any form of collusion. All generating units owned independently by the owners of the Joint Venture have different costs and accounting structures. The Joint Venture's bids, therefore, will have little, if any, relevance to bids for other generating resources in the PJM grid.

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2 At times, the Project may "self schedule" some or all of its output. Self-scheduled generation would not be subject to PJM's bidding process.

B. The Joint Venture Has Adopted Antitrust Safeguards

Although submission of a single bid for the Project's units raises little or no threat to competition, the Joint Venture has nonetheless adopted several antitrust safeguards.

1. **Preparation of Bids by Project Office**

The Project Office of the Joint Venture prepares all bids required for submission to PJM, without participation of the owners and without information as to the bids that any owner intends to submit for the same period or its separately generated operations. The Project Office, which reports to the Administrative Committee of the Joint Venture, was established over 25 years ago to monitor operations and purchase fuel for the Project. The Project Office maintains its office separate from the Project and the joint owners.

2. **Delayed Distribution of Bidding Information.**

The Project Office will provide the owners with delayed information about the bids submitted by the Joint Venture to PJM. The information about the bids for the KCPs will be made available to the owners only after the deadline for submission of bids to PJM each day. The delay in the availability of bid information is intended to reduce any risk, however slight, that such information could be used to facilitate collusion by participants in the Joint Venture with respect to bids they must submit for energy resources that are independent of the Joint Venture.

3. **Safeguards**

The Joint Venture has adopted an antitrust compliance policy and code of conduct for its operations. See Exhibit C. The Joint Venture's policy prohibits the participants in the Joint Venture from using the Venture to facilitate agreements affecting other plants or matters unrelated to efficient operation of the Project. The code of conduct is adapted from one developed by the Utilities Service Alliance for which the Division provided a business review letter on July 6, 1996.

Second, the Joint Venture has committed to remain educated and informed about antitrust law requirements and developments. In this regard, the Joint Venture has retained this law firm to assist it in understanding, and complying with, the antitrust laws.

Conclusion

For the foregoing reasons, we respectfully request the Antitrust Division to provide a business review letter indicating that it has no present intention of taking enforcement action with respect to the Joint Venture's proposed plan of operation. The Joint Venture provides low-cost energy that would not otherwise be available to consumers, lacks market power, and has adopted the antitrust safeguards described herein. The Joint Venture's proposed plan promotes competition.

We therefore appreciate your attention to this matter, and we will gladly provide any additional information that you require in assessing the proposed plan.

Sincerely,

REED SMITH SHAW & McCLAY, LLP

By: Gary Kaplan
Gary L. Kaplan

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