PPL CFO Issues Letter to Analysts

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Following is a letter that John R. Biggar, PPL Corporation's (NYSE: PPL) executive vice president and chief financial officer, sent to financial analysts Monday (6/17):

(Photo: http://www.newscom.com/cgi-bin/prnh/19981015/PHTH025)

To Members of the Financial Community:

I'm writing today to provide you with some additional information on recent media reports concerning PPL EnergyPlus' activities in the Pennsylvania-New Jersey-Maryland Interconnection capacity market.

You may have read that the Pennsylvania Public Utility Commission ("PUC") has completed its investigation of PPL's actions in this market and has issued a report referring the matter to the Department of Justice, the Federal Energy Regulatory Commission and the Pennsylvania Attorney General. The PUC alleges that PPL had "unfairly manipulated wholesale electricity markets in early 2001."

We're very disappointed with the PUC report. I want to point out that neither the PUC nor the PJM Market Monitor has claimed that PPL violated any law or regulation. In fact, the Market Monitor said that his comments on PPL EnergyPlus' market behavior applied criteria broader than the antitrust laws. In any venue in which we will need to respond, PPL will present evidence to prove that we acted ethically and legally, in compliance with all applicable laws and regulations.

As background, companies that sell electricity to end users in the PJM control area are required to have capacity credits to ensure the reliability of electricity service. In November of 2001, the PJM Market Monitor publicly released a report relating to the PJM capacity market in the first quarter of 2001. The report concluded that PPL EnergyPlus violated no PJM rules, but that report did (inaccurately) claim that PPL was able to exercise market power to raise the price of capacity credits.

Later in November 2001, the PUC issued an Investigation Order directing its Law Bureau to conduct an investigation into the Market Monitor's allegations. Various parties, including PPL, have filed comments and reply comments. Without receiving other evidence or hearing witnesses, the Commission issued its report on June 13 saying, among other things, that it had reason to believe that PPL had unfairly manipulated the wholesale electricity market. It also said that PJM rules did not prohibit PPL's actions.

As we stated in our comments and reply comments to the PUC in this proceeding, PPL made sound business decisions in a commodity market based on information that was available to all market participants. PPL decided to go into the first quarter of 2001 in a "long" position, while some other companies in the PJM decided to rely on the spot market for capacity. All participants in the market had the same opportunity to buy and sell capacity as did PPL. In this regard, PJM in October 2000 made public to both capacity owners and Load Serving Entities that an increase in capacity obligations would become effective beginning January 1, 2001. There is no allegation that PPL engaged in any deceptive conduct in its trading practices.

Capacity prices increased in the first quarter of 2001 not because of PPL's actions, but because of the increased PJM capacity requirements that became effective January 1, 2001.

We had neither a monopoly nor a dominant position in the capacity market. And, we had offered longer-term contracts at very moderate prices in late 2000, but a number of companies that apparently needed capacity declined those offers in favor of betting on the spot market. This is not the first time, as you know, when companies who chose to rely on the spot market had an unfavorable outcome and sought help from the regulators.

In case you'd like to better understand how this PJM market works, I've attached our description of this market that is excerpted from the comments we filed with the PUC.

PPL continues to believe that its actions were legal and ethical, and we will cooperate with any additional investigations that result from the PUC report. I should also point out that FERC already has rejected a claim by New Power related to PPL's actions in the PJM market, concluding that the conditions that caused temporary price increases in early 2001 were no longer affecting the PJM capacity market.

I'd like to assure you once again that PPL has long-standing policies to ensure that, across the Company, the actions of our marketing operation are ethical and legal. We take pride in the high standards that we have established for our energy marketing business. As I'm sure you know, we recently assured regulators that our energy marketing subsidiary has not engaged in the type of California trading strategies that have been attributed to Enron. Also, even before regulators asked PPL to do so, we confirmed that we have not engaged in so-called "wash trades," in which traders buy and sell electricity without profit or loss with the intent of increasing a company's sales volumes and revenues.

We'll keep you informed of any further developments in this matter. If you'd like to talk more about this issue, please call Joe Bergstein in our Investor Relations Department at 610/774-5609.

Sincerely,

John R. Biggar

Excerpt from Comments Filed by PPL EnergyPlus with the Pennsylvania Public
Utility Commission in Connection with the PUC's Investigation
Of PPL EnergyPlus in the PJM Capacity Market

Overview of the PJM Capacity Market.

The purpose of the PJM capacity market is to provide long-term generation adequacy for the PJM control area. Capacity is the ability to generate electric energy. Under PJM rules, capacity is accounted for and traded separately from electric energy, and serves a separate purpose. While the amount of energy demanded of each LSE [Load Serving Entity] varies on a second-by-second basis and is entirely dependent upon customer usage, capacity requirements are established in advance by the PJM Reliability Committee.(1) The capacity requirements are designed to ensure that the PJM pool as a whole has the continuing ability to match generation and load on an uninterrupted, on-going basis, both in the very short term (minute by minute) and over the long term as demand in the PJM pool grows.(2) These requirements are critical to maintaining reliable electric resources within the PJM system.

To set capacity requirements, the PJM Office of Interconnection, in consultation with the PJM Reliability Committee, undertakes an annual process that determines the capacity resources required for PJM as a whole. The process is entirely open and transparent and based on publicly available data, principally the pool-wide system peak loads and five-year rolling average forced outage rates for PJM system generation.(3) The total capacity requirement, including a reserve margin, is then allocated among the various LSEs based on zonal peak load (i.e., retail demand). This amount of capacity that each LSE is required to maintain on a daily basis is referred to as its "Accounted-For Obligation." An LSE can satisfy its Accounted-For Obligation by [1] self-supplying (using its own generation facilities), [2] acquiring capacity through bilateral contracts with other entities, or [3] purchasing capacity credits in one of the PJM capacity credit auction markets. Historically, LSEs in the PJM pool have satisfied approximately 95 percent of their capacity obligations either by self-supply or bilateral contracts, with the remaining five percent satisfied by transactions in capacity credit markets.(4)

PJM administers separate capacity credit markets for daily, monthly, and multi-monthly capacity transactions. These are auction markets, with daily auctions conducted for capacity credits to meet Accounted-For Obligations for the following day.(5) In the daily market, which is the subject of the MMU [Market Monitoring Unit] Report, a party that has capacity in excess of its needs for the next day may offer to sell its excess credits at a particular price (a "Sell Offer"). An LSE that needs additional capacity to meet its Accounted-For Obligation for the upcoming day may offer to buy, at whatever price it wishes to quote, the amount of capacity credits that it needs (a "Buy Bid"). After receiving all Sell Offers and Buy Bids for the day in question, the PJM staff ranks the Sell Offers from the lowest to the highest, and the Buy Bids from the highest to the lowest. The market-clearing price is the price at which the next (or marginal) Sell Offer is equal to or less than the next (or marginal) Buy Bid. Sellers who offered to sell at or below the market-clearing price receive that price, and buyers who bid at or above the price pay the market-clearing price.(6)

As in any auction, this process does not guarantee that all LSEs seeking to purchase capacity credits will succeed in purchasing what they need at the price they quote. A would-be buyer that bids below the market-clearing price will not have its bid accepted and thus might still be short of capacity needed to meet its Accounted-For Obligation for the next day. In addition, even if an LSE made a Buy Bid above the market-clearing price, the total capacity credits offered at that price could be insufficient to cover all Buy Bids. If an LSE is still short after the daily auction and is not otherwise able to secure its needed capacity in time for the next day, that LSE will -- under the terms of the RAA -- be assessed a capacity deficiency charge. The capacity deficiency charge is measured in MW per day (the "capacity deficiency rate" or "CDR") at a level based on the projected daily carrying costs for installation of a new combustion turbine generator. The capacity deficiency rate is subject to review and approval by FERC.(7)

(1) All LSEs in the PJM control area are required to be parties to the Reliability Assurance Agreement Among Load Serving Entities in the PJM Control Area (the "RAA"). A Reliability Committee, composed of representatives of the LSEs, administers the RAA, with day-to-day operations delegated to the PJM staff.

(2) Long-term planning is essential to reliability since development of new generation facilities generally takes a two-year lead time at a minimum.

(3) The established capacity requirements include an allowance for the probability of "forced" outages. The Accounted-For Obligation must be met on the basis of "unforced capacity," i.e., an adjusted amount of capacity that is projected to be available after taking account of forced outages.

(4) PJM Interconnection, L.L.C., 95 FERC q 61,175, at 61,563 (2001).

(5) The longer-term auctions occur at various intervals prior to the period for which the capacity credits are being traded.

(6) See PJM Interconnection, L.L.C., 86 FERC q 61,017, at 61,042 (1999).

(7) FERC's approval of the rate currently in effect, $177 per MW per day, occurred when PJM was established as an independent system operator. See PJM Interconnection, L.L.C., 81 FERC q 61,257, at 62,276 n.197 (1997).

In some instances, a deficient LSE may be assessed an amount higher than the CDR. Under the PJM rules, a deficient party must pay twice the capacity deficiency rate on a day when the pool as a whole is deficient. Also, LSEs that are chronically deficient are ultimately assessed a penalty that is somewhat above the capacity deficiency rate. For simplicity, we refer to this set of rules as the "capacity deficiency formula."

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