

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

|                |   |                            |
|----------------|---|----------------------------|
| Fern Solar LLC | ) |                            |
|                | ) | Docket Nos. ER20-2186-003, |
|                | ) | EL20-62-001                |
|                | ) |                            |

ON BEHALF OF THE  
INDEPENDENT MARKET MONITOR FOR PJM

**SUMMARY OF DIRECT AND ANSWERING TESTIMONY OF  
JOSEPH E. BOWRING ON BEHALF OF  
THE INDEPENDENT MARKET MONITOR FOR PJM**

1           The purpose of my testimony in this case is to identify flaws in the reactive  
2 capability rate proposed by the applicant and to explain why the generating facilities in  
3 these proceedings are not eligible to receive the requested compensation from PJM  
4 Interconnection, L.L.C. under Schedule 2 to the PJM Open-Access Transmission Tariff  
5 (“Schedule 2”). Schedule 2 is provided as Exhibit No. IMM-0002.

6           The out of market payment requested by Fern, \$1,515,821.19 per year, or  
7 \$15,158.21 per MW-Year, or \$41.53 per MW-day, is excessive. The *AEP* Method does  
8 not apply to solar facilities and should not be used to define the reactive revenue  
9 requirement for any unit in PJM markets. The capital recovery factor used by Fern to  
10 translate the capital investment into an annual revenue requirement is incorrect and not  
11 adequately supported.

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

Fern Solar LLC )  
 ) Docket No. ER20-2576-001  
 )

**DIRECT AND ANSWERING TESTIMONY OF JOSEPH E. BOWRING  
ON BEHALF OF THE INDEPENDENT MARKET MONITOR FOR PJM**

1 **Q 1. PLEASE STATE YOUR NAME AND POSITION.**

2 A. My name is Joseph E. Bowring. I am the Market Monitor for PJM. I am the  
3 President of Monitoring Analytics, LLC. My business address is 2621 Van Buren  
4 Avenue, Suite 160, Eagleville, Pennsylvania. Monitoring Analytics serves as the  
5 Independent Market Monitor (IMM) for PJM, also known as the Market Monitoring  
6 Unit (MMU or Market Monitor). Since March 8, 1999, I have been responsible for  
7 all the market monitoring activities of PJM, first as the head of the internal PJM  
8 Market Monitoring Unit and, since August 1, 2008, as President of Monitoring  
9 Analytics. The market monitoring activities of PJM are defined in the PJM Market  
10 Monitoring Plan, Attachment M and Attachment M-Appendix to PJM Open Access  
11 Transmission Tariff (OATT).<sup>1</sup>

12 **Q 2. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

13 A. The purpose of my testimony is to explain the Market Monitor's position on the  
14 proposed annual revenue requirement ("ARR") filed in this proceeding by Fern  
15 Solar LLC ("Fern") for its 100 MW solar generating facility located in Tarboro,  
16 North Carolina ("Fern Facility").

17 Fern proposes an annual revenue requirement of \$1,515,821.19 per year, or  
18 \$15,158.21 per MW-Year, or \$41.53 per MW-day. The proposed ARR is excessive.

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<sup>1</sup> See *PJM Interconnection, L.L.C.*, 86 FERC ¶ 61,247; 18 CFR § 35.34(k)(6).

1 The proposed ARR is a disproportionately large share of the total capital costs of the  
2 resource. The proposed ARR is significantly higher than the average rate paid for  
3 reactive power in PJM. The proposed ARR is 83 percent of the clearing price in the  
4 last PJM capacity market auction for the Rest of RTO LDA. On an equivalent  
5 capacity basis using the 60 percent derate factor for tracking solar, the proposed  
6 ARR is \$69.22 per MW-day, or 138 percent of the clearing price in the last PJM  
7 capacity market auction for the Rest of RTO LDA. In effect Fern Solar is proposing  
8 that customers pay more for the reactive ancillary service than the full price of  
9 capacity. That result would be unreasonable and excessive and inconsistent with a  
10 competitive market. The proposed ARR exceeds the \$2,199 per MW-year level of  
11 the ancillary services revenue offset included in the PJM market rules. The ARR  
12 should capped at \$2,199 per MWh-Year. The proposed annual carrying charge is  
13 incorrect and not adequately supported. The Market Monitor has calculated an  
14 appropriate capital recovery factor (“CRF”).

15 **Q 3. HAVE YOU PROVIDED TESTIMONY ON COMPENSATION FOR**  
16 **REACTIVE POWER IN OTHER PROCEEDINGS BEFORE THE FERC?**

17 A. Yes. I provided testimony in the *Panda Stonewall* reactive supply capability case  
18 (Docket No. ER21-1821-002), the *Whitetail Solar 3, et al.* reactive supply capability  
19 case (Docket No. ER20-1851-004 et al.), the *Mechanicsville Solar, LLC* reactively  
20 capability case (ER21-2091-000), and the *Holloman Lessee LLC* reactive capability  
21 case (ER20-2576-001). I provided an affidavit in support of opposition to an offer of  
22 settlement in the *Meyersdale Storage, LLC*, reactive supply capability case (ER21-  
23 864-000), the *Bluestone Farm Solar, LLC*, reactive supply capability case (ER21-  
24 1696-000), the *Altavista Solar, LLC*, reactive supply capability case (ER21-1937-  
25 000), and the *Pleinmont Solar 1, LLC et al.*, reactive supply capability case (ER21-  
26 2819-000 et al.).

27 **Q 4. HAVE YOU PARTICIPATED IN OTHER FERC PROCEEDINGS**  
28 **RELATED TO REACTIVE POWER?**

29 A. Yes, I was invited to participate in a Commission technical conference and provided  
30 comments to the Commission in a proceeding convened to “discuss compensation  
31 for Reactive Supply and Voltage Control (Reactive Supply) within the Regional

1 Transmission Organizations (RTOs) and Independent System Operators (ISOs).”<sup>2</sup>  
2 Specifically, the proceeding explored “types of costs incurred by generators for  
3 providing Reactive Supply capability and service; whether those costs are being  
4 recovered solely as compensation for Reactive Supply or whether recovery is also  
5 through compensation for other services; and different methods by which generators  
6 receive compensation for Reactive Supply (e.g., Commission-approved revenue  
7 requirements, market-wide rates, etc.).”<sup>3</sup>

8 On February 22 and March 23, 2022, the Market Monitor filed comments and reply  
9 comments responding to the Commission’s Notice of Inquiry in Docket No. AD22-  
10 2. The Notice of Inquiry included questions (at P 28 (question no. 5.d)) specifically  
11 addressing the over recovery issue. The Notice of Inquiry also included questions (at  
12 PP 20–28 (question no. 5) addressing the appropriateness of continuing to use the  
13 AEP Method in reactive capability proceedings, particularly proceedings to establish  
14 ARRs for asynchronous generators.

15 The Market Monitor has intervened in and actively participated in FERC reactive  
16 power cases during the past five years.

17 The Market Monitor includes analysis and recommendations related to reactive  
18 power in the State of the Market Reports for PJM.<sup>4</sup>

19 **I.**

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<sup>2</sup> *Reactive Supply Compensation in Markets Operated by Regional Transmission Organizations and Independent System Operators*, Docket No. AD16-17-000. I participated in a workshop convened June 20, 2016. The Market Monitor filed comments on July 29, 2016, and reply comments on September 20, 2016.

<sup>3</sup> *Id.* at 1.

<sup>4</sup> See, for example, *2020 State of the Market Report for PJM*, Section 10 (Ancillary Services Markets), which can be accessed at: [http://www.monitoringanalytics.com/reports/PJM\\_State\\_of\\_the\\_Market/2020.shtml](http://www.monitoringanalytics.com/reports/PJM_State_of_the_Market/2020.shtml).

1 **Q 5. WHY SHOULD THE PROPOSED ANNUAL REVENUE REQUIREMENT**  
2 **BE REJECTED?**

3 A. The proposed payment to the 100 MW Fern facility (ARR) of \$1,515,821.19 per  
4 year, or \$15,158.21 per MW-Year, or \$41.53 per MW-day is excessive.

5 The *AEP* Method that is typically used in reactive capability proceedings was  
6 developed for use with generating facilities that have very different engineering and  
7 operational characteristics.<sup>5</sup> Regardless of whether the *AEP* Method is itself  
8 appropriate for use in establishing reactive capability costs, there is no  
9 corresponding method for defining the reactive capability costs, if any, associated  
10 with solar facilities.

11 Even by the standards of the *AEP* Method, an ARR of \$1,515,821.19 per year, or  
12 \$15,158.21 per MW-Year, or \$41.53 per MW-day, is excessive, has not been  
13 demonstrated to have a rational basis, has not been demonstrated to be just and  
14 reasonable, and should be rejected. The average revenue requirement for reactive  
15 capability is about \$2,000 per MW-year. The revenue requirement for reactive  
16 capability included in the PJM Capacity Market is \$2,199 per MW-year.

17 There is no reasonable basis for such a wide disparity in cost for the same service.  
18 This result has not been explained or supported by Fern. This disparity is  
19 inconsistent with competitive markets.

20 **II.**

21 **Q 6. HOW DO PJM MARKET RULES PROVIDE THE OPPORTUNITY TO**  
22 **RECOVER REACTIVE CAPABILITY COSTS?**

23 A. The PJM market rules that account for recovery of reactive revenues are built into  
24 the auction parameters, specifically, the VRR Curve. The PJM market rules  
25 explicitly account for recovery of reactive revenues of \$2,199 per MW-year through  
26 inclusion in the Net CONE parameter of the capacity market demand (VRR) curve.<sup>6</sup>

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<sup>5</sup> See *American Electric Power Service Corp.*, 80 FERC ¶ 63,006 (1997), *aff'd*, 88 FERC ¶ 61,141 (1999); see also *Reactive Power Capability Compensation*, Notice of Inquiry, 177 FERC ¶ 61,118 (2021) (“Notice of Inquiry”).

<sup>6</sup> See OATT Attachment DD § 5.10(a)(v)(A).

1 The Net CONE parameter directly affects clearing prices by affecting both the  
2 maximum capacity price and the location of the downward sloping part of the VRR  
3 curve.

4 **Q 7. HOW DOES THE \$2,199 PER MW-YEAR NUMBER AFFECT THE**  
5 **DEMAND CURVE FOR CAPACITY?**

6 A. Elimination of the ancillary services revenue offset of \$2,199 per MW-Year would  
7 mean that the prices on the capacity market demand curve (VRR curve) for each  
8 MW level would be higher and the clearing prices for capacity that result from the  
9 interaction of the supply curve and the VRR curve, would be higher. The result  
10 would be the recovery of additional reactive capacity revenues in the price of  
11 capacity for all resources.

12 **Q 8. WHY IS THE DEMAND CURVE RELEVANT?**

13 A. If there were no nonmarket recovery of reactive revenue, there would be no reactive  
14 revenue offset to Net CONE and the demand curve would result in higher capacity  
15 market prices, all else held constant. If there were no nonmarket recovery of reactive  
16 revenue, the shape and location of the demand curve would give unit owners the  
17 opportunity to recover all reactive capability costs in the capacity market.

18 This is how the capacity market works for all the other costs of a generating plant  
19 other than short run marginal costs.

20 Payments based on cost of service approaches result in distortionary impacts on  
21 PJM markets. Elimination of the reactive revenue requirement and the recognition  
22 that capital costs are not distinguishable by function would increase prices in the  
23 capacity market. The VRR curve would shift to the right, the maximum VRR price  
24 would increase and offer caps in the capacity market would increase. The simplest  
25 way to address this distortion would be to recognize that all capacity costs are  
26 recoverable in the PJM markets.

27 The best approach would be to eliminate cost of service rates for reactive capability  
28 and allow for recovery of capacity costs through existing markets, including a  
29 removal of any offset for reactive revenue in offers and in the capacity market  
30 demand (VRR) curve. A second best approach would be to limit the revenue  
31 requirement that could be filed for under the OATT Schedule 2 to a level less than

1 or equal to the reactive revenue credit included in the capacity market design, in the  
2 VRR curve Net CONE value, currently \$2,199 per MW-year.

3 **III.**

4 **Q 9. SHOULD THE *AEP* METHOD BE USED TO CALCULATE THE RATE**  
5 **FOR THE FERN FACILITY?**

6 A. No. The current process does not actually compensate resources based on their costs  
7 of investment in reactive power capability. The *AEP* Method assigns costs between  
8 real and reactive power based on a unit's power factor. This is effectively an  
9 allocation based on a subjective judgment rather than actual investment. There are  
10 few if any identifiable costs incurred by generators in order to provide reactive  
11 power. Separately compensating resources based on a judgment based allocation of  
12 total capital costs was never and is not now appropriate in the PJM markets.  
13 Generating units are fully integrated power plants that produce both the real and  
14 reactive power required for grid operation.

15 The *AEP* Method originated with a regulated utility assigning costs between two  
16 sources of regulated revenue requirement. The practice persists in PJM only because  
17 it provides a significant, guaranteed stream of riskless revenue. Generation owners  
18 have an incentive to maximize such guaranteed revenue streams.

19 There is no logical reason to have a separate fixed payment for any part of the  
20 capacity costs of generating units in PJM. If separate cost of service rates for  
21 reactive continue, they need to be correctly integrated in the PJM market design.

22 The best and straightforward solution is to remove cost of service rates for reactive  
23 supply capability and to remove the offset. Investment in generation can and should  
24 be compensated entirely through markets. Removing cost of service rules would  
25 avoid the significant waste of resources incurred to develop unneeded cost of  
26 service rates.

27 The result would be to pay generators market based rates for both real and reactive  
28 capacity.

29 The *AEP* Method never accurately reflected the investment costs of providing  
30 reactive power, nor was it intended to do so. The *AEP* Method is a cost of service  
31 allocation approach designed to assign the regulated revenue requirement for



1 generating units to a regulated generation function and a regulated transmission  
2 function. The *AEP* Method was designed to split that cost recovery for generating  
3 units in a reasonable way, based on a judgment about what is reasonable. The *AEP*  
4 Method was never about actually identifying specific capital costs associated solely  
5 with the provision of reactive power. Cost of service approaches apply allocation  
6 factors to accounting line items based on assumptions. The assumptions are that X  
7 percent of a type of equipment at a generating plant is associated with reactive  
8 power while (1-X) percent is associated with real power. The false precision of the  
9 *AEP* Method is entirely based on arbitrary assumptions. Even proponents of the  
10 *AEP* Method do not assert that the goal is to recover only the costs associated with a  
11 specific portion of a power plant required for the production of reactive power, or,  
12 in most cases, that such identification is even possible. That is not what the *AEP*  
13 Method was intended to do or is intended to do. The *AEP* Method does not define  
14 costs that are uniquely associated with the production of reactive power.

15 The *AEP* Method is based on the incorrect premise that the capacity costs of an  
16 integrated power plant are separable. The capacity costs of an integrated power plant  
17 are not separable.

18 The fundamental flaw in the *AEP* Method approach is the assumption that the costs  
19 of providing reactive power are a function of the power factor. The power factor is  
20 the ratio of real power (expressed as megawatts or MW) to the total output (apparent  
21 power) of a generator (expressed as megavolt-amperes or MVA). The remaining  
22 output is reactive power (expressed as megavolt amperes reactive or MVAR). The  
23 allocator typically used by proponents of the *AEP* Method to assign costs to reactive  
24 power generation is  $(1 - (\text{PowerFactor})^2)$ . The power factor has superficial attraction  
25 as an appropriate allocator. The power factor is the core determinant of the reactive  
26 allocation factor in the *AEP* Method. Small changes in the power factor have large  
27 impacts on the costs allocated to reactive power. For a power factor of .95, the  
28 allocator is 9.75 percent while for a power factor of .90, the allocator is 19.00  
29 percent, and for a power factor of .70, the allocator is 51.00 percent. For a resource  
30 claiming a power factor of .70, does that mean that more than half of the generator's  
31 costs were incurred in order to provide reactive power? Does this mean that 51  
32 percent of the costs of the generator, exciter, and electrical equipment should be  
33 recovered through a cost of service rate? The answer to both questions is no. But  
34 resources have filed for guaranteed reactive revenue requirements on that basis.

1 The power factor has taken on somewhat mythical significance in the discussion of  
2 reactive power. There are frequently long discussions of power factors in reactive  
3 cases. The ratio of real to reactive power can vary significantly. The typical actual  
4 operating power factor of generators in PJM is determined by their voltage schedule  
5 and is usually between .97 and .99. The resultant *AEP* Method power factor  
6 allocator consistent with this actual reactive output of PJM generators and the actual  
7 tariff defined reactive output to generators is 5.91 to 1.99 percent. The nameplate  
8 power factor of thermal generating units is typically .85. But the nameplate power  
9 factor stamped on the generator at the factory and not based on actual operation on  
10 an actual grid. The nameplate power factor is meaningless for the actual operation  
11 of the power plant. The nameplate power factor does not mean that 27.75 percent of  
12 the power plant capital costs are associated with reactive power, although many  
13 resources have made that request because that is the power factor allocator based on  
14 the nameplate rating.

15 The power factor is not an appropriate allocator and does not reflect the actual  
16 capital costs associated with producing reactive power. The power factor has taken  
17 on a disproportionate significance in reactive rate cases because it is the single most  
18 important allocator in the *AEP* Method. That significance illustrates the fundamental  
19 flaws in the *AEP* Method.

20 The power factor does not measure reactive capability. The power factor does not  
21 determine a plant's reactive capability. The power factor does not identify costs  
22 associated with reactive capability or provide a reasonable basis for allocating those  
23 costs to reactive or real power production.

24 **IV.**

25 **Q 10. WHAT ARE THE ISSUES WITH THE COMPANY'S PROPOSED**  
26 **ANNUAL CARRYING CHARGE CALCULATION?**

- 27 A. Fern calculates an annual carrying charge which is a form of capital recovery factor  
28 (CRF). This CRF was presented in the prepared direct testimony of Donald J.  
29 Clayton on June 26, 2020.<sup>7</sup> Witness Clayton derives a fixed charge carrying rate

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<sup>7</sup> See FS-1 at 19–21.

1 which is the sum of a CRF and a fixed operating expense rate.<sup>8</sup> The CRF presented  
2 by Witness Clayton is the sum of a sinking fund depreciation factor and the before  
3 tax weighted average cost of capital, offset by a factor accounting for Accumulated  
4 Deferred Income Taxes. The analysis assumes a 25 year project life. The derivation  
5 does not accurately reflect the tax liability or the return on and the return of the  
6 capital investment.

7 The CRF is a rate, multiplied by the relevant investment, which defines the annual  
8 payment needed to provide a return on and of capital for the investment over a  
9 defined time period. CRFs include as inputs the weighted average cost of capital and  
10 its components, including the rate of return on equity and the interest rate on debt  
11 and the capital structure, in addition to depreciation and taxes. The Market  
12 Monitor's CRF accurately reflects the tax liability associated with the annual  
13 payment. The depreciation used in the calculation of the CRF should reflect the  
14 depreciation used for tax purposes. The sinking fund depreciation factor does not  
15 reflect the actual depreciation used by Fern and therefore should not be used in the  
16 calculation of the revenue requirement for the Fern facility.

17 Witness Clayton did not account for the actual tax treatment of the facility and did  
18 not adequately explain his tax treatment, did not account for the actual expected life  
19 of the facility, did not adequately explain or support his depreciation method, and  
20 did not account for the actual cost of capital of the facility.

21 **Q 11. HOW DO YOU PROPOSE TO CALCULATE THE CAPITAL RECOVERY**  
22 **FACTOR (CRF)?**

23 A. The best approach for calculating capital recovery over a defined period is the  
24 Capital Recovery Factor (CRF) used by the Market Monitor. I have attached to my  
25 testimony as Exhibit No. IMM-0003, a Capital Recovery Factors (CRF) Technical  
26 Reference prepared by the Market Monitor. The technical reference explains in  
27 detail the components for accurately and consistently calculating a CRF.

28 The CRF should be required for use in all cost based ratemaking provisions used in  
29 PJM, which now include black start service rates and reactive capability rates.

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<sup>8</sup> *Id.*

1 The CRF as proposed by the Market Monitor provides the necessary and sufficient  
2 level of revenue to pay the annual tax liability and the return on and return of the  
3 capital investment. The CRF approach proposed by the Market Monitor is based on  
4 the weighted average cost of capital (WACC) capital budgeting method. Under the  
5 WACC approach, the after tax cash flow is discounted at the after tax WACC rate  
6 and the payback of the investment in each cost recovery year reflects the defined  
7 capital structure. This approach can be efficiently reduced to a single formula for the  
8 CRF. FERC accepted this approach for black start service and directed PJM to  
9 include the CRF formula in the PJM tariff.<sup>9</sup> Additional details on the derivation of  
10 the CRF formula and examples are available in the MMU's CRF Technical  
11 Reference.

12 The Market Monitor used the CRF approach to determine an annual revenue  
13 requirement based on the capital cost data and financing structure provided in the  
14 Clayton Testimony. The results are shown in Exhibit Nos. IMM-0004 and IMM-  
15 0005. For a 25 year cost recovery period, the Market Monitor's CRF is 0.085862  
16 and the corresponding annual revenue payment is \$860,321.<sup>10 11</sup> The Market  
17 Monitor's CRF is lower than the CRF proposed by Clayton. The Market Monitor's  
18 annual revenue payment in Exhibit No. IMM-0004 reflects a reduction to the  
19 reactive capital cost to account for an investment tax credit (ITC). The Fern Solar  
20 plant would have been eligible for an ITC and it should be reflected in the reactive  
21 cost recovery. The annual payment for capital cost recovery proposed by Witness  
22 Clayton apparently does not reflect an ITC.

23 Holding other issues aside, solely as a result of the corrections to the CRF and the  
24 treatment of the ITC, Fern Solar's requested revenue requirement (ARR) is too high  
25 by \$377,550. Corrections to these two items alone reduce the ARR by 30.5 percent.  
26 This is not the Market Monitor's proposed reactive payment. This difference is the  
27 overstatement, within Fern Solar's own logic, of the revenue requirement. The

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<sup>9</sup> See *PJM Interconnection, L.L.C.*, 176 FERC ¶ 61,080 at PP 43–44 (2021).

<sup>10</sup> The formula for the CRF is equation (1.4) in the CRF Technical Reference. The calculation assumes the half year convention for the timing of revenue and tax payments.

<sup>11</sup> This value reflects the capital cost recovery and does not include fixed operating expenses to protect confidential information.

1 Market Monitor's CRF calculations in Exhibits Nos. IMM-0004 and IMM-0005  
2 reflect 100 percent bonus depreciation that allows generators placed in service after  
3 September 27, 2017, to fully depreciate the capital investment in the first year of  
4 operation. Exhibit No. IMM-0005 shows the Market Monitor's proposed capital  
5 cost recovery assuming a reduction for an ITC is not warranted.

6 Exhibit Nos. IMM-0004 and IMM-0005 also show the CRFs and corresponding  
7 capital recovery payments for recovery periods exceeding 25 years. For example,  
8 the Market Monitor's CRF for a 40 year cost recovery period is 0.075600. The  
9 corresponding annual payment is \$757,492 under the assumption that the reduction  
10 of the reactive capital cost by an ITC is applicable.<sup>12</sup>

11 Witness Clayton has not explained why a 25 year life rather than a 30 or 40 year life  
12 is appropriate for the Fern facility. It is my experience that comparable solar units  
13 frequently assert that they have useful life in excess of 25 years. Such longer life  
14 should be reflected in the CRF.

15 Witness Clayton has not explained the actual cost of capital for the Fern facility or  
16 explained why the actual cost of capital should not be used in the calculation of the  
17 CRF.

18 The tables in Exhibits Nos. IMM-0004 and IMM-0005 are included to illustrate the  
19 implications of the issues with the company's CRF calculations for the annual  
20 revenue requirement, based on the assumptions that the company's allocation of  
21 costs to reactive are correct. I do not support using the annual revenue requirements  
22 in Exhibits Nos. IMM-0004 and IMM-0005, but include the calculations solely for  
23 the purpose of showing the implications of the incorrect CRF calculations proposed  
24 by Fern.

25 **Q 12. DOES THIS CONCLUDE YOUR TESTIMONY?**

26 A. Yes.

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<sup>12</sup> This value reflects the capital cost recovery and does not include fixed operating expenses to protect confidential information.

**Exhibit IMM-0002**  
**PJM OATT Schedule 2**

PJM OATT Schedule 2 - Reactive Supply  
and Voltage Control from Generation or  
Other Sources Service

**SCHEDULE 2**  
**Reactive Supply and Voltage Control from**  
**Generation or Other Sources Service**

In order to maintain transmission voltages on the Transmission Provider's transmission facilities within acceptable limits, generation facilities and non-generation resources capable of providing this service that are under the control of the control area operator are operated to produce (or absorb) reactive power. Thus, Reactive Supply and Voltage Control from Generation or Other Sources Service must be provided for each transaction on the Transmission Provider's transmission facilities. The amount of Reactive Supply and Voltage Control from Generation or Other Sources Service that must be supplied with respect to the Transmission Customer's transaction will be determined based on the reactive power support necessary to maintain transmission voltages within limits that are generally accepted in the region and consistently adhered to by the Transmission Provider.

Reactive Supply and Voltage Control from Generation or Other Sources Service is to be provided directly by the Transmission Provider. The Transmission Customer must purchase this service from the Transmission Provider.

In addition to the charges and payments set forth in this Tariff, Schedule 2, Market Sellers providing reactive services at the direction of the Office of the Interconnection shall be credited for such services, and Market Participants shall be charged for such services, as set forth in Tariff, Attachment K-Appendix, section 3.2.3B.

The Transmission Provider shall administer the purchases and sales of Reactive Supply. PJMSettlement shall be the Counterparty to (a) the purchases of Reactive Supply from owners of Generation or Other Sources and Market Sellers and (b) the sales of Reactive Supply to Transmission Customers and Market Participants.

**Charges**

Purchasers of Reactive Supply and Voltage Control from Generation or Other Sources Service shall be charged for such service in accordance with the following formulae.

Monthly Charge for a purchaser receiving Network Integration Transmission Service or Point-to-Point Transmission Service to serve Non-Zone Load = Allocation Factor \* Total Generation Owner or other source owner Monthly Revenue Requirement

Monthly Charge for a purchaser receiving Network Integration Transmission Service or Point-to-Point Transmission Service to serve Zone Load = Allocation Factor \* Zonal Generation Owner or other source owner Monthly Revenue Requirement \* Adjustment Factor

Where:



Purchaser serving Non-Zone Load is a Network Customer serving Non-Zone Network Load or serving Network Load in a zone with no revenue requirement for Reactive Supply and Voltage Control from Generation or Other Sources Service, or a Transmission Customer where the Point of Delivery is at the boundary of the PJM Region.

Zonal Generation Owner or other source owner Monthly Revenue Requirement is the sum of the monthly revenue requirements for each generator or other source located in a Zone, as such revenue requirements have been accepted or approved, upon application, by the Commission.

Total Generation Owner or other source owner Monthly Revenue Requirement is the sum of the Zonal Generation or other source owner Monthly Revenue Requirements for all Zones in the PJM Region.

Allocation Factor is the monthly transmission use of each Network Customer or Transmission Customer per Zone or Non-Zone, as applicable, on a megawatt basis divided by the total transmission use in the Zone or in the PJM Region, as applicable, on a megawatt basis.

For Network Customers, monthly transmission use on a megawatt basis is the sum of a Network Customer's daily values of DCPZ or DCPNZ (as those terms are defined in Tariff, Part III, section 34.1) as applicable, for all days of the month.

For Transmission Customers, monthly transmission use on a megawatt basis is the sum of the Transmission Customer's hourly amounts of Reserved Capacity for each day of the month (not curtailed by PJM) divided by the number of hours in the day.

Adjustment Factor is determined as the sum of the total monthly transmission use in the PJM Region, exclusive of such use by Transmission Customers serving Non-Zone Load, divided by the total monthly transmission use in the PJM Region on a megawatt basis.

In the event that a single customer is serving load in more than one Zone, or serving Non-Zone Load as well as load in one or more Zones, or is both a Network Customer and a Transmission Customer, the Monthly Charge for such a customer shall be the sum of the Monthly Charges determined by applying the appropriate formulae set forth in this Schedule 2 for each category of service.

### **Payment to Generation or Other Source Owners**

Each month, the Transmission Provider shall pay each Generation Owner or other source owner an amount equal to the Generation Owner's or other source owner's monthly revenue requirement as accepted or approved by the Commission. In the event a Generation Owner or

other source owner sells a generator or other source which is included in its current effective monthly revenue requirement accepted or approved by the Commission, payments in that Generation Owner's or other source owner's Zone may be allocated as agreed to by the owners of the generator or other source in that Zone. Such Generation Owner or other source owners shall inform the Transmission Provider of any such agreement and submit either a filing to revise its cost-based rate or an informational filing in accordance with the requirements below in this Schedule 2. In the absence of agreement among such Generation Owners or other source owners, the Commission, upon application, shall establish the allocation. Generation Owners shall not be eligible for payment, pursuant to this Schedule 2, of monthly revenue requirement associated with those portions of generating units designated as Behind The Meter Generation. The Transmission Provider shall post on its website a list for each Zone of the annual revenue requirements for each Generation Owner receiving payment within such Zone and specify the total annual revenue requirement for all of the Transmission provider.

At least 90 days prior to the Deactivation Date or disposition date of a generator or other source receiving payment in accordance with a Commission accepted or approved revenue requirement for providing reactive supply and voltage control service under this Schedule 2, the Generation Owner or other source owner must either:

(1) submit to the Commission the appropriate filings to terminate or revise its cost-based revenue requirement for supplying reactive supply and voltage control service under this Schedule 2 to account for the deactivated or transferred generator or other source; or

(2) provide to the Transmission Provider and file with the Commission an informational filing that includes the following information:

- (i) the acquisition date, Deactivation Date, and transfer date of the generator or other source;
- (ii) an explanation of the basis for the decision by the Generation Owner or other source owner not to terminate or revise the cost-based rate approved or accepted by the Commission associated with the planned generator or other source deactivation or disposition;
- (iii) a list of all of the generators or other sources covered by the Generation Owner's or other source owner's cost-based tariff from the date the revenue requirement was first established until the date of the informational filing;
- (iv) the type (i.e., fuel type and prime mover) of each generator or other source;
- (v) the actual (site-rated) megavolt-ampere reactive ("MVAR") capability, megavolt-ampere ("MVA") capability, and megawatt capability of each generator or other source, as supported by test data; and
- (vi) the nameplate MVAR rating, nameplate MVA rating, nameplate megawatt rating, and nameplate power factor for each generator or other source.

The Generation Owner or other source owner must submit the informational filing in the docket in which its cost-based revenue requirement was approved or accepted by the Commission or as otherwise directed by the Commission.

The requirement to submit the filings at least 90 days prior to the Deactivation Date or disposition date of a generator or other source shall not apply to generators or other source deactivations or transfers occurring between June 18, 2015, and September 16, 2015. For generator or other source deactivations or transfers occurring between June 18, 2015, and September 16, 2015, the Generation Owner or other source owner shall submit the informational filing or filings to terminate or revise its cost-based revenue requirement by September 16, 2015.

**Exhibit IMM-0003**  
**Capital Recovery Factors**  
**Technical Reference**



# **Capital Recovery Factors (CRF) Technical Reference**

Monitoring Analytics, LLC

April 25, 2022

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## 1 The Basics of CRF

A capital recovery factor (CRF) is used to convert the principal amount of a capital investment into an equivalent stream of uniform payments. A typical CRF formula found in engineering economics textbooks is given in equation (1.1).<sup>1</sup>

(1.1)

$$CRF = \frac{r(1+r)^N}{(1+r)^N - 1}$$

Variable  $r$  is an interest rate,  $N$  is the number of uniform annual payments and the payments are assumed to occur at the end of year. To derive equation (1.1) the CRF is first denoted by  $c$ , allowing the annual payment to be stated as  $A = cK$  where  $K$  is the capital investment. Then  $c$  is the value that solves the following present value equation,

$$\begin{aligned} K &= \sum_{j=1}^N \frac{cK}{(1+r)^j} \\ &= cK \sum_{j=1}^N \left(\frac{1}{1+r}\right)^j \end{aligned}$$

The summation in the equation above is a finite geometric series. A general formula for the sum of a finite geometric series is given by

(1.2)

$$\sum_{j=H}^W v^j = \frac{v^H}{1-v} (1 - v^{W-H+1}).$$

$H$  and  $W$  are positive integers and  $v$  is any number except one ( $v \neq 1$ ). It is straightforward exercise to show that equation (1.2) is valid.<sup>2</sup>

Using equation (1.2) with  $H = 1$ ,  $W = N$  and  $v = 1/(1+r)$  yields

$$\sum_{j=1}^N \left(\frac{1}{1+r}\right)^j = \frac{(1+r)^N - 1}{r(1+r)^N}.$$

Replacing the summation in the present value equation yields

$$K = cK \left( \frac{(1+r)^N - 1}{r(1+r)^N} \right)$$

<sup>1</sup> For example, see pages 21-22 in "Economic Evaluation and Investment Decision Methods," Stermole, F.J. and Stermole, J.M. (1993).

<sup>2</sup> If  $S$  is the sum on the left hand side of equation (1.2), then  $S - vS = v^H - v^{W+1}$  and solving for  $S$  gives the right hand side of (1.2).

and solving for  $c$  produces equation (1.1).

## 1.1 CRF That Reflect Taxable Income

The revenue that results from a capital investment is taxable income. The revenue payment  $A$ , obtained by multiplying the capital investment amount  $K$  by the CRF in equation (1.1), would be too low in cases where the revenue is taxable. The goal, in the presence of taxes, is to have a CRF for which the product  $CRF \cdot K$  yields an annual payment  $A$  that will provide the necessary and sufficient level of revenue to cover the investors' annual tax payments, and the return on and return of the capital investment. In other words, over the life of the project, the revenue in excess of the tax payments and investment return should equal the original capital investment. The annual revenue payment can be determined by solving an equation where the present value of the after tax cash flows resulting from the annual revenue payment is equal to the initial capital investment.

The composition of the after tax cash flow is dependent upon the capital budgeting model. The weighted average cost of capital (WACC) approach was used to develop the CRF for PJM Black Start Service which was accepted by FERC in August 2021.<sup>3 4</sup> The WACC approach to capital budgeting discounts the after tax cash flow at the after tax weighted average cost of capital rate and payback of the investment in each recovery year reflects the assumed debt and equity financing structure.<sup>5</sup> The CRF must satisfy the following present value equation,

$$K = \sum_{j=1}^N \frac{CF_j}{(1+r)^j} .$$

$K$  is the capital investment,  $CF_j$  is the after tax cash flow for year  $j$ ,  $r$  is the WACC rate, and the revenue, tax and debt payments are assumed to occur at the end of the year. The model variables are defined in Table 1-1. In the WACC model, the after tax cash flow is revenue net of taxes, and the tax calculation includes an offset for depreciation. The after tax cash flow for year  $j$  is

$$\begin{aligned} CF_j &= cK - (cK - \delta_j K)s \\ &= cK(1 - s) + \delta_j Ks \end{aligned}$$

<sup>3</sup> 176 FERC ¶ 61,080 (August 10, 2021) at 43-44.

<sup>4</sup> Additional details on the weighted average cost of capital approach to capital budgeting can be found in Section 17.3 in "Corporate Finance," Ross, Westerfield, Jaffe, 4<sup>th</sup> Edition, 1996.

<sup>5</sup> The after tax weighted average cost of capital rate is equal to *Equity Funding Percent* x *Equity Rate* + *Debt Funding Percent* x *Debt Interest Rate* x (1- *Effective Tax Rate*).



where  $c$  is the CRF,  $K$  is the total capital investment including debt and equity,  $cK$  is the annual revenue payment,  $s$  is the effective tax rate and  $\delta_j$  is the depreciation factor for year  $j$ . Upon replacing  $CF_j$  in the present value equation

$$K = cK(1 - s) \sum_{j=1}^N \frac{1}{(1 + r)^j} + Ks \sum_{j=1}^N \frac{\delta_j}{(1 + r)^j}.$$

Equation (1.2) with  $H = 1$ ,  $W = N$  and  $v = 1/(1 + r)$  gives

$$\sum_{j=1}^N \frac{1}{(1 + r)^j} = \frac{(1 + r)^N - 1}{r(1 + r)^N}$$

and substituting into the previous equation results in

$$K = cK(1 - s) \left( \frac{(1 + r)^N - 1}{r(1 + r)^N} \right) + Ks \sum_{j=1}^N \frac{\delta_j}{(1 + r)^j}.$$

Solving for  $c$  yields the CRF formula in equation (1.3).

(1.3)

$$CRF = \frac{r(1 + r)^N}{(1 - s)[(1 + r)^N - 1]} \left\{ 1 - s \sum_{j=1}^N \frac{\delta_j}{(1 + r)^j} \right\}$$

**Table 1-1 Variable descriptions for the WACC capital budgeting model**

| Variable   | Description                                |
|------------|--|
| $r$        | After tax weighted average cost of capital |
| $s$        | Effective tax rate                         |
| $N$        | Cost recovery period                       |
| $\delta_j$ | Depreciation factor for recovery year $j$  |

Substituting the parameter values shown in Table 1-2 into the CRF formula, assuming a five year capital recovery period and straight line depreciation yields a CRF of 0.274938. With a capital investment of \$1 million, the annual payment is \$274,938.

Table 1-3 provides a cash flow summary for a \$1 million capital investment with a five year cost recovery period that uses straight line depreciation. The revenue for each year, equal to the product of the CRF and the capital investment amount, is \$274,938. The tax payment for each year is equal to the effective tax rate times the revenue net of depreciation. The return on the capital investment in year 1 is equal to the product of the WACC rate and the initial capital investment of \$1,000,000.

**Table 1-2 Financial parameter and tax assumptions<sup>6</sup>**

| Parameter                                      | Parameter Value |
|--|-----------------|
| Equity Funding Percent                         | 50.0000%        |
| Debt Funding Percent                           | 50.0000%        |
| Equity Rate                                    | 12.0000%        |
| Debt Interest Rate                             | 7.0000%         |
| Federal Tax Rate                               | 21.0000%        |
| State Tax Rate                                 | 9.0000%         |
| Effective Tax Rate (s)                         | 28.1100%        |
| After tax Weighted Average Cost of Capital (r) | 8.5162%         |

After accounting for the tax payment and return on investment in year 1, \$168,711 is available as payback to the investors. The remaining capital investment is \$831,289 at the end of year 1. The year 2 return on investment is the product of the WACC rate and the remaining capital investment at the end of year 1. Payback to investors is \$183,079 in year 2. The cash flows for years 3 through 5 are analogous to the year 2 cash flow.

**Table 1-3 Cash flow summary for 5 year, \$1 million investment with straight line depreciation<sup>7</sup>**

| Recovery Year                | 1         | 2         | 3         | 4         | 5         |
|------------------------------|-----------|-----------|-----------|-----------|-----------|
| Revenue                      | \$274,938 | \$274,938 | \$274,938 | \$274,938 | \$274,938 |
| Depreciation                 | \$200,000 | \$200,000 | \$200,000 | \$200,000 | \$200,000 |
| Tax Payment                  | \$21,065  | \$21,065  | \$21,065  | \$21,065  | \$21,065  |
| Return on capital investment | \$85,162  | \$70,794  | \$55,202  | \$38,283  | \$19,923  |
| Capital investment payback   | \$168,711 | \$183,079 | \$198,670 | \$215,590 | \$233,949 |
| Remaining capital investment | \$831,289 | \$648,209 | \$449,539 | \$233,949 | \$0       |

After the final revenue payment in year 5, the remaining capital investment is reduced to \$0. Summing horizontally across the capital investment payback row in Table 1-3 produces \$1,000,000. This example illustrates that the revenue payment determined by the CRF provides the necessary and sufficient annual revenue to pay the taxes associated with the revenue payment as well as the required return on and return of the capital investment. This important point is established as a general result in the following proposition.

*Proposition 1.1.* The CRF given by equation (1.3) is the unique value, assuming a WACC capital budgeting model with end of year payments, for which the resulting annual revenue payment is

<sup>6</sup> The effective tax rate (parameter s in the formula) is equal to  $State\ Tax\ Rate + Federal\ Tax\ Rate \times (1 - State\ Tax\ Rate)$ .

<sup>7</sup> WACC model with end of year revenue and tax payments.

necessary and sufficient, over the term of the investment, to provide for the annual tax liability and the return on and return of the capital investment.

## 1.2 Half Year Convention

The revenue and tax payments would likely be made on a monthly or quarterly basis rather than occurring at the end of the year. A better model with respect to the timing of the revenue and tax payments is obtained by assuming the revenue and tax payments occur at the midpoint of each year. To derive a CRF corresponding to midyear revenue and tax payments, the present value equation from the previous section is modified to reflect the new timing assumption. Each after tax cash flow amount is assumed to occur a half year earlier than in the previous model. The revised present value equation is

$$K = \sum_{j=1}^N \frac{CF_j}{(1+r)^{j-0.5}},$$

or equivalently,

$$K = \sqrt{1+r} \sum_{j=1}^N \frac{CF_j}{(1+r)^j}.$$

Making the substitution,

$$CF_j = cK(1-s) + \delta_j Ks$$

and solving for  $c$  yields equation (1.4).

(1.4)

$$CRF = \frac{r(1+r)^N}{(1-s)[(1+r)^N - 1]} \left\{ \frac{1}{\sqrt{1+r}} - s \sum_{j=1}^N \frac{\delta_j}{(1+r)^j} \right\}$$

Using the parameter values in Table 1-2, with a five year capital cost recovery period and straight line depreciation, equation (1.4) yields a CRF of 0.260798. With an initial capital investment of \$1 million, the annual payment is \$260,798. Table 1-4 shows the corresponding cash flow summary.

**Table 1-4 Cash flow summary for 5 year, \$1 million investment with half year convention**

| Service Year                  | 1         | 2         | 3         | 4         | 5         |
|-------------------------------|-----------|-----------|-----------|-----------|-----------|
| Revenue                       | \$260,798 | \$260,798 | \$260,798 | \$260,798 | \$260,798 |
| Depreciation                  | \$200,000 | \$200,000 | \$200,000 | \$200,000 | \$200,000 |
| Tax Payment                   | \$17,090  | \$17,090  | \$17,090  | \$17,090  | \$17,090  |
| Return on Capital Investment  | \$41,711  | \$67,959  | \$52,992  | \$36,751  | \$19,126  |
| Payback of Capital Investment | \$201,997 | \$175,749 | \$190,716 | \$206,957 | \$224,582 |
| Remaining Capital Investment  | \$798,003 | \$622,255 | \$431,539 | \$224,582 | \$0       |

The calculation of the values in Table 1-4 is identical to the corresponding values in Table 1-3 except that the year 1 return on investment reflects a half year period. The return on investment in year 1 is equal to the product of the capital investment and the half year rate of return  $\sqrt{1+r} - 1$ . The cash flow summary shows that the revenue payment determined by the CRF is necessary and sufficient to pay the taxes associated with the revenue payment as well as the required return on and return of the capital investment.

Changing the depreciation assumption to 3 year MACRS produces a CRF of 0.254231. The MACRS depreciation factors are shown in Table 1-8. The lower CRF relative to the straight line depreciation example reflects the lower tax payment under MACRS due to the accelerated depreciation schedule. In years 1 and 2, the tax payment in Table 1-5 is negative due to the accelerated depreciation assumption.<sup>8</sup> The cash flow summary in Table 1-5 shows that the revenue payment determined by the CRF, using 3 year MACRS depreciation, is at the necessary and sufficient level to provide for the taxes associated with the revenue payment as well as the required return on and return of the capital investment.

**Table 1-5 Cash flow summary for 5 year, \$1 million investment with 3 year MACRS**

| Service Year                  | 1          | 2          | 3         | 4         | 5         |
|-------------------------------|------------|------------|-----------|-----------|-----------|
| Revenue                       | \$254,231  | \$254,231  | \$254,231 | \$254,231 | \$254,231 |
| Depreciation                  | \$333,300  | \$444,500  | \$148,100 | \$74,100  | \$0       |
| Tax Payment                   | (\$22,226) | (\$53,485) | \$29,833  | \$50,635  | \$71,464  |
| Return on Capital Investment  | \$41,711   | \$65,170   | \$44,515  | \$29,195  | \$14,343  |
| Payback of Capital Investment | \$234,747  | \$242,546  | \$179,883 | \$174,401 | \$168,424 |
| Remaining Capital Investment  | \$765,253  | \$522,708  | \$342,825 | \$168,424 | \$0       |

The depreciation assumption has a significant impact on the CRF level. Generally, the faster the capital is depreciated for tax purposes, the lower the CRF. The Tax Cuts and Jobs Act (TCJA), signed into law on December 22, 2017 included bonus depreciation rates applicable to capital investments placed in service after September 27, 2017.<sup>9 10</sup> Capital investments placed into service after September 27, 2017 and before January 1, 2023, are eligible for 100 percent bonus depreciation.<sup>11</sup>

<sup>8</sup> It is assumed that the capital investor would use the negative tax liability from this project as an offset against the tax liability resulting from other revenue.

<sup>9</sup> Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2096, Stat. 2105 (2017).

<sup>10</sup> 26 U.S. Code §11(b)

<sup>11</sup> Bonus depreciation is 100 percent for capital investments placed in service after September 27, 2017 and before January 1, 2023. Bonus depreciation is 80 percent for capital investments placed in service after December 31, 2022 and before January 1, 2024, and the bonus depreciation level is reduced by 20

Assuming 100 percent bonus depreciation results in a CRF of 0.247523. The corresponding cash flow summary is given in Table 1-6. The CRF for straight line depreciation for a five year cost recovery period is 5.3 percent higher than the CRF corresponding to 100 percent bonus depreciation.

**Table 1-6 Cash flow summary for 5 year, \$1 million investment with bonus depreciation**

| Service Year                  | 1           | 2         | 3         | 4         | 5         |
|-------------------------------|-------------|-----------|-----------|-----------|-----------|
| Revenue                       | \$247,523   | \$247,523 | \$247,523 | \$247,523 | \$247,523 |
| Depreciation                  | \$1,000,000 | \$0       | \$0       | \$0       | \$0       |
| Tax Payment                   | (\$211,521) | \$69,579  | \$69,579  | \$69,579  | \$69,579  |
| Return on Capital Investment  | \$41,711    | \$49,621  | \$38,692  | \$26,834  | \$13,965  |
| Payback of Capital Investment | \$417,334   | \$128,324 | \$139,252 | \$151,111 | \$163,980 |
| Remaining Capital Investment  | \$582,666   | \$454,343 | \$315,091 | \$163,980 | \$0       |

The CRF for a capital investment with a 20 year recovery period is 0.103149 and the corresponding cash flow summary is given in Table 1-7 for a capital investment totaling \$10,000,000.

percent for each subsequent year through 2026. Capital investments placed in service after December 31, 2026 are not eligible for bonus depreciation. See 26 U.S. Code §168(k)(6)(A).

**Table 1-7 Cash flow summary for 20 year, \$10 million investment with bonus depreciation**

| Service Year | Revenue     | Depreciation | Tax Payment   | Return on Capital Investment | Payback of Capital Investment | Remaining Capital Investment |
|--------------|-------------|--------------|---------------|------------------------------|-------------------------------|------------------------------|
| 1            | \$1,031,492 | \$10,000,000 | (\$2,521,048) | \$417,109                    | \$3,135,431                   | \$6,864,569                  |
| 2            | \$1,031,492 | \$0          | \$289,952     | \$584,597                    | \$156,943                     | \$6,707,626                  |
| 3            | \$1,031,492 | \$0          | \$289,952     | \$571,231                    | \$170,308                     | \$6,537,318                  |
| 4            | \$1,031,492 | \$0          | \$289,952     | \$556,728                    | \$184,812                     | \$6,352,506                  |
| 5            | \$1,031,492 | \$0          | \$289,952     | \$540,989                    | \$200,551                     | \$6,151,955                  |
| 6            | \$1,031,492 | \$0          | \$289,952     | \$523,910                    | \$217,630                     | \$5,934,325                  |
| 7            | \$1,031,492 | \$0          | \$289,952     | \$505,376                    | \$236,164                     | \$5,698,161                  |
| 8            | \$1,031,492 | \$0          | \$289,952     | \$485,264                    | \$256,276                     | \$5,441,886                  |
| 9            | \$1,031,492 | \$0          | \$289,952     | \$463,439                    | \$278,101                     | \$5,163,785                  |
| 10           | \$1,031,492 | \$0          | \$289,952     | \$439,756                    | \$301,784                     | \$4,862,001                  |
| 11           | \$1,031,492 | \$0          | \$289,952     | \$414,055                    | \$327,484                     | \$4,534,517                  |
| 12           | \$1,031,492 | \$0          | \$289,952     | \$386,166                    | \$355,373                     | \$4,179,143                  |
| 13           | \$1,031,492 | \$0          | \$289,952     | \$355,902                    | \$385,638                     | \$3,793,505                  |
| 14           | \$1,031,492 | \$0          | \$289,952     | \$323,061                    | \$418,479                     | \$3,375,026                  |
| 15           | \$1,031,492 | \$0          | \$289,952     | \$287,422                    | \$454,117                     | \$2,920,909                  |
| 16           | \$1,031,492 | \$0          | \$289,952     | \$248,749                    | \$492,791                     | \$2,428,118                  |
| 17           | \$1,031,492 | \$0          | \$289,952     | \$206,782                    | \$534,758                     | \$1,893,361                  |
| 18           | \$1,031,492 | \$0          | \$289,952     | \$161,241                    | \$580,298                     | \$1,313,062                  |
| 19           | \$1,031,492 | \$0          | \$289,952     | \$111,822                    | \$629,717                     | \$683,345                    |
| 20           | \$1,031,492 | \$0          | \$289,952     | \$58,195                     | \$683,345                     | \$0                          |

In each example, the annual revenue payment, equal to the product of the capital investment and the CRF obtained from equation (1.4) is the necessary and sufficient revenue amount to cover the tax liability and the return on and return of the investment capital. This observation is generalized in the following proposition.

*Proposition 1.2.* The CRF given by equation (1.4) is the unique value, assuming a WACC capital budgeting model with the half year convention, for which the resulting annual revenue payment is necessary and sufficient, over the term of the investment, to pay the annual tax liability and the return on and return of the capital investment.

**Table 1-8 Modified Accelerated Cost Recovery System (MACRS) with half year convention<sup>12</sup>**

| Year | 3 year<br>Depreciation<br>Factors | 5 year<br>Depreciation<br>Factors | 10 year<br>Depreciation<br>Factors | 15 year<br>Depreciation<br>Factors | 20 year<br>Depreciation<br>Factors |
|------|-----------------------------------|-----------------------------------|------------------------------------|------------------------------------|------------------------------------|
| 1    | 33.33%                            | 20.00%                            | 10.00%                             | 5.00%                              | 3.750%                             |
| 2    | 44.45%                            | 32.00%                            | 18.00%                             | 9.50%                              | 7.219%                             |
| 3    | 14.81%                            | 19.20%                            | 14.40%                             | 8.55%                              | 6.677%                             |
| 4    | 7.41%                             | 11.52%                            | 11.52%                             | 7.70%                              | 6.177%                             |
| 5    |                                   | 11.52%                            | 9.22%                              | 6.93%                              | 5.713%                             |
| 6    |                                   | 5.76%                             | 7.37%                              | 6.23%                              | 5.285%                             |
| 7    |                                   |                                   | 6.55%                              | 5.90%                              | 4.888%                             |
| 8    |                                   |                                   | 6.55%                              | 5.90%                              | 4.522%                             |
| 9    |                                   |                                   | 6.56%                              | 5.91%                              | 4.462%                             |
| 10   |                                   |                                   | 6.55%                              | 5.90%                              | 4.461%                             |
| 11   |                                   |                                   | 3.28%                              | 5.91%                              | 4.462%                             |
| 12   |                                   |                                   |                                    | 5.90%                              | 4.461%                             |
| 13   |                                   |                                   |                                    | 5.91%                              | 4.462%                             |
| 14   |                                   |                                   |                                    | 5.90%                              | 4.461%                             |
| 15   |                                   |                                   |                                    | 5.91%                              | 4.462%                             |
| 16   |                                   |                                   |                                    | 2.95%                              | 4.461%                             |
| 17   |                                   |                                   |                                    |                                    | 4.462%                             |
| 18   |                                   |                                   |                                    |                                    | 4.461%                             |
| 19   |                                   |                                   |                                    |                                    | 4.462%                             |
| 20   |                                   |                                   |                                    |                                    | 4.461%                             |
| 21   |                                   |                                   |                                    |                                    | 2.231%                             |

### 1.3 Proof of Proposition 1.2

*Proposition 1.2.* The CRF given by equation (1.4) is the unique value, assuming a WACC capital budgeting model with the half year convention, for which the resulting annual revenue payment is necessary and sufficient, over the term of the investment, to pay the annual tax liability and the return on and return of the capital investment.

*Proof.*  $K_0$  is the initial capital invested and  $K_j, j \geq 1$ , represents the capital investment remaining at the midpoint of cost recovery year  $j$ .  $K_1$  is the remaining capital investment at the midpoint of year 1 after using the year 1 revenue net of taxes and return on investment, as a payback to investors. The proposition states that the CRF in equation (1.4) is the unique value that will result in  $K_N = 0$ . Representing the CRF in equation (1.4) as  $c$ , the year 1 revenue net of taxes and return on investment is

<sup>12</sup> See Appendix A, Table A-1, IRS Publication 946, United States Department of Treasury (2020).

$$cK_0(1-s) + \delta_1 K_0 s - K_0(\sqrt{1+r} - 1).$$

The rate of return on the investment reflects a half year of return due to the half year convention. The equity investment that remains at the midpoint of year 1 is

$$\begin{aligned} K_1 &= K_0 - \left( cK_0(1-s) + \delta_1 K_0 s - K_0(\sqrt{1+r} - 1) \right) \\ &= K_0\sqrt{1+r} - cK_0(1-s) - \delta_1 K_0 s. \end{aligned}$$

The year 2 revenue net of taxes and return on investment is

$$cK_0(1-s) + \delta_2 K_0 s - rK_1$$

and the capital investment that remains at the midpoint of year 2 is

$$K_2 = K_1(1+r) - cK_0(1-s) - \delta_2 K_0 s.$$

Substitution for  $K_1$  yields

$$K_2 = K_0(1+r)^{3/2} - cK_0(1-s)[(1+r) + 1] - [\delta_1(1+r) + \delta_2]K_0 s.$$

Repeating this process through the end of the cost recovery period yields

(1.5)

$$K_N = K_0(1+r)^{N-1/2} - cK_0(1-s) \sum_{j=1}^N (1+r)^{j-1} - K_0 s \sum_{j=1}^N \delta_j (1+r)^{N-j}.$$

Equation (1.2) with  $H = 1$ ,  $W = N$  and  $v = 1+r$  gives

$$\sum_{j=1}^N (1+r)^{j-1} = \frac{1}{1+r} \sum_{j=1}^N (1+r)^j = \frac{(1+r)^N - 1}{r}.$$

Replacing the first summation in equation (1.5) yields

(1.6)

$$K_N = K_0(1+r)^{N-1/2} - cK_0(1-s) \left( \frac{(1+r)^N - 1}{r} \right) - K_0 s \sum_{j=1}^N \delta_j (1+r)^{N-j}.$$

Replacing  $c$  in (1.6) with the CRF formula in (1.4) results in  $K_N = 0$ . Equation (1.6) also establishes the uniqueness of the CRF. If there are two CRF values, for instance  $c_1$  and  $c_2$ , satisfying the proposition, then each will produce  $K_N = 0$  and one can quickly deduce from the equation (1.6) that  $c_1 = c_2$ .



**Exhibit IMM-0004**  
**CRF and Annual Payment–Capital**  
**Reduced for ITC**

Exhibit IMM-0004  
Docket Nos. ER20-2186-003,  
EL20-62-001

| Recovery Period (years)                                    | 25           | 30           | 35           | 40           |
|--|--------------|--------------|--------------|--------------|
| Reactive Capital Cost per Horigan Testimony                | \$13,558,569 | \$13,558,569 | \$13,558,569 | \$13,558,569 |
| Investment Tax Credit <sup>1</sup>                         | \$3,538,787  | \$3,538,787  | \$3,538,787  | \$3,538,787  |
| Capital Cost to be recovered through Reactive Compensation | \$10,019,782 | \$10,019,782 | \$10,019,782 | \$10,019,782 |
| Capital Recovery Factor <sup>2</sup>                       | 0.085862     | 0.080869     | 0.077690     | 0.075600     |
| Annual Payment for Capital Cost Recovery                   | \$860,321    | \$810,289    | \$778,440    | \$757,492    |

<sup>1</sup> Assumes an investment tax credit of 30 percent was applied to 87.0 percent of the capital cost to be recovered through reactive compensation. The percent applicable value of 87.0 percent is the average capital cost ITC eligibility rate the MMU has encountered in its MOPR review related to the PJM capacity auctions.

<sup>2</sup> Calculated using equation (1.4) in the CRF Technical Reference

**Exhibit IMM-0005**  
**CRF and Annual Payment—not reduced**  
**for ITC**

Exhibit IMM-0005  
Docket Nos. ER20-2186-003,  
EL20-62-001

| Recovery Period (years)                                    | 25           | 30           | 35           | 40           |
|--|--------------|--------------|--------------|--------------|
| Reactive Capital Cost per Horigan Testimony                | \$13,558,569 | \$13,558,569 | \$13,558,569 | \$13,558,569 |
| Investment Tax Credit <sup>1</sup>                         | \$0          | \$0          | \$0          | \$0          |
| Capital Cost to be recovered through Reactive Compensation | \$13,558,569 | \$13,558,569 | \$13,558,569 | \$13,558,569 |
| Capital Recovery Factor <sup>2</sup>                       | 0.085862     | 0.080869     | 0.077690     | 0.075600     |
| Annual Payment for Capital Cost Recovery                   | \$1,164,169  | \$1,096,467  | \$1,053,369  | \$1,025,022  |

<sup>1</sup> Assumes a reduction for ITC is not applicable.

<sup>2</sup> Calculated using equation (1.4) in the CRF Technical Reference

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

Fern Solar LLC

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Docket No. ER20-2576-001

**DECLARATION**

JOSEPH E. BOWRING states that I prepared the testimony to which this declaration is attached with the assistance of the staff of Monitoring Analytics, LLC, and that the statements contained therein are true and correct to the best of my knowledge and belief. Monitoring Analytics, LLC, is acting in its capacity as the Independent Market Monitor for PJM.

Pursuant to Rule 2005(b)(3) (18 CFR § 385.2005(b)(3), citing 28 U.S.C. § 1746), I further state under penalty of perjury that the foregoing is true and correct.

Executed on April June 15, 2022.



Joseph E. Bowring