PJM Capacity (Performance) 2018–19 Auction Outlook
The Quest for the Marginal Generator

Executive Summary
Capacity performance, or CP, does increase the marginal cost of capacity for marginal generators in the upcoming auction, but the bullish impact should be less than the market expects. Performance penalties, in the form of shortage pricing, should be partially priced into last year's auction, with penalties now at $3,300/MW-hour when a generator cannot deliver energy during reserve shortages. CP is simply a more far-reaching, stricter penalty structure that penalizes generators for nonperformance outside of reserve shortages but contains a stop-loss. There is no stop-loss in shortage pricing.

We estimate that the combination of CP, demand response partially "stepping out," and increased confidence of marginal generators to raise prices will cause CP to clear at $150/MW-day and Base Capacity at $140 for upcoming 2018-19 PJM Base Residual Auction. Although generators participating in CP will not be constrained by their avoidable cost rates this year — allowing generation to offer up to net CONE times the balancing ratio — we suspect that few generators will raise offer prices for this reason alone. If we believed that generators would include in their offers all increased marginal costs associated with CP, we would be materially more bullish the clear. However, in practice, generators' offers are much more conservative to ensure that they clear, and we do not expect generators to recover all of their marginal cost increases associated with CP. We also highlight the possible expected increase in dark spreads over the 2018–19 time frame because of the large increase in LNG exports over this time period; this could add downside pressure to capacity offers from coal generation in PJM.

Key Takeaways
► Bullish: CP penalties increase the marginal cost of capacity for the marginal generators by lowering expected net revenues.
► Bullish: Increased constraints on demand response, or DR, and the uncertainties related to the Supreme Court's review of EPSA v. FERC will mean more price-sensitive generator offers in the auction.
► Bearish: PJM's load forecast for 2018–19 is 2.6% lower than previously forecasted. We think this will offset any bullish implications from the removal of the short-term resource procurement target (+2.5%).
► Bearish: Performance penalties in the form of shortage pricing should have already been partially priced into the marginal costs of generators in previous auctions, thus capacity performance costs are only incremental to the existing regime.

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