

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

Compensation For Generating Units	*	Docket Nos.	PL04-2-000
Subject To Local Market Power Mitigation	*		
In Bid-Based Markets	*		EL03-236-000
PJM Interconnection, L.L.C.	*		

**POST-TECHNICAL CONFERENCE COMMENTS  
OF THE JOINT CONSUMER ADVOCATES**

Pursuant to the Commission’s Notice of February 6, 2004 in the above-captioned dockets, the Maryland Office of People’s Counsel (“MPC”), the Pennsylvania Office of Consumer Advocate (“Pa. OCA”), the Ohio Consumers Counsel (“OCC”) and the District of Columbia Office of People’s Counsel (“D.C. OPC”) (collectively referred to as the “Joint Consumer Advocates”) respectfully submit these Post-Technical Conference Comments.

**I. Introduction**

On September 30, 2003, PJM Interconnection, L.L.C. (“PJM”), pursuant to Section 206 of the Federal Power Act (“FPA”) and in compliance with the Commission’s directive in *Reliant Energy Mid-Atlantic Power Holdings, L.L.C. v. PJM*, 104 FERC ¶61,040 (2003) (“Reliant Order”), submitted amendments to the PJM Open Access Transmission Tariff and the Amended and Restated Operating Agreement of PJM regarding mitigation of local market power. These amendments include implementing an auction to solve long-term scarcity problems should they arise in PJM. On January 12, 2004, the Commission issued a Notice in the above-captioned cases instituting a technical

conference on the generic issue of mitigation of local market power including a specific session on the PJM filing. The Joint Consumer Advocates intervened in Docket No. EL03-236, filed Comments generally supporting the PJM proposal, and participated in a technical conference. These comments will provide a summary of our position on the PJM filing, our general response to the technical conference, and specific responses to the questions posed in the Commission's February 6, 2004 notice.

## **II. Summary Of Position Of The Joint Consumer Advocates<sup>1</sup>**

The Joint Consumer Advocates are a group of statutorily created state offices that represent the interests of consumers of electricity. We have been actively involved in the discussions concerning the compensation for units located in load pockets in the PJM stakeholder process. The paramount interest of consumers is for reliable service at reasonable prices. We conclude that administrative solutions are necessary to ensure reliability. We further conclude that markets will work best at producing reasonable, non-volatile prices. However, where markets do not exist, administrative action is necessary in order to ensure that prices are just and reasonable. It is our position that the following principles must be followed to avoid unjust or unreasonable results.

1. Scarcity pricing is only appropriate where resources are genuinely inadequate and within a truly competitive market.
  - A. Scarcity pricing is only acceptable within a competitive market with sufficiently elastic demand and adequate supply. "Scarcity pricing" in a load pocket that is deemed non-competitive will certainly produce high prices. However these prices do not provide efficient price signals and cannot constitute just and reasonable rates. Only administrative solutions will produce a just and reasonable result in load pockets.

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<sup>1</sup> The Joint Consumer Advocates presented this position summary as a handout during the technical conference.

- B. True scarcity conditions exist in a load pocket when there is insufficient capacity to serve load in accordance with applicable reliability rules. Many PJM load pockets have sufficient capacity to serve load in accordance with applicable reliability rules yet are subject to the exercise of market power by dominant suppliers. Where existing supply is adequate, there is no economic justification for prices to rise to levels sufficient to attract new investment.
2. Even where scarcity exists a pricing scheme that attempts to attract new investment through short term energy prices may simply result in extreme price volatility, harming consumers and producing insurmountable barriers to entry.
  3. The compensation scheme for incumbent monopoly suppliers in a load pocket should be based on the reasonable costs to provide the required service.
  4. Under no circumstances is it reasonable to pay the incumbent an amount in excess of its cost of service for the provision of reliability must run (“RMR”) services in load pockets.

The Joint Consumer Advocates filed comments in Docket No. EL03-236-000 generally supporting the PJM filing that proposes to hold auctions to acquire resources to resolve long-term local scarcity issues. This proposal retains the current approach to mitigating local market power in the energy market. The Joint Consumer Advocates support this approach because it uses a market mechanism to set prices. This is the best alternative because it maintains energy prices at levels consistent with a fully competitive market.

Should local scarcity arise, it would be identified through the planning process and resolved through the auction. The prices paid for the resources acquired through the local auction would be the minimum price at which the market is able and willing to provide the resources required to resolve the reliability concerns in the local area. The auction would provide a market-based determination of the price needed to induce investment.

In contrast, a “scarcity pricing” scheme that relies on an administratively selected short term energy price may or may not induce the needed investment in a timely manner. Moreover, several of the “scarcity pricing” proposals that we have reviewed to date would, based on the principles stated above, result in unjust and unreasonable prices, as well as economically inefficient activity, because they would apply “scarcity prices” to situations where there is neither true scarcity nor competition.

### **III. The Joint Consumer Advocates’ General Response To Technical Conference**

#### **A. There Is A Greater Level Of Consensus Among PJM’s Stakeholders Than Appeared At The Technical Conference**

Despite representations during the technical conference, PJM stakeholders strongly support the proposal to implement an auction to resolve long-run local scarcity issues. The instant filing by PJM fell short by only a few votes of receiving the supermajority needed for filing under Section 205 of the FPA.<sup>2</sup> Unfortunately, the composition of certain of the panels during the technical conference may have given the appearance that there is significant disagreement among PJM stakeholders as to whether the “prices are right” in PJM and whether the local auction approach is the best method for securing capacity to resolve local scarcity issues. The Commission should note that representatives of four of the sectors, as well as the PJM market monitor, supported the auction approach as superior to alternative “scarcity pricing” approaches during the technical conference.<sup>3</sup> Also, the panelists from the financial community questioned the

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<sup>2</sup> The “proposed amendments were supported by approximately 62.5 percent of the PJM members on a sector basis and have broad support.” PJM Filing Letter in Docket No. EL03-236-000, p. 3-4.

<sup>3</sup> Those speaking in support of the auction approach during the technical conference included representatives from the Transmission Owner sector (PECO and PSE&G), the Transmission Dependent Utility sector (Old Dominion Electric Cooperative), a retail supplier in the Other Supplier sector (First Energy), and End-Use customers (Joint Consumer Advocates).

efficacy of relying on volatile, short-term prices to attract an investment in generating capacity.<sup>4</sup> Nevertheless, despite this broad support, there is enough opposition among the PJM generation owners to frustrate further progress on the details of an auction without Commission direction.

**B. The “Scarcity Pricing” Approach Has Numerous Flaws**

The concept of a “scarcity pricing” gives the appearance of corresponding to some general economic theories while creating numerous practical difficulties. Almost all participants in the technical conference agreed that scarcity pricing in the absence of scarcity is a bad idea. In order to avoid “scarcity pricing” in the absence of scarcity, a line must be drawn to distinguish scarcity from other conditions so that scarcity pricing is permitted only when appropriate. Technical conference participants also largely agreed that there still must be some cap on bids or prices to prevent out-of-control price gouging if full competition does not exist in the load pocket. Otherwise, prices reflect neither competitive market forces nor the costs of production. As discussed below, the disconnect of pricing from functional markets severely undermines the validity “scarcity pricing” approaches. This leaves only administrative solutions.

**1. There Is No Acceptable Trigger Mechanism To Identify Scarcity Situations In The Short-Term**

The scarcity pricing alternatives to the PJM-filed proposals put forward during the technical conference all trigger “scarcity pricing” based on some percentage of hours that a unit is mitigated for local market power. In fact, mitigation is not a measure of scarcity.

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<sup>4</sup> Transcript for February 4, pp. 21 and 108 (Frank Napalitano, Lehman Brothers, Inc.) and 38-39 (Jonathan Baliffe, Credit Suisse First Boston Corporation).

In PJM, units are capped when they have the ability to exercise local market power.

The PJM Market Monitor has stated that despite the fact that certain units are bid capped for local market power during a significant percentage of their run hours, no area in PJM currently has inadequate generation. PJM load pockets exist because transmission constraints prevent lower cost generation outside of the pocket from serving load within the pocket. This does not mean that there are not sufficient resources, albeit higher priced resources, available within the load pocket to serve load.

According to the PJM Market Monitor, the principle reason for bid capping in local market pockets is to mitigate market power caused by high concentration of ownership, not due to capacity deficiency. Because of local market pocket concentration, when generation needs to be called on within the load pocket, the owners of that capacity have the ability to raise prices above a competitive level. Their generation is properly mitigated under the PJM local mitigation rules in order to prevent the exercise of market power, but there is no scarcity.

Some proposals in the Technical Conference would allow generation owners with the ability to exercise local market power to raise prices above competitive levels in the name of “scarcity pricing.” However, this would send no useful signal to the market because new resources are not needed. At best, these proposals will produce prices that are unreasonably high. At worst, prices will be unreasonably high AND unnecessary generation will be built. The only sure thing is that incumbent monopoly generators will benefit from unnecessarily high prices.

These proposals suffer not only from the fact that they do not signal new investment but also from the fact that because of zonal pricing for Load Serving Entities

("LSEs") in PJM, the high prices that would be paid to generators within the load pocket would be averaged with prices outside of the load pocket to create a zonal price used by all LSEs in the zone.<sup>5</sup>

Thus, the intended price signal to load would be greatly diluted for those in the load pocket and unfairly spread to those outside the load pocket. During working group sessions on this issue, PJM produced information that showed that allowing units within a load pocket to raise their bids above the currently mitigated levels can result in a dollar-for-dollar increase to prices for an entire zone. In this case, the zonal price would reflect the price signal attempted to be sent to those in the load pocket. The load in the load pocket would see the intended price, but all other load in the zone would also see that same price.<sup>6</sup> This would result in unnecessary payments for load in the zone to generation in the zone, it would introduce a variety of inefficiencies into the market and it could lead to uneconomic actions by market participants.

In the technical conference, the only concrete proposals for implementation of "scarcity pricing" involve using the percentage of run hours mitigated as a trigger for scarcity pricing. However, there was also general discussion of the concept of using the level of local operating reserves to trigger "scarcity pricing." When this matter has been discussed in the PJM stakeholder process, it has become apparent that local operating reserves for an area as small as the PJM load pockets is not a defined quantity in the PJM tariff, agreements, or manuals.<sup>7</sup> To define such a requirement, all possible operating

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<sup>5</sup> The PJM tariff does allow LSEs to choose nodal pricing for certain types of customers. There are technical restrictions on eligibility for nodal pricing such as metering capability requirements. However, no LSE would volunteer to have nodal pricing for load in a load pocket in order to receive higher prices.

<sup>6</sup> LSEs for certain customers would be able to switch to nodal pricing to avoid the high zonal rates. However, this would only be an option for the largest customers.

<sup>7</sup> There are operating reserve requirements for large portions of the PJM system as defined by its major interfaces, but the load pockets in PJM are significantly smaller than those areas.

conditions will have to be anticipated so that a firm threshold for reliable operations will have to be set. To the knowledge of the Joint Consumer Advocates as participants in the PJM's stakeholder process, there has been no attempt to date to address this analytical problem. The PJM system is an amalgam of the systems of many different utilities within which numerous unique subsystems of the grid exist. Thus, it will be extremely difficult to establish a set of local operating reserve requirements that capture all operating conditions within PJM. To sum up, any general system of local operating reserves will not address the many variations in actual requirements while an operating reserves system tailored to each local requirement will be so complex as to be infeasible while ignoring the dynamic nature of the system.

Any attempt to define such standards would not be able to take full account of the ability of an operator to analyze system conditions in real time and determine a course of reliable system operation using the least amount of resources possible. Therefore, there would be situations that were defined as scarcity because the written local operating reserve requirements were not met, while the operator, in real time and using the ability to analyze actual system operation, considered to be reliable system operations. Again, "scarcity pricing" in this situation would send a signal that more resources were needed when in fact they were not actually, and not historically, considered to be needed. A competitive market is not much of an advantage to consumers if the rules skew the results and call for more resources than were needed under regulation for reliable system operations.

Also, attempting to devise a local operating reserve requirement for the entire PJM system to use as a trigger for "scarcity pricing" would be ill-advised because, even if

reasonably done, the intended signal would miss the investment community, one of its primary intended targets. The investment community representatives on the panels at the technical conference stated that investors view as too risky to “smart money” the use of an obscure set of rules for pricing.<sup>8</sup>

## 2. **There Is No Reasoned Basis For Setting Bid Caps Above Marginal Cost**

The second of two main challenges in designing a “scarcity pricing” approach to local scarcity issues is the need to set a price or bid cap to restrain the exercise of market power. As Dr. David Patton, testifying as market adviser for the New York ISO, stated, sending signals through energy prices can be “overwhelming” to local areas.<sup>9</sup> A common proposal for establishing bid caps is the use of some type of a “proxy unit,” usually the cost to install new capacity in the area.

Assuming that the “scarcity pricing” is only being applied when generation is inadequate to satisfy demand, a proxy price approach will set prices that do not reflect the actual cost of new capacity in the load pocket. Thus, prices will be either too high or too low. Prices are too high will result in over-recovery for generation within the load pocket which is unjust and unreasonable under the FPA. Given the lead time for new generation and limited demand response, it may take years to have a market response to such price signals. In the meantime, load will pay unreasonably high prices. Further, the reality of the retail market is that for significant segments of customers, mainly small customers, there is no long-term relationship between LSEs and the load. Therefore, high “scarcity prices” would not be “self-correcting.” As a general matter, retail competition

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<sup>8</sup> Transcript for February 4, p. 108 (F. Napolitano) and 209-210 (J. Baliff).

<sup>9</sup> *Id.* at 61.

rules at the state level have broken any long-term relationship between the local utility and retail customers. These rules also have resulted in the institution of wholesale supply procurement by the utility for retail customers that remain with it that buys supply in short-term purchases of one, two or three years. With no long-term relationship between load and LSEs, it is incorrect to believe that a majority of consumers would be able to take any actions through the operations of the market to respond to “scarcity prices.”<sup>10</sup>

On the other hand, if the proxy price is set too low, it will fail to attract needed investment even in a scarcity situation. Without intervention of some kind, this could create an unacceptable degradation of reliability. These hazards result from the fact that the “scarcity pricing” proposals are proposals for administratively set prices. The auction concept of the PJM filing avoids this problem because the charges to load to pay for the resources acquired through the auction result from a competitive market process. Thus the charges that result from the auction proposal can be determined to be just and reasonable charges for maintaining a reliable system.

#### **IV. Joint Consumer Advocates Responses To The Commission’s Questions**

In the February 6, 2004 “Notice on Post-Technical Conference Procedures” the Commission posed ten questions for which it requested responses in post-technical conference comments.

1. What type of mitigation measures and offer capping should apply to existing units?

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<sup>10</sup> As discussed above, a further difficulty with the “scarcity price” approach is that the intended price signal to load is obscured by the fact that LSEs pay a zonal energy price for their load unless they volunteer for a nodal or aggregate settlement price.

The Joint Consumer Advocates support the continuation of the current PJM method of capping bids for generating units with the ability to exercise local market power at the unit's marginal cost plus ten percent. This approach limits bids to levels that are expected in a competitive environment. Mitigated bids are treated as any other bid in the PJM process of dispatch of units and setting of energy prices. Thus, the prices paid to mitigated units can, and do, rise above the level of mitigated bids when the load pocket is not congested. Because bids are maintained at levels expected in competitive markets and energy prices are calculated and paid as they otherwise are in PJM, the energy market results under this regimen are in accordance with the expectations of a competitive market. The Joint Consumer Advocates conclude that using mitigation when necessary and market prices whenever possible maintains prices at just and reasonable levels. Also, it sends the appropriate price signals for potential market entrants. Allowing bids above the levels allowed by the PJM system would result in an inefficient dispatch of units because the least expensive unit to serve the next increment of load would not necessarily be utilized. Response by demand to these price signals will result in inefficient economic activity.

2. What type of mitigation measures should apply to post-1996 units?

The same mitigation rules should apply to all generating units. There are no exceptions to the requirement for just and reasonable pricing based on when a unit went into service. Prices that are the result of the exercise of market power are unreasonable regardless of how recently the unit exercising that market power was built. Generation owners have argued that there were certain expectations based on the current PJM rules, which exempt post-1996 units from the automatic local market power bid mitigation

regiment of PJM. Given the provisions of the FPA requiring just and reasonable prices, as well as the Commission orders establishing the market monitoring function in PJM and authorizing it to monitor for any market power in the PJM market, it would have been an unreasonable expectation for a generation developer to believe that it could profit from the exercise of market power in PJM energy markets.

3. Should there be differences in the types of mitigation applied to units built before and after 1996? Should there be a tighter market screen for post-1996 units?

As discussed in response to the previous question, the Joint Consumer Advocates believe that the same mitigation rules should apply to all units.

4. Should an auction be conducted to procure resources in a load pocket? Should the auction be held only when scarcity is determined, and, if so, how should the scarcity determination be made? When should this auction be held? How should an auction be structured?

The Joint Consumer Advocates support an auction process to procure needed resources in a load pocket. The auction should only be held when scarcity is determined for the load pocket. Scarcity pricing in the absence of scarcity will only result in the exercise of market power and a transfer of wealth from load to owners of generation in the load pocket.

In order to make the determination of scarcity, PJM should perform a reliability assessment of the entire region on a regular basis. This assessment should study a period three to five years into the future. PJM should forecast load growth for that timeframe and analyze whether there are any areas of the system that do not meet the appropriate planning reliability criteria. As a general statement, the planning criteria would be the N-1 criteria used by the Mid-Atlantic Area Council (“MAAC”). As PJM recommends in its filing, there should be a retirement policy and procedure for units located within PJM.

This procedure should require units to give PJM notice of intent to retire the unit and allow PJM reasonable period of time to study the reliability implications of such a retirement. PJM would use the same criteria in studying the potential retirement as it does to study the effect of load growth. If PJM finds that there is an area of the system that does not meet the reliability criteria either as a result of load growth or retirement, there would be a further evaluation of whether an auction would be necessary in that area to address that situation. There could be transmission or generation projects about to come on line that would eliminate the reliability violation without the need for an auction. The auction should be held with adequate time to allow the resources selected in the auction process to come on line prior to a scarcity situation actually existing in PJM. A unit retirement might trigger an immediate auction or the scarcity situation might be in the future and the auction would not need to be held immediately. As PJM's filing proposes, there should be a compensation scheme to allow a unit to recover its going forward costs net of other revenue if the retirement of the unit would cause an immediate reliability concern.

The auction should be structured to procure the least-cost resolution to the scarcity. All possible solutions should be considered including generation, transmission, demand response, and regulated transmission projects. Different types of solutions should be evaluated on an equivalent basis such that the solution that results in the least cost to customers is selected. The auction needs to be conducted by a neutral party that is in possession of all the necessary information and expertise to conduct such an auction. The Joint Consumer Advocates believe that the RTO is the most logical choice to administer the auction. This does not mean that the RTO would be taking a position in

the market. Rather, PJM would just be administering an auction which results in obligations on the part of a supplier and payments on the part of load, or LSEs, per the PJM tariff, just as PJM administers energy, capacity, and ancillary service markets today. The cost of the resources procured through such an auction would need to be allocated among customers. This allocation could spread over multiple service territories and even multiple jurisdictions. Thus, an entity with a regional scope, such the RTO, is best suited to administer the process.

5. Do the parties need a Commission determination on the concept of an auction in order to go forward?

The Joint Consumer Advocates strongly believe that the parties require a determination on the concept of an auction in order to go forward. The PJM stakeholder process has suffered from the fact that a segment of the stakeholders oppose the auction process in favor of some scarcity pricing mechanism for addressing local market power. A Commission determination approving the concept of the auction and directing PJM to make a compliance filing with the details of the auction is needed to allow the parties to move forward towards a resolution of the issues.

6. How does the local market power mitigation issue apply specifically to the PJM market? Please provide data if available.
  - a. How often are units offer-capped?
  - b. Are the offer-capped units just peaking units?
  - c. Does offer-capping only apply within certain load pockets?

The Joint Consumer Advocates do not have any independent information or responses to these questions and anticipates that PJM will provide this information.

7. Do concerns about exercise of market power of post-1996 units only apply to certain areas or units, or are the concerns across the board?

The concerns about the exercise of market power of post-1996 units only apply to instances when the unit can exercise local market power. While there are areas in PJM that chronically have local market problems, the same problem can arise throughout the system. In that sense, the concern is across-the-board because these mitigation rules must be applied throughout the region. However, the mitigation rules only result in change when the unit, per the PJM test, has the ability to exercise market power. In all other times, the mitigation scheme does not affect the units bid.

8. What should be the interaction between auctions and the economic expansion process within PJM's Regional Transmission Expansion Planning protocol?

The local scarcity auction is designed to address reliability problems that have not been otherwise resolved at a point in time where it is unreasonable to wait any longer to start a process to resolve the reliability problem. The economic expansion process should take into account any resources acquired through the local scarcity auction because those resources could obviate the need for an economic expansion or alter the cost-benefit analysis for a potential economic expansion. Because the local auction only takes place when it is necessary to ensure reliability, it cannot be deferred to await results of the economic planning process.

9. Should market participants have a process at FERC where they can file to adjust their bid caps if they are not recovering enough revenue to continue in operation? If so, how can the data be made available to FERC and the parties so that they can meaningfully participate in the process?

The Joint Consumer Advocates oppose this proposal. For one, there should be no special subsidy for a unit unless its retirement would create a violation of reliability criteria. Units that are not needed for reliability and are not making sufficient revenues in the energy market are inefficient units that should retire through the workings of the

competitive market. Also, this proposal appears to be similar to the Peaking Unit Safe Harbor (“PUSH”) mechanism implemented in New England that has not been perceived as successful.<sup>11</sup> Allowing individual units to increase their bids beyond competitive levels would allow for increased recovery for all units in the load pocket and might lead to a situation of unjust and unreasonable compensation. This would increase prices for the generators in the load pocket, but because of zonal pricing for LSEs, it would raise the load’s prices throughout the entire zone. This creates an incorrect, and unreasonable, price signal for all the load in the zone located outside of the load pocket and heavily dilutes the price signal to the load within a load pocket.

10. Who has and should have the ultimate responsibility for capacity procurement – RTOs or LSEs under state oversight?

Currently no one entity, or type of entity, has ultimate responsibility for capacity procurement, either locally or globally, in PJM. LSEs have a capacity obligation which obligates them to pay up to the deficiency rate if they have not secured capacity. LSEs do not have the obligation to procure capacity in any particular region in PJM. PJM analyzes the capacity requirements of the region, the relationship of the available capacity to the capacity requirement, and provides that information to market participants and stakeholders. PJM also administers capacity markets per its FERC tariff. The states, in general, only require retail suppliers serving load in their jurisdiction to comply with PJM’s rules for LSEs.

The independent position of the RTO, as well as its possession of the pertinent information and knowledge of the system should be utilized to provide analyses of the capacity needs, both global and local, of the system to maintain reliability. If those

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<sup>11</sup> Transcript for February 4, p. 182-3 (Robert Ethier, ISO-NE Market Monitor).

capacity needs have not been met by the market by some designated point in time prior to the capacity need, then the RTO can administer a procurement process that results in suppliers taking on obligations to provide capacity and load, or the loads' LSEs at the time of service, having payment obligations. The RTO can act as the conduit for payment from load to suppliers at the time the capacity is supplied.

Respectfully submitted,

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DATED: February 20, 2004

**CERTIFICATE OF SERVICE**

I HEREBY CERTIFY that on this 20<sup>th</sup> day of February, 2004, a copy of the forgoing Post-Technical Conference Comments of the Joint Consumer Advocates was mailed first-class, postage-prepaid to each person designated on the official service list compiled by the Secretary in these proceedings.

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February 20, 2004

Hon. Magalie Roman Salas  
Office of the Secretary  
Federal Energy Regulatory Commission  
Dockets Room – Room 1A  
888 First Street, N.E.  
Washington, DC 20426

**Re: Docket Nos. PL04-2-000 and EL03-236-000**

Dear Secretary Salas:

Attached is the Post-Technical Conference Comments of the Joint Consumer Advocates for electronic filing in the above-referenced proceeding.

If you have any questions, please do not hesitate to contact me.

Very truly yours,

William F. Fields  
Assistant People's Counsel

WFF/mcm  
Enclosures  
cc: Service List