

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

**Demand Response Compensation in            )  
Organized Wholesale Markets                )     Docket No. RM10-17-000**

**REPLY COMMENTS OF THE ELECTRIC POWER SUPPLY ASSOCIATION**

Pursuant to Rule 213 of the Rules of Practice and Procedure of the Federal Energy Regulatory Commission (“FERC” or the “Commission”),<sup>1</sup> the Electric Power Supply Association (“EPSA”)<sup>2</sup> hereby submits reply comments on the notice of proposed rulemaking issued in the above-captioned proceeding on March 18, 2010.<sup>3</sup> In the NOPR, the Commission proposes to revise its regulations to require independent system operators (“ISOs”) and regional transmission organizations (“RTOs”) with tariff provisions permitting demand response (“DR”) providers to participate in energy markets to pay these DR resources, in all hours, the market price for energy (*i.e.*, the full Locational Marginal Price (“LMP” or “full LMP”)). As detailed in EPSA’s initial

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<sup>1</sup> 18 C.F.R. § 385.213 (2009).

<sup>2</sup> EPSA is the national trade association representing competitive power suppliers, including generators and marketers. These suppliers, who account for 40 percent of the installed generating capacity in the United States, provide reliable and competitively priced electricity from environmentally responsible facilities. EPSA seeks to bring the benefits of competition to all power customers. The comments contained in this filing represent the position of EPSA as an organization, but not necessarily the views of any particular member with respect to any issue.

<sup>3</sup> *Demand Response Compensation in Organized Wholesale Energy Markets*, Notice of Proposed Rulemaking, 130 FERC ¶ 61,213 (2010) (the “NOPR”). The NOPR did not specifically set a date for the submission of reply comments. Nonetheless, these reply comments are a permissible answer under Rule 213(a)(3) of the Commission’s Rules of Practice and Procedure, 18 C.F.R. § 385.213(a)(3) (2009), inasmuch as the comments to which EPSA is responding are not pleadings to which answers are prohibited under Rule 213(a)(2) of the Commission’s Rules of Practice and Procedure, 18 C.F.R. § 385.213(a)(2) (2009). To the extent necessary, EPSA moves pursuant to Rule 212 of the Commission’s Rules of Practice and Procedure, 18 C.F.R. § 385.212 (2009), for leave to file these reply comments.

comments in this proceeding,<sup>4</sup> EPSA and its members fully support the participation by diverse resources in ISO/RTO markets and EPSA's members have been involved in numerous proceedings and efforts to develop viable, properly structured DR products. Additionally, EPSA member companies are involved in the provision of demand response products in several markets across the country. Despite this full support of the role of DR in functional energy markets, EPSA and numerous other independent sources and stakeholders either strongly oppose or raise serious concerns regarding subsidizing DR through payment of full LMP in all hours in all cases. Unfortunately, the NOPR's proposal will not achieve its stated goal of ensuring that ISO/RTO prices are just and reasonable due to the significant legal, economic, policy, and operational flaws identified by EPSA and numerous other diverse commenters in these proceedings.

## **I. BACKGROUND AND SUMMARY**

The Commission's NOPR proposing a generic compensation approach for DR acting as a resource in organized wholesale energy markets has wrought comments from approximately 130 entities representing a spectrum of interested stakeholders and market participants. An extensive and impressive array of those comments supports the participation of DR in the wholesale energy markets but does not support the compensation as proposed in the NOPR as the best avenue to incent beneficial levels of price responsive demand. Unfortunately, some commenters who fully support the NOPR have attempted to mischaracterize the discussion as simply a clear delineation between those who are "for" DR and those who are "against" DR (erroneously implied to

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<sup>4</sup> See Comments Of The Electric Power Supply Association at 2-3, Docket No. RM10-17-000 (filed May 12, 2010) (the "EPSA Initial Comments").

be primarily suppliers). Somehow, to oppose full LMP compensation in all hours on all days is merely a lack of “vision” by those attempting to keep the national electricity grid antiquated and staid.<sup>5</sup> Instead, the record in this proceeding is heartening as it indicates that a chorus of diverse commenters, many representing states and markets, share the fundamental concerns raised by competitive suppliers in initial comments. As EPSC has stressed repeatedly, DR is an important and valuable element of the electricity markets. How DR is compensated, however, does not represent a theological battle or a “dialectic interrogation”<sup>6</sup> as if the Commission were a plenary legislative body. Rather the Commission is no doubt well aware that it is bound by statutory responsibilities, the limitations of the law and the realities of the electric grid. In that vein, numerous comments from diverse parties were pragmatic, constructive discussions of the proposal, raising serious questions that merit consideration (including alternatives that may reflect regional and state facts and situations). These are considerations and elements that should be addressed in any final rule as they were not addressed in the brief NOPR and its very limited proposed tariff language.

While parties differ on preferred compensation formulas, there is now extensive commentary in the record that there must be some purchase requirement or representative offset to allow a DR provider to “sell” a commodity that it owns to the ISO/RTO. Without this purchase or a reflection of a purchase, there is no question that one megawatt of supply is not equal to one megawatt of demand. If demand is to be

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<sup>5</sup> See Reply Comments of Viridity Energy, Inc., Docket No. RM10-17-000 (filed June 18, 2010) (“Viridity Reply Comments”), pp. 5-6.

<sup>6</sup> See *Affidavit of John C. Tysseling, Ph.D., regarding Reply Comments of Viridity Energy, Inc.*, Docket No. RM10-17-000 (June 18, 2010), p. 5. “With its wholesale market leadership, the Commission must also foster and facilitate a dialectic interrogation of its policy impacts on retail market regulation, load serving entities (“LSEs”) and retail customers.”

treated as a comparable resource to supply, concerns raised in the record should be addressed in any final rule. Additionally, numerous commenters noted that even if full LMP is designated as the appropriate compensation, that compensation should not apply in all hours on all days; rather, there should be some threshold, triggers or defined circumstances in which DR creates value for the system during peak or scarcity periods, without which most consumers will be harmed. While the NOPR offers the proposition that one megawatt of demand is equal to one megawatt of supply, that concept is belied by feedback from many diverse interested parties and market participants.

Certainly demand response is an integral part of a properly structured competitive electricity market. However, the contention in the NOPR that some undefined level of additional demand response is *always needed* in order to make the organized markets competitive, or mitigate market power among suppliers, is not supported by an array of commenters; instead, concerns are raised that the full LMP compensation proposal would distort those markets. Several regulators and consumer interests raise concerns that the NOPR compensation proposal results in subsidies for demand response which will increase rates for residential consumers that are unable to bid their load in to the wholesale market, and in fact creates barriers to a plethora of dynamic retail response programs being pursued at the local and state levels.

Additionally, a true barrier to economic DR lies at the retail level, where infrastructure to support DR is only in early stages of development. Recently the head of a well-known DR provider, EnerNOC CEO Tim Healy, noted “Demand response is probably trying to graduate from first innings of the game to maybe the top of the second inning now, where we’re seeing demand response thought of as not just some

sort of emergency resource but as an integrated resource.”<sup>7</sup> Exemplifying that we are in early innings, the Gridwise Alliance, a consortium of public and private partners, is organizing the Gridwise Global Forum to be held in Washington, D.C., in September 2010 in order to respond to a smart grid “backlash” in the states. According to coverage in Energy Washington, “Public acceptance of the smart grid and how customers view their energy use are topics that have never been thoroughly examined in a way that can provide insight on how best to shape policies, say sources with the group.”<sup>8</sup> Similarly, the American Council for an Energy-Efficient Economy (“ACEEE”) has just released a report looking at whether smart meters are sufficient to empower residents to cut their household electricity use significantly:

ACEEE found that three of the most promising approaches in the short- to medium-term include enhanced billing, daily/weekly feedback, and “off line” and Web-based real-time feedback. However, far-reaching programs that go beyond “smart meters” are few and far between. According to ACEEE, no U.S. utilities are currently providing the full range of needed services... John A. “Skip” Laitner, director, Economic and Social Analysis, American Council for an Energy-Efficient Economy, said: “The bottom line here is very simple: Smart meters in and of themselves are just not ‘smart’ enough to get the job done for consumers and our economy.”<sup>9</sup>

There remain questions as to where the country and states are on the spectrum in the use and reliance of DR as a supply resource equivalent in the wholesale markets, and whether the NOPR compensation proposal would move us into the next inning.

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<sup>7</sup> See “DR’s fate debated by power industry dignitaries,” covering the National Town Meeting on Demand Response & Smart Grid in Washington, DC, *Restructuring Today*, Thursday, June 24, 2010, p. 1.

<sup>8</sup> “Major Smart Grid Forum Will Tackle Policy Issues, Consumer ‘Backlash,’” *Energy Washington*, June 28, 2010.

<sup>9</sup> “ACEEE Study Finds “Smart Meters” Not Smart Enough To Slash Residential Power Use and Significantly Reduce Consumer Electric Bills,” ACEEE press release, June 29, 2010, available here: <http://www.aceee.org/press/e105pr.htm>.

In a similar vein, NERC addresses the growing role of DR in electricity markets, noting that it can provide reliability benefits during off-peak periods as well as during peak periods, but NERC also notes,

Unlike traditional generating resources with many decades of historic data for analysis, the longterm projections of Demand Response resources involve greater forecasting uncertainty. For example, the New England and New York electricity markets integrate large Demand Response programs; however, the long-term availability of these resources remains uncertain. While extremely valuable in planning and operations, less understood attributes of the resources, such as response fatigue or economic-base participation rates must be carefully monitored to assure they do not pose reliability issues in the future. In most cases, forecasting of Demand Response is not performed. Rather, projections are based on resource requirements and the amount contracted during a commitment period.<sup>10</sup>

This relatively nascent state of DR as a resource motivated Congress to direct the Commission to develop the recently published National Action Plan on Demand Response to be implemented over the next five to ten years.<sup>11</sup> That report focused on how local and regional programs and products can best be developed, fostered and communicated. At this stage, the NOPR may implement a sweeping wholesale market subsidy that could create unintended negative consequences for the broader development of diverse DR products through the states as Congress intended in section 529 of the Energy Independence and Security Act of 2007 requiring the action plan.

If, as the NOPR proposes, demand is to be treated either equally or comparably in order to be compensated equally or comparably to supply, it must follow that demand

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<sup>10</sup> *NERC 2009 Long-Term Reliability Assessment 2009-2018*, p. 19. Available here: [http://www.nerc.com/files/2009\\_LTRA.pdf](http://www.nerc.com/files/2009_LTRA.pdf). The Report also notes that going forward, “To monitor historical performance of Demand Response, NERC, in coordination with the North American Energy Standards Board (NAESB), is developing the Demand response Availability Data System (DADS) to assess the capability and availability of Demand Response.” p. 20.

<sup>11</sup> *National Action Plan on Demand Response*, Docket No. AD09-10-000 (June 17, 2010); available here: <http://www.ferc.gov/legal/staff-reports/06-17-10-demand-response.pdf>.

response providers should and must be subject to the same or comparable market rules, mitigation mechanisms, penalties and requirements as suppliers. If, however, DR provides a necessary and important balancing service (as many of the supporters of the NOPR proposal agree it does), then both treatment by the market operator and compensation should reflect that more limited role. Further, several comments express the importance of dealing with the very difficult issues of cost allocation and measurement and verifiability of demand response in tandem with or in advance of the consideration and implementation of a uniform compensation mechanism. EPSA agrees.

Finally, there remain fundamental and foundational jurisdictional issues that have not been laid to rest by any of the comments entered in to the record in this proceeding. Simply, the Commission lacks the authority to require “just and reasonable” compensation for the provision of non-jurisdictional demand response services as those services do not represent a FERC-jurisdictional sale for resale. This lack of jurisdiction extends to whether DR compensation “affects” jurisdictional rates. Where the Commission is foreclosed from directly regulating non-jurisdictional rates, it may not circumvent the limits on its statutory authority by claiming to do so based on the fact that such non-jurisdictional rates may “affect” jurisdictional rates. To argue so would read out of the Federal Power Act (“FPA”) the express restrictions on the Commission’s ratemaking authority in a given state. For reasons stated in EPSA’s initial comments, amplified here, and not refuted in other comments to date, the Commission does not have a record in this docket to base jurisdiction on the alternative theory that the NOPR is needed to further mitigate wholesale energy prices.

EPSA's initial comments raised serious concerns over mandating a uniform method of compensation across all RTOs, an approach that the Commission has recently chosen not to utilize in the development of transmission cost allocation mechanisms, just as it has not with most other RTO design elements.<sup>12</sup> Regional deference and consensus development over a fundamental market element for transmission, and current barriers to the development of additional transmission infrastructure, represents the best approach to achieving answers for particular regional situations, and is the approach that should be employed in this instance as well.

These reply comments focus on four priority issues that deserve emphasis due to the extensive concerns raised by a diverse set of stakeholders in their initial comments, and to underscore that one uniform compensation mechanism which indiscriminately subsidizes one class of market participant is inappropriate and should be reassessed by the Commission. Those four issues are:

- A. The DR compensation proposal is not necessary to ensure the competitiveness and efficiency of the ISO/RTO markets.
- B. While one megawatt of demand is not equal to one megawatt of supply, for purposes of allowing DR to bid in to energy markets as a resource as proposed, all market rules, mitigation, obligations and requirements must apply to DR as well as to supply.
- C. A rule establishing a standard compensation for DR must also address measurability and verification requirements, and should reflect suggested changes including an offset and thresholds for participation.
- D. The Commission lacks jurisdiction to set just and reasonable rates for DR.

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<sup>12</sup> See *FERC Notice of Proposed Rulemaking: Transmission Planning and Cost Allocation by Transmission Owning and Operating Public Utilities*, 131 FERC ¶ 61,253, Docket No. RM10-23-000 (June 17, 2010).

This proceeding could represent a milestone in a process that stretches back to enactment of the Energy Policy Act of 1992 (“EPAAct 1992”), the statute that laid the groundwork for the development of competitive wholesale electricity markets and consumers’ access to the most cost effective and efficient electric power supply. A continuum of legislative and regulatory actions, including Order No. 888, Order No. 2000, Order No. 890, Order No. 719, EPAAct 1992 and the Energy Policy Act of 2005 (“EPAAct 2005”), have sought to refine and enhance the viability of those markets and access to supply, using a variety of tools. For this reason, EPSA highlights concerns and questions raised by numerous commenters so that this NOPR not impede the progress which has been achieved to date, and instead may move forward in a responsible, practical, efficient and beneficial manner for consumers and suppliers.

## **II. REPLY COMMENTS**

### **A. THE DR COMPENSATION PROPOSAL IS NOT NECESSARY TO ENSURE COMPETITIVENESS AND EFFICIENCY OF THE ISO/RTO MARKETS**

As EPSA previously noted in this proceeding, there is no showing or evidence in the NOPR that additional steps, such as paying DR resources full LMP in all hours in all cases, is necessary to ensure either the competitiveness of the markets or that wholesale rates continue to be just and reasonable.<sup>13</sup> After reviewing comments filed by interested parties in this proceeding, EPSA further asserts that no other party has submitted evidence to support a finding that this is necessary.

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<sup>13</sup> EPSA Initial Comments, p. 6.

While numerous comments point to one set of facts (PJM savings from DR during the August 2006 record heat wave, discussed below) to support the proposal to pay full LMP in all hours, this evidence of cost savings attributable to DR is offered without context or discussion. In August 2006, PJM experienced a period of extreme stress to its system, resulting in very steep supply curves representing peak demand and high prices.<sup>14</sup> Demand resources at that time were able to respond, saving a great deal of money for consumers in PJM. It is incontrovertible that DR can have a valuable dampening effect on clearing prices during certain times, and few dispute that payments during those times when benefits accrue to customers should reflect that value. Of note, however, is that this particular example occurred during a time of extreme stress – therefore the savings opportunities were great. The same would not occur during the much more common normal or low stress hours, though the NOPR would pay DR as if it would. In an analysis of different demand response compensation schemes undertaken pursuant to a request from the Maryland Public Service Commission, PJM found that in the highest priced 100 hours the benefits of demand response paid full LMP to consumers remaining on the system are positive. However, the analysis noted,

[B]ut when considering all hours in the year, these estimates are largely negative figures signifying that for remaining load, the extra payments necessary to support the “Full LMP” while leaving the LSE revenue neutral is far larger than [sic] the reduced expenditures from reduced LMPs resulting from demand response resulting in higher costs to the remaining load versus no demand response at all.<sup>15</sup>

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<sup>14</sup> See PJM News Release “Early August Demand Response Produces \$650 Million Savings In PJM,” (issued August 17, 2006). The news release is available here: <http://www.pjm.com/~media/about-pjm/newsroom/2006-releases/20060817-demand-response-savings.ashx>.

<sup>15</sup> See PJM Interconnection, L.L.C., *Analysis of Load Payments and Expenditures under Different Demand Response Compensation Schemes*, May 12, 2010, available at: <http://www.pjm.com/markets-and-operations/demandresponse/~media/markets-ops/dsr/analysis-of-load-payments->

While DR has value during peak periods and should be compensated appropriately, overcompensation in most conditions is a net negative for customers remaining on the grid, and commenters have not submitted evidence or support detailing the non-economic benefits of overcompensating DR outside of a theoretical polemic stance that this is necessary for the future of electricity.

Additionally, the demand which responded during the 2006 heat wave was a combination of economic DR, capacity DR and emergency program DR, all of which exist today and would very likely respond in a similar manner without the NOPR's uniform pricing mechanism. Certainly EPSA is not aware of anything in the record to date that purports to show the NOPR is necessary and appropriate to replicate the 2006 scenario under those conditions. In fact, the payment of full LMP to economic demand at all times incents such response even when it is not helpful, efficient or economic.

Based on the lack of a showing or evidence that the ISO/RTO markets are not sufficiently competitive or rates are not just and reasonable without the NOPR's DR pricing mechanism, EPSA continues its firm position that the NOPR's DR compensation proposal is simply *not* needed to maintain or improve competition in ISOs/RTOs. Nor is this proposed compensation necessary to facilitate participation of economic and efficient DR resources. EPSA agrees with the comments of Battelle Pacific Northwest, et al. who stated that "[s]ubsidies can increase demand-side activity, but do not

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andexpenditures.ashx. Note that the full PJM analysis report has been submitted in this record as Attachment B of *Reply Comments of the PJM Power Providers Group and Motion to Accept Reply Comments*, filed June 14, 2010.

necessarily bring about the kind of participation that is desired for a mature and competitive market.”<sup>16</sup>

The NOPR and certain commenters assert, among other things, that DR resources in wholesale energy markets help to improve the functioning and competitiveness of such markets in several ways, including through lower clearing prices and mitigating generator market power.<sup>17</sup> Contrary to such assertions, recent State of the Market (SOM) reports for several RTOs or other RTO market announcements issued since initial comments were submitted in this docket in May 2010 provide additional evidence that organized wholesale markets remain competitive and are sufficiently mitigated without the NOPR's approach. In the event increasing DR resources is intended to provide additional mitigation and further lower wholesale prices already down 50 percent in many organized markets, EPSA asserts there must be a detailed assessment and reconsideration of the applicability of the current mitigation structures and the additional rules and requirements applicable to DR resources to ensure comparability among treatment of resources and to guard against the potential for demand-side market power or the over-mitigation of supply.

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<sup>16</sup> Response to Federal Energy Regulatory Commission Notice of Proposed Rulemaking, p. 2, David P. Chassin, Battelle Pacific Northwest Division; Lynne Kiesling, Northwestern University; and Michael Giberson, Texas Tech University, Docket No. RM10-17-000, (filed May 13, 2010).

<sup>17</sup> NOPR at P 2-7. Also, *see generally* Comments of the Coalition of Midwest Transmission Customers; Comverge, Inc.; EnergyConnect, Inc. EnerNOC, Inc.; PJM Industrial Customer Coalition; Viridity Energy, Inc. and Wal-Mart Stores, Inc. (collectively, “DR Supporters”), RM10-17-000, (filed May 13, 2010) (“DR Supporters Comments”) and Comments of the Consumer Demand Response Initiative, RM10-17-000 (filed May 13, 2010) (“CDRI Comments”).

Of note, CDRI is a “an informal coalition of businesses, trade associations, non-profit organizations, and education and health care institutions that seek to provide a voice for electricity consumers of all sizes in regional and national policy discussions on the future of Demand Response and electricity markets.” Membership of CDRI is not available from their representative or online for the purposes of this proceeding.

Finally, the DR Supporters' arguments that insufficient DR has resulted in diminished grid and market efficiency to the detriment of consumers is unsupported.<sup>18</sup> While EPSA recognizes the benefits that may result from market participation by economic and efficient DR resources, EPSA believes a greater concern to grid efficiency and reliability is the potential for DR "saturation" with increasing (and unspecified but Commission-desired) levels of DR – not subject to the same rules and requirements as supply resources – spurred by an unnecessary subsidy payment. To facilitate grid efficiency and reliability, EPSA submits the Commission should instead take expeditious action to address barriers to development of DR resources, such as the lack of robust scarcity pricing, and encourage the transition to price responsive demand resources.

#### **1. Market Monitors Continue To Determine That ISO/RTO Markets Are Already Competitive And Sufficiently Mitigated**

The market monitors for the Midwest ISO,<sup>19</sup> California ISO ("CAISO"), New York ISO ("NYISO"), and ISO New England ("ISO-NE") have all recently issued either annual or quarterly SOM reports for their respective markets, in which they determine these

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<sup>18</sup> DR Supporters Comments, pp. 9, 14-15.

<sup>19</sup> Independent Market Monitor (IMM) Quarterly Report for the Midwest ISO, First Quarter 2010, (issued April 14, 2010). The quarterly report is available here: [http://www.potomaceconomics.com/uploads/midwest\\_presentations/IMM\\_Report\\_Q1\\_2010\\_Final.pdf](http://www.potomaceconomics.com/uploads/midwest_presentations/IMM_Report_Q1_2010_Final.pdf). (See pg 2: "Overall, the markets performed competitively while producing slightly higher prices than those in the first quarter of 2009...The energy price increases were primarily due to higher fuel prices. Higher load associated with the economic recovery also contributed to the increase.")

wholesale markets are competitive and sufficiently mitigated today.<sup>20</sup> Collectively, these recent reports solidly underpin the position of EPSA and contradict assertions in the NOPR and by other commenters that increased levels of DR obtained through a subsidy and without clear rules or requirements will somehow provide a needed “check” on highly monitored wholesale electric markets that are and have historically been deemed competitive and thoroughly mitigated. For example, the CAISO’s Department of Market Monitoring (“DMM”) annual market report finds that,

The overall performance of the new day-ahead and real-time markets in 2009 were highly efficient and competitive. Prices in the energy markets were approximately equal to competitive baseline prices that DMM estimates would result under highly competitive conditions.<sup>21</sup>

Furthermore, these reports detail the extent to which DR resources currently participate in aggregate across the various RTO markets, including the capacity, ancillary services and energy markets, representing increased total levels of participation and compensation. For example, the ISO-New England Internal Market Monitor’s (“IMM”) annual report<sup>22</sup> reflects that the number of megawatts (“MW”) of enrolled DR resources rose about 17 percent in 2009, from 2,546 MW in December 2008 to 2,998 MW in December 2009 (IMM Report at 11.) Additionally, the ISO-NE IMM report shows that,

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<sup>20</sup> These reports were issued soon after the PJM Independent Market Monitor’s SOM report making similar findings for the PJM wholesale markets as referenced in the earlier EPSA Initial Comments in this proceeding.

<sup>21</sup> CAISO Department of Market Monitoring (DMM), *2009 Annual Report on Market Issues and Performance*, p. 1, (issued April 2010). The DMM Report is available here: <http://www.caiso.com/2777/27778a322d0f0.pdf>.

<sup>22</sup> ISO New England Internal Market Monitor, *2009 Annual Markets Report* (May 18, 2010). The IMM Report is available here: [http://www.iso-ne.com/markets/mkt\\_anlys\\_rpts/annl\\_mkt\\_rpts/2009/index.html](http://www.iso-ne.com/markets/mkt_anlys_rpts/annl_mkt_rpts/2009/index.html).

[P]ayments for all demand-resource programs totaled \$111.5 million in 2009. Forward Capacity Market transition payments made to eligible demand resources rose from \$77.6 million in 2008 to \$106.8 million in 2009 due to increased program enrollments and a higher transition payment rate. (IMM Report at 12.)

Likewise the NYISO's Market Monitoring Unit SOM report details the participation of DR resources in the NYISO markets, "particularly the capacity market where demand resources provide more than 2 GW of supply."<sup>23</sup> The NYISO SOM report also indicates that the most significant barrier to widespread participation by retail loads is that most of them are not exposed to wholesale prices and discusses efforts by the ISO to develop ways to allow price-responsive retail loads to participate in the wholesale market.<sup>24</sup>

Also of note, PJM recently announced the results of its Reliability Pricing Model (RPM) capacity auction for the June 2013 to May 2014 delivery year. The results show that renewable resources, demand response and energy efficiency made up nearly three-fourths of the new capacity available and about 7 percent of the resources clearing the auction.<sup>25</sup> Specifically, the RPM auction procured 152,743 MW of capacity

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<sup>23</sup> Potomac Economics, Market Monitoring Unit, *2009 State of the Market Report, New York ISO Electricity Markets*, p. 12, (issued April 2010). The NYISO 2009 SOM report is available here: [http://www.potomaceconomics.com/uploads/nyiso\\_presentations/2009\\_NYISO\\_SOM\\_Final\\_4-30-2010.pdf](http://www.potomaceconomics.com/uploads/nyiso_presentations/2009_NYISO_SOM_Final_4-30-2010.pdf). Also see Quarterly Report on the New York ISO Electricity Markets, First Quarter 2010, Potomac Economics, Market Monitoring Unit, (issued May 2010). The NYISO Quarterly Report is available here: [http://www.potomaceconomics.com/uploads/nyiso\\_presentations/NYISO\\_Quarterly\\_Report\\_2010-Q1\\_final.pdf](http://www.potomaceconomics.com/uploads/nyiso_presentations/NYISO_Quarterly_Report_2010-Q1_final.pdf).

<sup>24</sup> Id. Also, the PJM Independent Market Monitor has made similar findings. See EPSA Initial Comments in this proceeding at pp. 7, 24-26.

<sup>25</sup> See PJM News Release, "Renewable Resources Grow in PJM's RPM Auction," issued May 14, 2010. The PJM news release is available here:

<http://www.pjm.com/~media/about-pjm/newsroom/2010-releases/20100514-rpm-auction-results-2013-2014.ashx>.

resources including 9,282 MW of cleared demand response, which represents a 32 percent increase from last year's RPM auction for the 2012-2013 delivery year.<sup>26</sup>

In sum, the underpinning propositions in the NOPR that the ISOs/RTOs are not competitive or sufficiently competitive, or that DR is not participating in the markets in a beneficial or robust manner, are incorrect. In part, the debate over market competitiveness and the impacts of DR participation stems from a lack of clarity or discussion about what levels of DR would be deemed sufficient by the Commission, why all types of DR are not viewed and assessed as a whole in terms of their important role in the ISOs/RTOs, and what measurement of competitiveness is driving the NOPR proposal that is not recognized or supported by independent market monitors.

## **2. DR Resources Must Be Subject To Market Rules and Mitigation If They Bid In to Energy Markets as a Resource**

If, as it appears, a critical contention of the NOPR is that the DR compensation proposal is an important means of further mitigating market power in wholesale markets, then EPSA submits that current ISO/RTO market mitigation measures should be re-assessed, otherwise the wholesale markets will be over-mitigated, given the findings above from the various ISO/RTO market monitors regarding the wholesale markets' competitiveness and sufficient mitigation that is already in place. However, if DR is going to bid in to energy markets as a resource that is to be comparable with supply resources, then it must also be subject to the full array of rules, requirements and penalties applicable to supply resources, including market mitigation and reliability measures and registration across the ISO/RTO markets and NERC reliability regions.

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<sup>26</sup> Id.

However, based on the record established by comments in this proceeding, it is clear that demand response products have different physical abilities from generation products, and in fact, that all demand response products are not equal to each other in terms of dispatchability, capabilities and services offered. As the Commission's regulations set out to treat demand response products comparably, it is important to consider also a demand responder's obligations as a market participant. If the resource cannot perform under these market obligations, yet is paid what the NOPR suggests, the resource will be getting preferential treatment, not comparable or even equitable treatment, though EPSA and others contend that LMP without any purchase or equivalent offset is in fact an unjustified subsidy for that product. However, in order to move towards true comparability, a resource's ability to conform to and perform pursuant to the same market rules and standards must be part of the analytical equation, though this was not addressed in the NOPR proposal in any manner whatsoever.

Old Dominion Electric Cooperative ("ODEC") notes that in PJM,

The rules under which demand response being treated as a resource operate create disparities between generation resources and demand resources. Unlike generation resources that are dispatched by system operators, demand response is a voluntary reduction in electric consumption in response to price and to the end-use facility operational needs, such as an industrial customer needing to immediately complete a production run to fulfill a customer order. The amount of load reduction is determined by the responder and can vary from hour to hour in PJM's program. There is no potential cost penalty for demand resources if they choose not to curtail, and a responder's curtailment decision is generally made without consideration of the grid's operation and stability.<sup>27</sup>

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<sup>27</sup> Request For Leave To Submit One Day Out-Of-Time And Comments Of Old Dominion Electric Cooperative On Notice Of Proposed Rulemaking, p. 10, Docket No. RM10-17-000, (filed May 14, 2010) ("ODEC Comments").

ODEC further notes that critical market mitigation rules do not apply to demand resources. “Thus, in order to be considered comparable to generation resources, demand resources participating in the wholesale energy markets would have to be dispatchable and subject to requirements that are comparable to generation resources. This is not the case at this time.”<sup>28</sup>

Market obligations for supply bidding into the energy markets ensure reliability of the system and protect consumers from unlawful exercises of market power. While supporters of the Commission’s proposal spent many pages extolling the virtue of demand response as a balancing service, there was not commensurate emphasis or discussion of DR’s ability to adhere to market rules and standards in order to support the proposition of either equivalent or comparable compensation.

While industrials and DR providers who seek the proposed subsidy state that, “sufficient compensation will call forth substantial amounts of demand response and that inadequate compensation will not,”<sup>29</sup> this stance is not supported by the operation of the system. Valuation for demand response products, the services they can provide and the market obligations they can fulfill should be decided on a market-by-market, product-by-product basis. Over-compensating DR as a general category simply to incent more, with no regard to how its value compares with the benefits it brings to the system, is not the answer. Indeed, even vehement supporters of the NOPR’s proposal have said that “even multiples of full LMP compensation will be insufficient to attract

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<sup>28</sup> Id., p. 12.

<sup>29</sup> Comments of Viridity Energy, Inc., p. 5, Docket No. RM10-17-000, (filed May 13, 2010) (“Viridity Initial Comments”).

greater levels of demand response”<sup>30</sup> unless the Commission works to remove barriers to market entry for those resources. That should be an important focus of market participants, consumers, states, the regional wholesale markets and the Commission.

Additionally, the Commission must carefully assess the role of DR resources in applying mitigation measures, such as the three-pivotal supplier test utilized in PJM. This is not a frivolous matter. The incentive for uneconomic and inefficient market participation by DR resources, as well as the potential for the exercise of demand-side market power under the full LMP compensation proposal has been raised by a significant number of parties in this proceeding.<sup>31</sup> Among the aspects of FERC’s

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<sup>30</sup> DR Supporters Comments, p. 31.

<sup>31</sup> For example, the following economic experts raise concerns regarding the incentive for uneconomic and inefficient market participation by DR resources under the NOPR proposal: Affidavit of Dr. Roy J. Shanker, p. 2, Exhibit 1 to Comments of the New England Power Generators, Docket No. RM10-17-000 (filed May 13, 2010) (Shanker Affidavit); Comments by Constantine P. Gonatas of CPG Advisors, Inc., p. 11, Docket No. RM10-17-000 (filed April 13, 2010); Comments of Dr. Samuel Newell, Dr. Kathleen Spees, and Philip Q. Hanser, pp. 2-3, Docket No. RM10-17-000, (filed May 13, 2010) (The Brattle Group); Comments of Dr. Charles J. Cicchetti, Ph.D., Docket No. RM10-17-000, (filed April 27, 2010); Comments of Robert L. Borlick, Energy Consultant, p. 4, Docket No. RM10-17-000, (filed May 13, 2010) (Borlick Comments); William W. Hogan, "Implications for Consumers of the NOPR's Proposal to Pay the LMP for All Demand Response, p. 2, Attachment 1 to the EPSA Initial Comments, Docket No. RM10-17-000, (filed May 12, 2010) (Hogan Paper). Also, see Footnote 82 reflecting the numerous commenters, who raise concerns that developing accurate baselines is essential to guard against the potential for abuse.

Additionally, the following comments all raised concerns over uneconomic and inefficient market behavior by DR resources in response to the NOPR proposal: *Comment of Battelle/Pacific Northwest Laboratories*, Docket No. RM10-17-000 (May 13, 2010); *Comments of Capital Power Corporation*, Docket No. RM10-17-000 (May 13, 2010); *Comment of Consolidated Edison Energy, Inc., et. al*, Docket No. RM10-17-000 (May 13, 2010), p.2; *Comments of Edison Electric Institute*, Docket No. RM10-17-000 (May 13, 2010), p.22; *Comments of Exelon Corporation*, Docket No. RM10-17-000 (May 13, 2010), p.4; *Comment of the Federal Trade Commission*, Docket No. RM10-17-000 (May 13, 2010), p.7; *Comments of ISO New England Inc*, Docket No. RM10-17-000 (May 13, 2010), p. 16; *Comments of Massachusetts Attorney General and Maine Public Advocate*, Docket No. RM10-17-000 (May 13, 2010), pp. 7-13; *Comments of the Midwest ISO Transmission Owners*, Docket No. RM10-17-000 (May 13, 2010), p.19; *Comments of Monitoring Analytics, LLC*, Docket No. RM10-17-000 (May 13, 2010), p.7; *Comments of New England Conference of Public Utilities Commissioners*, Docket No. RM10-17-000 (May 13, 2010), p.3; *Comments of the Northern California Power Agency*, Docket No. RM10-17-000 (May 13, 2010), p.3; *Comments of NSTAR Electric Company*, Docket No. RM10-17-000 (May 14, 2010), p.3; *Comments of D.C. Office of the People's Counsel*, Docket No. RM10-17-000 (May 13, 2010), p.5; *Comments of Old Dominion Electric Cooperative*, Docket No. RM10-17-000 (May 14, 2010), p.26; *Comments of PJM Power*

increased oversight that must be considered is which DR entity FERC would regulate. For example, under the NOPR proposal presumably there would be certain large industrials dealing directly with the RTOs. However, there are also third-party DR providers that will aggregate multiple companies and sources. When a third party is involved, presumably the full LMP gets paid to the third party DR provider, while the actual consumer gets paid less than LMP. How does that impact the analysis for full LMP? Are these third parties required to apply for and receive market-based-rate (MBR) authority, with the attendant market power tests? What is to prevent these entities from exercising market power unless they are also subject to the ISO/RTO mitigation measures? In addition to applying the rules and requirements to DR resources that are applied to generation, the Commission must explicitly address regulatory oversight surrounding these third parties as none of these elements are addressed in the NOPR and must be considered as part of the overall decision on whether to adopt the full LMP compensation proposal. EPSA and other commenters have concerns regarding the potential for gaming by DR under this proposal, as well as the potential for demand-side market power of a relatively small number of third party DR providers and the potential for abuse.<sup>32</sup>

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*Providers Group*, Docket No. RM10-17-000 (May 13, 2010), p. 37; *Comments of Potomac Economics, Ltd.*, Docket No. RM10-17-000 (May 13, 2010), p 4; *Comments of the PPL Parties*, Docket No. RM10-17-000 (May 13, 2010).

32 ““Adverse selection” and “moral hazard” give market participants incentives to inflate baseline estimates and extract program payments for essentially normal consumption behavior. Under adverse selection, customers have the incentive to selectively join a demand response program just before the end of their peak usage season. The baseline would be established using load data compiled during the customer’s high usage season, which allows the customer to receive demand reduction payments as the customer’s load naturally begins to decline because the customer is transitioning into its off-peak season. Under moral hazard, customers may actively manipulate their load to create a higher-than-normal baseline and then receive payments for essentially normal consumption. Behavior associated with adverse selection and moral hazard was observed in the DALRP in the fall of 2007, which prompted

Professor William Hogan addresses the implications for demand-side market power in his policy paper in this proceeding as follows:

An argument has been made that the inefficiencies and cost increases for remaining consumers would be justified or avoided by achieving price reductions in LMPs that would reduce the total payments by consumers. For example, in the [now-terminated] PJM proceeding, Allen Freifeld provided an affidavit for the Demand Response Providers asserting that the imputed demand response program would provide a “price mitigation service to all load in the region”....The price reduction argument misses the impact it would have on other aspects of the electricity market, most visibly in the case of organized RTO/ISO markets with explicit capacity requirements or markets....

**In effect, this price mitigation service is not a policy to move towards a more competitive and efficient market. Rather, it would be an application of regulatory authority to enforce a buyers’ cartel.** The price mitigation policy would not be improving efficiency. To the contrary, it would be employing government authority to transfer income from producers to consumers. **Thus the pursuit of price mitigation of this type would run contrary to the Commission’s policy of supporting and facilitating efficient, non-discriminatory electricity markets.**<sup>33</sup> (Emphasis added.)

It is highly significant that the market monitors for **all** the ISOs/RTOs with DR programs available in their respective energy markets submitted comments raising serious concerns regarding the market inefficiencies and negative impacts of imposing a standardized one-size-fits-all approach to DR compensation without reducing load on the grid.<sup>34</sup> For example, the comments of the ISO-NE IMM also raise concerns

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changes to the program rules so as to limit the hours in which a demand reduction offer could clear under the program.” Comments of ISO New England, pp. 32-33, Citations omitted, Docket No. RM10-17-000, (filed May 13, 2010) (“ISO-NE Comments”).

<sup>33</sup> William W. Hogan, “Implications for Consumers of the NOPR’s Proposal to Pay the LMP for All Demand Response,” at 12-13, Attachment 1 to the EPSA Initial Comments, Docket No. RM10-17-000, (filed May 12, 2010) (Hogan Paper).

<sup>34</sup> See Comments of the ISO New England Inc. Internal Market Monitor, pp. 5-7, Docket No. RM10-17-000, (filed May 13, 2010) (ISO-NE IMM Comments); See *generally* Comments of the Independent Market Monitor for PJM, Docket No. RM10-17-000, (filed May 13, 2010) (PJM IMM Comments); and, Comments of Potomac Economics, Ltd., pp. 9-10, Docket No. RM10-17-000, (filed May 13, 2010) (Potomac Economics Comments). Note that Potomac Economics serves as the External Market Monitor or the Independent Market Monitor (IMM) for the Midwest ISO, New York ISO, ISO New England, and ERCOT.

regarding demand-side market power issues, including the potential for gaming by shifting load behind meters across multiple facilities while being paid DR subsidies.<sup>35</sup>

The ISO-NE IMM notes,

The full-LMP proposal also can present incentives for demand response providers, if they have energy-consuming facilities behind more than one meter, to shift load behind those meters to create illusory demand reductions. These incentives are caused by the necessity to estimate what would have been consumed using an administratively determined customer baseline. **The use of such an administrative approach means that demand resource programs do not include a requirement for underlying ownership or property rights that typically serve as a foundation for a competitive market; that is, a competitive market for a good is premised on the voluntary exchange of a privately owned products, and therefore requires participants to own what they are selling.** The full-LMP approach does not require demand response providers to own the reductions they are selling, relying instead on the customer baseline as an estimate of what would have been used. One way that the use of an administrative baseline can be exploited is through unproductive load-shifting behind a customer's multiple meters to create illusory demand reductions...Other load-shifting schemes likely exist.<sup>36</sup> (Emphasis added)

The ISO-NE IMM discusses a range of negative market impacts posed by the NOPR DR compensation proposal, including that a full LMP payment in all hours is economically inefficient, and results in preferential, non-comparable treatment of DR resources in relation to generating resources. Additionally, "The current proposal would also create incentives for customers to develop load-shifting arrangements and other schemes that would result in demand response that is not genuine."<sup>37</sup> The ISO IMM includes an Attachment to its comments to illustrate how customers can manipulate their operations in order to collect DR payments without actually reducing load at all.

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<sup>35</sup> ISO-NE IMM Comments, pp. 7-14, Docket No. RM10-17-000, (filed May 13, 2010).

<sup>36</sup> Id., p. 11. Also, see Hogan Paper, pp. 7-12.

<sup>37</sup> ISO-NE IMM Comments, p. 4.

This load shifting strategy is not simply an operational choice about where to run operations, but it creates phantom DR which receives a payment, while the customer does not decrease its overall demand. The ISO-NE IMM concludes, “Other customers bear the burden of payments for the illusory demand reduction while the manufacturing company receives the payments at virtually zero opportunity costs.”<sup>38</sup>

Among other things, the ISO-NE IMM recommends that, if the Commission permits a full LMP payment, it should also adopt a “buy-the-baseline” approach that would require the DR resource to purchase its expected amount of energy consumption in the day-ahead energy market (i.e., “buys the baseline”) and sell any demand reduction from that level subsequently in the real-time market, essentially resulting in a compensation approach similar to LMP- G supported by numerous parties in this proceeding.<sup>39</sup> This approach, according to the ISO-NE IMM, also resolves the concerns raised by reliance on an administratively set customer baseline.

### **3. FERC Should Focus On Addressing Barriers To Economic DR Development**

The DR Supporters comments continue [from the PJM proceeding] to make a number of arguments (with a lack of support, other than referencing the NOPR) that can be boiled down to the general assertion that insufficient DR has resulted in diminished grid efficiency and market efficiency to the detriment of consumers. EPSC’s prior comments both in this proceeding and the PJM proceeding have noted in detail the significant recent increases of DR participation in total across various ISO/RTO

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<sup>38</sup> ISO-NE IMM Comments, Attachment A, p. 2.

<sup>39</sup> Id., p. 12. Also, see Bushnell, Hobbs and Wolak, “When it Comes to Demand Response, is FERC its Own Worst Enemy?,” The Electricity Journal, pp. 9-18 (October 2009).

markets, including capacity markets, where DR resource participation has yielded significant levels of compensation. It cannot be ignored that the DR Supporters arguments in support of full LMP compensation to address these perceived inefficiencies is completely at odds with numerous comments filed in this proceeding, including those by a number of state commissions, market monitors, ISOs/RTOs, and other market participants, who correctly assert instead that the NOPR's compensation proposal raises many concerns regarding both diminished grid efficiency (with respect to reliability as addressed elsewhere herein) and market efficiency.

For example, the Midwest TDUs highlight that,

Requiring RTOs to dismantle and re-configure existing demand response programs will truncate the demand response compensation experiment in RTO markets before meaningful results are in. Cutting short the development of the existing, regional compensation regimes for demand response may in fact stifle, rather than accelerate, the development of effective demand response...."<sup>40</sup>

Several states raised concerns regarding the inefficiencies to the market of the NOPR proposal, including the Organization of MISO States ("OMS") which noted the following:

"The payment of the full LMP distorts consumer behavior and would result in inefficient decisions to curtail load. In addition, the subsidy would have to be recovered from non-participating customers."<sup>41</sup> PJM also raises concerns with the market inefficiencies

posed by potential cost shifting under the NOPR proposal as follows:

In order to avoid large wealth transfers from loads that do not engage in demand response activity to loads that do provide demand response, PJM believes that appropriate and efficient demand response compensation may require

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<sup>40</sup> Comments of the Midwest TDUs, pp. 19-29, Docket No. RM10-17-000, (filed May 13, 2010) ("Midwest TDUs Comments").

<sup>41</sup> Comments of the Organization of MISO States, p. 3, Docket No. RM10-17-000, (filed May 13, 2010) ("OMS Comments"). Also see Comments of the Illinois Commerce Commission, Docket No. RM10-17-000, (filed May 6, 2010) ("ICC Comments").

coordination between the Commission, [retail regulators], competitive retail suppliers, and other RTOs, and possibly action on the part of [retail regulators] and competitive suppliers. Otherwise, if there is no coordination or supporting [retail regulatory] or competitive supplier action, as necessary, the payment of the incorrect amount of economic load response compensation may significantly and unnecessarily increase the total dollar amount that PJM will need to charge PJM Market Participants, result in large cost shifts among Market Participants, and/or distort otherwise efficient incentives in the wholesale energy market.<sup>42</sup>

As a further example, the PJM IMM discussed that it is incorrect to drive prices below competitive levels and stated,

The most basic barrier to a fully functional demand side of the market is that not all customers are exposed to the actual incremental cost of energy. The assertion that demand side participants should be paid full LMP, regardless of their retail tariff rate, because the current approach of paying LMP minus G represents an intervention into retail rate design, cannot be correct. The entire demand side program exists only because of the disconnect between wholesale and retail rates. The assertion that the program should not account for the details of the retail rate design leads to the conclusion that there should be no demand side program at all.<sup>43</sup>

It is also important to provide a correction of the DR Supporters' comments, which reference that the PJM IMM "has consistently pointed out that the demand side of wholesale electricity markets in PJM is 'underdeveloped.'"<sup>44</sup> The PJM IMM certainly has made this statement in several SOM reports, as well as the report on Barriers to Demand Side Response in PJM required by Order No. 719. However, the context for the discussion that the demand side of wholesale electricity markets in PJM is "underdeveloped" is presented in these IMM reports in the context that this is due to

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<sup>42</sup> Comments of PJM Interconnection, LLC, pp. 8-9, Docket No. RM10-17-000, (filed May 13, 2010) ("PJM Comments").

<sup>43</sup> PJM IMM Comments, p. 5.

<sup>44</sup> DR Supporters Comments, p. 14 and fn 32 (referencing the PJM IMM's State of the Market Reports for PJM for 2006-2009, as well as the Order No. 719-required report on Barriers to Demand Side Response in PJM).

retail market barriers to DR participation (i.e., the lack of dynamic pricing). EPSCA submits this concern is reflected in the PJM IMM's comments in this proceeding and as noted above. There is no indication in the IMM reports or elsewhere that any lack of participation is due to actions by any ISO/RTO or market participant that directly or indirectly discourages participation in DR programs that "operate as a restraint of trade" as alluded to in the DR Supporters comments.<sup>45</sup>

Importantly, there are numerous commenters who raise the concern that the NOPR proposal will in fact interfere with or stifle retail dynamic price response programs or other utility or state DR products.<sup>46</sup> The Illinois Commerce Commission states, "[A]s the value of the subsidy increases, the state commission's likelihood of implementing

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<sup>45</sup> Id., pp. 30-32.

<sup>46</sup> *Comment of Robert Borlick*, Docket No. RM10-17-000 (May 13, 2010), p. 4; *Comments of the California ISO*, , Docket No. RM10-17-000 (May 13, 2010), p. 4; *Comments of Calpine Corporation*, Docket No. RM10-17-000 (May 13, 2010), p. 4; *Comments of Capital Power Corporation*, Docket No. RM10-17-000 (May 13, 2010), p. 6; *Comment of Constantine Gonatas of CPG Advisors Inc.*, Docket No. RM10-17-000 (May 13, 2010); *Comment of the Delaware Public Service Commission*, Docket No. RM10-17-000 (May 13, 2010), p. 2; *Comment of the Detroit Edison Company*, Docket No. RM10-17-000 (May 13, 2010), p. 4; *Comments of Dominion Resources Services, Inc.*, Docket No. RM10-17-000 (May 13, 2010), pp. 7-8; *Comment of Duke Energy*, Docket No. RM10-17-000 (May 13, 2010), p. 4; *Comments of Edison Electric Institute*, Docket No. RM10-17-000 (May 13, 2010), p.22; *Comments of Exelon Corporation*, Docket No. RM10-17-000 (May 13, 2010), p.4; *Comment of the Federal Trade Commission*, Docket No. RM10-17-000 (May 13, 2010), p.8; *Comments of Illinois Commerce Commission*, Docket No. RM10-17-000 (May 6, 2010), p 13; *Comments of ISO New England Inc. Internal Market Monitor*, Docket No. RM10-17-000 (May 13, 2010), pp. 5-6; *Comment of ISO/RTO Council*, Docket No. RM10-17-000 (May 13, 2010); *Comments of Midwest TDUs*, Docket No. RM10-17-000 (May 13, 2010), p.13; *Comments of Monitoring Analytics, LLC*, Docket No. RM10-17-000 (May 13, 2010), p. 5; *Comments of New England Conference of Public Utilities Commissioners*, Docket No. RM10-17-000 (May 13, 2010), p. 4; *Comments of the New England Power Generators Association*, Docket No. RM10-17-000 (May 13, 2010), p. 2; *Comments of the New York ISO*, Docket No. RM10-17-000 (May 13, 2010); *Comment of New York State Public Service Commission*, Docket No. RM10-17-000 (May 13, 2010); *Comments of Samuel Newell, Kathleen Spees, and Philip Q Hanser*, Docket No. RM10-17-000 (May 13, 2010); *Comments of D.C. Office of the People's Counsel*, Docket No. RM10-17-000 (May 13, 2010); *Comments of Old Dominion Electric Cooperative*, Docket No. RM10-17-000 (May 14, 2010), p. 6; *Comment of Organization of MISO States*, Docket No. RM10-17-000 (May 13, 2010), p. 4; *Comments of PJM Interconnection*, Docket No. RM10-17-000 (May 13, 2010), pp. 5-6; *Comment of Public Utilities Commission of Ohio*, Docket No. RM10-17-000 (May 13, 2010), p.5; *Comment of Public Utilities Commission of the State of California*, Docket No. RM10-17-000 (May 13, 2010), pp. 9-10; *Comments of RRI Energy, Inc*, Docket No. RM10-17-000 (May 13, 2010), p. 2; *Joint Comments of Southern California Edison Company, Pacific Gas & Electric & San Diego Gas & Electric*, , Docket No. RM10-17-000 (May 13, 2010), pp, 3-5.

time-differentiated retail rates decreases.”<sup>47</sup> The Organization of MISO States reiterates,

[I]t should be clear to the Commission that state commissions and LSEs have significant concerns that the potential costs for non-participating customers may exceed the benefits that ARCs can provide to their states and to participating customers. State commissions will have a significant disincentive to support the participation of ARCs in RTO energy markets and in their states if the proposed rule is adopted.<sup>48</sup>

Implementing market structures that allow for the participation of ARCs should not include the establishment of inefficient price signals which distort demand response behavior and result in a cost burden on other customers. Further, State Commissions and LSEs should not be forced to make expensive and complex changes to retail tariffs and billing systems in order to accommodate the participation of ARCs. This would likely result in State Commissions either taking action to “opt-out” or declining to “opt-in” under the provisions approved in Order 719-A.<sup>49</sup>

These concerns reflect two critical problems with the NOPR proposal for full LMP in all hours – that it overcompensates (or functions as a subsidy) one resource in the wholesale market and thereby distorts market results, and that the proposal misdirects the focus on eliminating barriers by attempting to create a wholesale “fix” to bridge infrastructure and retail pricing barriers (which pose much greater obstacles for most load entities, particularly for residential customers). The DR Supporters themselves note that even were the Commission to require multiples of full LMP for DR providers, this could still be insufficient compensation due to the existence of other barriers.<sup>50</sup> Interestingly, several state commissions and advocates make a similar case, but

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47 ICC Comments, p 14.

48 OMS Comments, p 7.

49 OMS Comments, p 9.

50 DR Supporters Comments, p 31.

reverse the conclusion, instead expressing concerns that the full LMP in all hours proposal will negatively impact or stall efforts to implement dynamic pricing at the utility or state level.<sup>51</sup>

The ISO-NE IMM notes,

[E]ach state has a different set of factual circumstances informing the decision on the need to provide extra incentives for demand response. As noted earlier, California has started on the road to dynamic pricing. Many states have taken significant steps to implement advanced meters and have implemented programs to encourage efficient use of energy. The success of these efforts should be a factor in deciding whether and how to implement demand response programs in the wholesale market.<sup>52</sup>

Importantly, this concern is bolstered by the recent issuance of the National Action Plan on Demand Response by the Commission on June 17, 2010. This report represents an extensive effort by the Commission staff and a plethora of stakeholders representing every type of interest to craft a plan that supports local, state and regional efforts to develop all manner of demand response programs and products as Congress intended. The report indicates the level of interest, effort and resources focused on developing local DR, and the importance of assessing costs and benefits in order to do so.<sup>53</sup>

Numerous commenters, including state commissions and consumer advocates, raised concerns that this NOPR would in fact erect a barrier to those efforts. APPA and NRECA reiterate the need to preserve local and regional DR programs,

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51 See Footnote 45 above.

52 Comments of the ISO-NE IMM, p 6.

53 See *National Action Plan on Demand Response generally*, also p 67 on valuating costs and benefits specifically.

In the NOPR, the Commission appears to divert from the broad and inclusive approach of the proposed National Action Plan, by prescribing one method of compensation for demand response that bids into RTO-run wholesale energy markets. APPA and NRECA, however, support allowing local and regional differences to be reflected in pricing rules in RTO-run markets.<sup>54</sup>

In general, demand response rules in RTO-run markets have evolved to meet specific needs. Local and regional conditions largely determine what form and what compensation level for demand response is appropriate. The availability of particular resources in a particular region can mean that different compensation levels are needed to optimize the development of demand response. Varying consumer load profiles and retail market structures dictate that different compensation levels are appropriate in different RTO-run markets.<sup>55</sup>

Another concern in the context of assessing increased DR participation in the wholesale markets is the DR “saturation” issue with respect to grid efficiency and reliability impacts to the system if such resources are not available to perform when called, particularly given that such resources are not currently subject to the same rules and requirements as supply resources. Accordingly, EPSA recommends that, among other things, the Commission should take expeditious action to address identified barriers to development of DR resources and encouraging the transition to price responsive demand (PRD) resources. Several RTOs, including CAISO, NYISO, PJM and ISO-NE have such PRD stakeholder initiatives, which have been underway for some time now, though some appear to have been slowed pending the outcome of this NOPR.

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<sup>54</sup> *Comments of the American Public Power Association and the National Rural Electric Cooperative Association*, Docket No. RM10-17-000 (May 13, 2010), p 3. (APPA/NRECA Comments)

<sup>55</sup> APPA/NRECA comments, pp 11-12.

**B. WHILE ONE MEGAWATT OF DEMAND IS NOT EQUAL TO ONE MEGAWATT OF SUPPLY, FOR PURPOSES OF ALLOWING DR TO BID IN TO ENERGY MARKETS AS A “COMPARABLE” RESOURCE ALL MARKET RULES, MITIGATION, OBLIGATIONS AND REQUIREMENTS MUST APPLY TO DR AS WELL AS TO SUPPLY**

As EPSA stated in its May 12 comments, one megawatt of demand is not equal to one megawatt of traditionally generated supply. The Commission’s policy is comparability, and it is important to note the distinctions between the two resource types in order to achieve actual comparability. Within the comments filed on the NOPR, the comparability debate has divided into three categories – the nature of demand response as a balancing resource, the dispatchability of demand response, and a demand response product’s obligations as a market participant in organized wholesale electric markets. APPA and NRECA aptly summarize a widely held understanding of how DR should be treated in energy markets:

It is not unjust and unreasonable to treat demand response resources differently than generators and other suppliers. By analogy to Order No. 890, demand response, generation and transmission are to be treated “comparably,” but it does not follow that each of them is “the same” and therefore must be compensated in the same manner.<sup>56</sup>

Additionally, the Illinois Commerce Commission includes a graphic economic analysis to support the difference between supply and demand as resources.

In pure economic terms a reduction in demand is fundamentally different from an increase in supply. Demand reductions and supply increases are not only intuitively divergent, but treating them equivalently has material implications. Graphical depictions will be used to illustrate how demand reductions and supply increases affect the dispatch model and result in different market outcomes. The ICC believes that demand response should be incentivized and participants should be fairly compensated, but

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<sup>56</sup> APPA/NRECA Comments, pp. 12-13.

these comments show that they are not particularly comparable with generation supply.<sup>57</sup> (Citation omitted.)

**1. IF DR IS A BALANCING SERVICE IT SHOULD BE TREATED AND COMPENSATED AS A SERVICE, NOT AS SUPPLY**

Even supporters of the Commission's proposal have admitted to varying degrees that the physical abilities of demand response are different from those of generation resources. Some commenters have spoken generally and rhetorically about demand response, as if it were all one product type, seeming not to notice that the Commission's proposal targets economic, non-emergency demand response.<sup>58</sup> Other commenters have conceded that some demand response resources are controllable and callable while others are not.<sup>59</sup> Regardless of the degree to which supporters of the NOPR's proposal understand various demand response products, they largely seem to agree on one thing – that demand response is a balancing service.

The Consumer Demand Response Initiative ("CDRI") notes that "a reduction in consumption is comparable to an increase in production for the purpose of balancing supply and demand *at the margin*."<sup>60</sup> The joint public interest organizations ("PIO") assert that "a reduction in energy consumption meets essential system needs, including load balancing and resource adequacy."<sup>61</sup> Demand Response Supporters state that,

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<sup>57</sup> ICC Comments, p. 2 See graphic models as verified by Nicholas Bowden, Economic Analyst, Federal Energy Program, ICC.

<sup>58</sup> See Viridity Initial Comments and CDRI Comments.

<sup>59</sup> DR Supporters Comments, p. 20, "On the load side of the balancing equation, some loads will be relatively inflexible and uncontrollable. Other forms of load can be controlled – by the grid operator or the customer – in response to price."

<sup>60</sup> CDRI Comments, p. 10. (Emphasis added.)

<sup>61</sup> *Corrected* Joint Comments of Public Interest Organizations On Notice of Proposed Rulemaking (NOPR), p. 4, Docket No. RM10-17-000, (filed May 14, 2010) ("PIO Comments").

“flexible and price-responsive demand that can reduce the supply requirements required for balance has the equal impact of reducing the marginal price of achieving a reliable and balanced grid.”<sup>62</sup> The types of benefits they say that price-responsive demand produces are similar, if not equal to, other balancing products that operate in Ancillary Services Markets.

The Demand Response Supporters extrapolate from their discussion that,

[P]roviding additional generation and curtailing consumption effectively provide the same service to the market, [therefore] it is crucial that the Commission provide compensation to demand-side resources that is comparable to compensation for generation – i.e., full LMP in today's markets.<sup>63</sup>

However, balancing services have wholly different compensation algorithms from generation resources. In most markets, a balancing service is assigned a value by the stakeholder process, its compensation is agreed upon, finalized in a tariff proposal and ultimately subject to approval by the Commission. These services usually are compensated relative to opportunity costs. PJM, ISO-NE, MISO, NYISO and ERCOT all have fully functioning ancillary services markets that buy and sell balancing services to the grid.<sup>64</sup> Certainly providers of ancillary services are important to the maintenance and improvement of the reliability of the system and require appropriate compensation. However, that compensation is not a direct reflection of the supply of electricity as demand response bids cannot abide by all of the parameters and requirements of

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62 DR Supporters Comments, p. 9.

63 Id., p 22.

64 For examples of how different values are placed on differing products, see: *A Review of Generation Compensation and Cost Elements in the PJM Markets* (2009), available at: <http://www.pjm.com/~media/committees-groups/committees/mrc/20100120/20100120-item-02-review-of-generation-costs-and-compensation.ashx>.

supply (see section on market obligations below). Therefore, an option for an appropriate compensation mechanism for price responsive demand should reflect and be developed in a manner similar to other products in the ISO/RTO ancillary services markets, which would likely vary by region as do other ancillary service payment levels.

## **2. TO BE COMPARABLE, DR MUST BE DISPATCHABLE**

A major element of the comparability argument in this proceeding has been the dispatchability of demand response resources, and how these resources affect the economic dispatch of the system. Some supporters of the NOPR refer to economic DR as “controlled” or “actively managed” load, but that control and management is by the DR provider.<sup>65</sup> As discussed in the NOPR and supporting comments, DR economic bids are entirely voluntary,<sup>66</sup> and there is no regulatory language or explanation in the NOPR as to the important question of how economic DR is accepted or dispatched by the market operator. EPISA’s initial comments touched on the fact that most DR resources are technically incapable of acting as traditional dispatchable supply. A plethora of commenters not only agreed with EPISA, but expanded on why demand response is not the same as an energy product in technical terms.<sup>67</sup>

In its comments, ISO New England raised another dispatchability concern – the possibility for preferential dispatch of high cost demand response resources over lower cost generation resources. As the independent market administrator, ISO New England

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<sup>65</sup> Viridity Reply Comments, pp. 3, 6 and generally.

<sup>66</sup> *Reply Statement of Audrey Zibelman, regarding Reply Comments of Viridity Energy, Inc.*, Docket No. RM10-17-000 (June 18, 2010), p. 11. “The economic decision that the customer uses to dispatch these resources is complex and requires algorithmic based calculus, system understanding and contingency analysis *to produce the desired economic outcome.*” (Emphasis Added)

<sup>67</sup> For examples, see: EEI, p 15; P3, pp.2-3; Monitoring Analytics, p.5; NYISO, p.3; PJM, p.6; ISO-NE, p. 18-19; PJM Power Providers, Tranen affidavit, p. 2-3; Borlick Comments, p. 4.

is apprehensive that paying full LMP to demand responders will produce a more expensive resource, as the demand responder is also experiencing cost-savings in its energy bill plus any incentive payments from the regional wholesale market. Thus, because generation resources experience no such savings and are paid the same LMP price, the proposed rule will dispatch higher-cost demand resources. “By dispatching higher-cost demand resources, lower-cost generating resources are displaced, which is inefficient and increases the total resource costs in the energy market,” ISO-NE concluded.<sup>68</sup> The Brattle Group echoes this concern:

At a wholesale level, the economically efficient level of compensation for load reductions (not load shifts) is the LMP minus the avoidable generation portion of the retail rate, resulting in a net savings equal to the LMP. The efficient compensation for any load that shifts from one hour to another is the LMP difference between the two hours. Providing more would distort incentives and lead to inefficient system dispatch.

Any higher compensation, including compensation at the full LMP, represents a subsidy for DR that could distort market incentives, resulting in inefficient load management and inefficient dispatch of behind-the-meter generation. This incentive distortion could be particularly problematic if instituted in markets with mature DR penetration.<sup>69</sup>

ISO-NE and the Brattle Group have highlighted an important point. Not only does it incorporate the economic principles espoused by Dr. Hogan in EPSA’s initial comments, but it also relates to Dr. Hogan’s arguments regarding market operation and comparability issues. There is a fundamental market design flaw that will emerge if the NOPR’s proposal is allowed to go forward – competitive markets designed to dispatch the lowest-cost supply first will no longer be able to do so because it is not clear from

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68 ISO-NE Comments, p. 3.

69 *Comments of Samuel Newell, Kathleen Spees, and Philip Q Hanser*, Docket No. RM10-17-000 (May 13, 2010), pp 2-3, p 8.

the NOPR that DR is dispatched as part of the supply stack. EPSA will not reiterate all of ISO-NE's arguments in these reply comments; however, the nexus that ISO-NE has found between Dr. Hogan's economic arguments speaks to the very essence of the competitive market structure. If the NOPR's proposal is allowed to go forward, that structure that seeks to dispatch the lowest cost supply first will be compromised. EPSA agrees with ISO-NE's assessment and urges the Commission to consider the negative effects the NOPR proposal will have on competitive market structures. In fact, this argument negates the proposition from those who support the NOPR that the proposal will bolster competition. EPSA agrees with ISO-NE that the NOPR proposal will harm competitive market practices, particularly security-constrained economic dispatch in which low cost supply is called upon first.

**C. ANY RULE ON DR COMPENSATION MUST ADDRESS CONCERNS OVER MEASURABILITY AND VERIFICATION AND SHOULD REFLECT SUGGESTED CHANGES TO INCLUDE AN OFFSET AND/OR THRESHOLDS FOR PARTICIPATION**

Striking among comments was the recurrent call from numerous types of stakeholders for several changes that must be made to the compensation mechanism or included in any final rule in order to ensure that the resulting compensation methodology and the role of economic DR in the ISOs/RTOs is beneficial both to the efficiency and operation of the market and broadly to consumers in the end. These required changes address two primary areas: the compensation methodology itself, and what must be addressed in addition to compensation in order for the rule to function rationally. As to the compensation methodology, many stakeholders echoed EPSA's concern that the full LMP proposal does not reflect any offset to represent the purchase of energy, as should be required to enable a sale of energy back to the system.

Additionally, numerous commenters raised concerns that the compensation as proposed would apply in all hours rather than in those times when needed and called by the system. This notion leads to the next basket, in that the pricing proposal for all hours raises concerns about how customer baselines would be assessed and managed, which is tied in to the oft repeated request that the issues of measurability and verification must be addressed at least in tandem with if not in advance of imposing any uniform compensation methodology. Additionally, as payment of full LMP in all hours will create additional costs that must be paid to DR providers by customers unable to leave the grid, how costs related to DR compensation are allocated (e.g., within each LSE, across the entire ISO/RTO, etc.) was an important concern among several commenters, yet not addressed in the NOPR.

#### **1. The Economically Efficient Price for DR Reflects an Offset for the Purchase of Energy**

While numerous commenters characterized the economically efficient and proper price for economic DR in different ways, there was basic agreement across a wide array of stakeholders that there must be an offset to reflect the avoided cost, or the purchase of, the energy that the DR provider is not taking from the system.<sup>70</sup> The Organization of MISO States, representing over 40 million electricity customers in 14 states, noted,

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<sup>70</sup> *Comment of American Electric Power Service Corporation*, Docket No. RM10-17-000 (May 13, 2010); *Comments of the American Public Power Association and the National Rural Electric Cooperative Association*, Docket No. RM10-17-000 (May 13, 2010); *Comment of Battelle/Pacific Northwest Laboratories*, Docket No. RM10-17-000 (May 13, 2010); *Comment of Robert Borlick*, Docket No. RM10-17-000 (May 13, 2010); *Comments of Calpine Corporation*, Docket No. RM10-17-000 (May 13, 2010); *Comments of Capital Power Corporation*, Docket No. RM10-17-000 (May 13, 2010); *Comment of Consolidated Edison Energy, Inc., et. al*, Docket No. RM10-17-000 (May 13, 2010); *Comment of Constantine Gonatas of CPG Advisors Inc.*, Docket No. RM10-17-000 (May 13, 2010); *Comments of Dominion Resources Services, Inc.*, Docket No. RM10-17-000 (May 13, 2010); *Comment of Duke Energy*, Docket No. RM10-17-000 (May 13, 2010); *Comments of Edison Electric Institute*, Docket No. RM10-17-000 (May 13, 2010); *Comments of Edison Mission Energy*, Docket No. RM10-17-000 (May 12, 2010); *Comments of Exelon Corporation*, Docket No. RM10-17-000 (May 13, 2010); *Comment of the Federal*

An “efficient” payment to the retail customer is the amount necessary to provide sufficient incentive for customers to make consumption decisions as if they were facing the wholesale rate and thus not to exercise their option to purchase at the lower retail rate. The question at hand becomes: How much does the retail rate have to be increased so that retail customers behave as if they are facing the wholesale LMP? Because the retail customer is already facing the retail rate, the efficient payment is represented by the difference between the LMP and the retail rate.<sup>71</sup>

Importantly, OMS continues,

The payment of any amount in excess of this difference to the ARC, such as the full LMP, would result in a “distortionary subsidy” to the retail customer and the ARC. The concept that the payment of the full LMP to ARC’s is inefficient and would result in market distortions is well-known has been discussed in various reports and in comments to the Commission in other proceedings.<sup>4</sup>The payment of the full LMP distorts consumer behavior and would result in inefficient decisions to curtail load. In addition, the subsidy would have to be recovered from non-participating customers. It is

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*Trade Commission*, Docket No. RM10-17-000 (May 13, 2010); *Comments of GDF Suez Energy North America, Inc.*, Docket No. RM10-17-000 (May 13, 2010); *Comments of Illinois Commerce Commission*, Docket No. RM10-17-000 (May 6, 2010); *Comment of Independent Power Producers of New York, Inc.*, Docket No. RM10-17-000 (May 13, 2010); *Comments of the Indicated New York Transmission Owners*, Docket No. RM10-17-000 (May 13, 2010); *Comment of International Power America, Inc.*, Docket No. RM10-17-000 (May 14, 2010); *Comments of ISO New England Inc*, Docket No. RM10-17-000 (May 13, 2010); *Comments of ISO New England Inc. Internal Market Monitor*, Docket No. RM10-17-000 (May 13, 2010); *Comment of ISO/RTO Council*, Docket No. RM10-17-000 (May 13, 2010); *Comment of Midwest Independent System Transmission Operator, Inc.*, Docket No. RM10-17-000 (May 13, 2010); *Comments of the Midwest ISO Transmission Owners*, Docket No. RM10-17-000 (May 13, 2010); *Comments of Midwest TDUs*, Docket No. RM10-17-000 (May 13, 2010); *Comments of Mirant Corporation*, Docket No. RM10-17-000 (May 13, 2010); *Comments of Monitoring Analytics, LLC*, Docket No. RM10-17-000 (May 13, 2010); *Comments of the New England Power Generators Association*, Docket No. RM10-17-000 (May 13, 2010); *Comments of the New York ISO*, Docket No. RM10-17-000 (May 13, 2010); *Comment of New York State Public Service Commission*, Docket No. RM10-17-000 (May 13, 2010); *Comments of Samuel Newell, Kathleen Spees, and Philip Q Hanser*, Docket No. RM10-17-000 (May 13, 2010); *Comments of Northeast Utilities Service Company*, Docket No. RM10-17-000 (May 13, 2010); *Comments of the Northern California Power Agency*, Docket No. RM10-17-000 (May 13, 2010); *Comments of Old Dominion Electric Cooperative*, Docket No. RM10-17-000 (May 14, 2010); *Comment of Organization of MISO States*, Docket No. RM10-17-000 (May 13, 2010); *Comments of PJM Interconnection*, Docket No. RM10-17-000 (May 13, 2010), pp. 6-8; *Comments of Potomac Economics, Ltd.*, Docket No. RM10-17-000 (May 13, 2010); *Comments of the PPL Parties*, Docket No. RM10-17-000 (May 13, 2010); *Comments of the PSEG Companies*, Docket No. RM10-17-000 (May 13, 2010); *Comment of Public Utilities Commission of Ohio*, Docket No. RM10-17-000 (May 13, 2010); *Comments of RRI Energy, Inc*, Docket No. RM10-17-000 (May 13, 2010); *Comments of Southwest Power Pool, Inc.*, Docket No. RM10-17-000 (May 13, 2010).

71 OMS Comments, p. 3.

clear that the proposed rule would replace one inefficient price signal with a different inefficient price signal and would result in a subsidy to ARCs and participating customers.<sup>72</sup>

While the OMS notes that the Commission's compensation proposal could be corrected at the state level to represent an efficient price signal and price, this correction would be complicated and possibly legally difficult. Instead, this can be more simply resolved by setting a wholesale compensation formula which subtracts the retail rate from the LMP for payments to Aggregators of Retail Customers ("ARCs"). This sentiment is echoed by the Illinois Commerce Commission,<sup>73</sup> which through detailed economic analysis and modeling supports that the payment of LMP minus the retail rate, "makes the load serving entity indifferent between the consumption of another unit of electricity and the consumption of a unit of demand response. Correctly aligning the load serving entity's incentives with the desired behavior is an integral part of accomplishing any policy objective."<sup>74</sup>

In another approach to achieve the same rational and efficient economic result, the ISO-New England explains that, "Comparability and symmetry are achieved by netting out the bill savings from the full LMP payment made to a demand response provider for demand reductions, for demand resources that have reduced consumption relative to an estimated baseline."<sup>75</sup> In order to achieve this comparability, ISO-NE states that DR can either be paid  $LMP - G$ , or,

[I]f the objective is payment of the full LMP in all hours in which the consumption of electricity was reduced from expected levels in response to price signals, then the day-ahead purchase of expected energy use, or some other advance purchase requirement, should be required. This is

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72     Id.

efficient, avoids the need for an estimated baseline, and avoids the need to allocate costs of payments to demand resources.<sup>76</sup>

The FTC summarizes,

We question the soundness of a policy that would pay companies the proceeds from the sale of power that they never bought in the first place. Such a policy would create situations in which a demand response provider would find it more profitable to sell its power rights (*i.e.*, provide demand response) than to consume that power, even though the value to society of consuming that power exceeds the power's cost to society.<sup>77</sup>

Essentially, if there is not an offset for avoided cost (or retail charge), there should be an actual purchase requirement for expected energy use in the Day Ahead market. This proposal is echoed by the ISO-New England Internal Market Monitor, which refers to this as a “buy the baseline” approach.<sup>78</sup> This approach also resolves concerns over inauthentic or manipulated DR baselines.

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<sup>73</sup> Ironically, some of the parties who insist most vociferously that the Commission does have jurisdiction over DR as a “service [that] is rendered in the wholesale market,” (Reply Comments of Viridity, p. 3), take a much narrower view of the Commission’s jurisdiction when discussing offsets to DR compensation to account for avoided retail rates. For example, Viridity claims that such proposals “seek to draw the Commission into a review of retail rate matters beyond the Commission’s jurisdiction.” *Id.* at 13. As EPSA previously explained in response to similar objections to PJM’s LMP – G proposal, parties seeking to have the Commission assert jurisdiction over DR compensation while averting its gaze from avoided retail charges are attempting to have it both ways and ignoring the fact that the Commission is not purporting to set the retail rate (*i.e.*, “G”) but instead is using that rate, as determined by state regulators, as an input to a wholesale rate formula. See Motion for Leave to Answer and Answer of the Electric Power Supply Association and White Paper by Professor William W. Hogan, pp. 11-17, Docket No. EL09-68-000 (filed Oct. 30, 2009). In any event, the fact that state regulators, including the Illinois Commerce Commission and the members of OMS, filed comments supporting the LMP – G illustrates that this approach does not infringe upon state jurisdiction.

<sup>74</sup> ICC Comments, p 13.

<sup>75</sup> ISO-NE Comments, pp 3-4.

<sup>76</sup> ISO-NE Comments, p 5.

<sup>77</sup> FTC comments, p 2.

<sup>78</sup> “A modification to the Commission’s proposal based on requiring ownership of the energy reduction sold into the market by the demand resource provider would permit the payment of full LMP to demand response providers consistent with economic efficiency. This approach, referred to herein as “buying the baseline,” requires a demand response provider to purchase its expected amount of demand reduction in the day-ahead energy market in order to be paid full LMP in the real-time energy market. The

Additionally, it is important to note that the NYISO and CAISO, characterized as currently paying full LMP to DR, are in special circumstances as one state, one utility commission, one ISO markets. For instance, while the California investor-owned utilities support the NOPR as some DR supporters stress, those utilities also clarify that the retail jurisdictional entity will adjust compensation as necessary through retail revenue settlements, which for CAISO is just one regulatory body. While characterized as supporters of the NOPR, the California utilities actually state,

Adjustments to the full LMP compensation will be necessary given the potential for a retail customer to be overpaid if it receives compensation for reducing its load via wholesale markets and also benefits from bill savings on its retail tariffs. As with under-compensation, over-compensation of DR will send an incorrect price signal and result in market inefficiency.

This factual difference is important in understanding the comments and programs in place in both California and New York, as compensation will be adjusted to reflect a retail offset, thus reaching the same result EPSA advocates.

## **2. The Proposal to Pay Full LMP in All Hours Creates Operational and Economic Concerns**

Similar to the reaction to the payment of full LMP with no sort of offset for a purchase or obligation, there was a wide array of opposition to the proposal to pay DR market prices in all hours at all times.<sup>79</sup> The concerns reflect the

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advantage of the buy-the-baseline approach is that it can be implemented by the Commission without changes in state policies.” ISO-NE IMM Comments, p 4.

<sup>79</sup> *Comment of American Electric Power Service Corporation*, Docket No. RM10-17-000 (May 13, 2010), pp. 9-10; *Comments of the American Public Power Association and the National Rural Electric Cooperative Association*, Docket No. RM10-17-000 (May 13, 2010), p. 14; *Comments of Capital Power Corporation*, Docket No. RM10-17-000 (May 13, 2010), p.5; *Comment of Constantine Gonatas of CPG Advisors Inc.*, Docket No. RM10-17-000 (May 13, 2010), pp. 9-10; *Comments of the Indicated New York*

operational impacts created by the economic incentive to reduce demand during non-peak, low stress periods. Largely this is manifested in whether and how DR baselines for expected consumption can be accurately established and frequently updated. Additionally, payment of full LMP to DR during many hours will not result in net benefits to customers, as the DR payments will be substantially more than the savings created by reducing the clearing price at that time. Therefore, numerous commenters suggest that LMP payments be limited to those hours in which net benefits will be realized by a broad class of all consumers generally.

On the operational concerns, New England Public Systems, representing cooperatives in Connecticut, Massachusetts and New Hampshire, explains that based on extensive experience detailed in its comments,

[Opposition to the mandate in the NOPR] is premised upon our region's hard-earned experience attempting to integrate demand response resources in a day-ahead load-response program that paid DR resources the full LMP under certain conditions: an attempt that—because of poorly defined baselines—ended up paying millions of dollars for “demand response” that failed to represent a real departure from normal operations.<sup>80</sup>

Additionally, ISO-NE explains,

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*Transmission Owners*, Docket No. RM10-17-000 (May 13, 2010), p. 5; *Comments of ISO New England Inc*, Docket No. RM10-17-000 (May 13, 2010), pp. 28-29; *Comments of Massachusetts Attorney General and Maine Public Advocate*, Docket No. RM10-17-000 (May 13, 2010), pp. 7-11; *Comments of National Grid USA*, Docket No. RM10-17-000 (May 13, 2010), pp. 3-6; *Comments of New England Conference of Public Utilities Commissioners*, Docket No. RM10-17-000 (May 13, 2010), p.3; *Comment of New York State Consumer Protection Board*, Docket No. RM10-17-000 (May 13, 2010); *Comment of New York State Public Service Commission*, Docket No. RM10-17-000 (May 13, 2010), p.10; *Comments of NSTAR Electric Company*, Docket No. RM10-17-000 (May 14, 2010).

<sup>80</sup> *Comments of Connecticut Municipal Electric Energy Cooperative, Massachusetts Municipal Wholesale Electric Company, and New Hampshire Electric Cooperative, Inc.* (Collectively, “New England Public Systems”), pp 1-2.

The proposed rule also introduces baseline estimation and cost allocation problems, neither of which is addressed in the NOPR and both of which must be fully addressed before any final rules can be issued. The Commission's proposed requirement that those who reduce consumption of electricity from *expected levels* in response to price signals be paid the full LMP for such reductions *in all hours* creates a situation in which baseline estimation becomes a substantial challenge. There is no baseline estimation technique that can accurately and reliably estimate what a customer's energy usage pattern would have been if that customer responds frequently to price signals.<sup>81</sup>

The New England Public Systems explain that they are troubled by the LMP in all hours approach as it "appears to do away with minimum offer requirements that the Commission previously found to be necessary to guard against abuse, without proposing an alternative baseline-setting mechanism to prevent such abuse."<sup>82</sup> The issue of developing useful, accurate baselines permeated many of the comments, and clearly requires careful attention in any final rule that would establish a compensation mechanism for economic DR.<sup>83</sup>

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81 ISO-NE Comments, p 4, emphasis reproduced as appears in comments.

82 New England Public Systems Comments, Docket No. RM10-17-000 (May 13, 2010), p. 15.

83 *Comment of American Electric Power Service Corporation*, Docket No. RM10-17-000 (May 13, 2010), p. 12; *Comments of Connecticut Municipal Electric Energy Cooperative, Massachusetts Municipal Wholesale Electric Company, and New Hampshire Electric Cooperative, Inc.* Docket No. RM10-17-000 (May 13, 2010), pp. 7-14; *Comments of Dominion Resources Services, Inc.*, Docket No. RM10-17-000 (May 13, 2010), p. 7; *Comments of Edison Electric Institute*, Docket No. RM10-17-000 (May 13, 2010), p.19; *Comment of the Federal Trade Commission*, Docket No. RM10-17-000 (May 13, 2010), p.8; *Comment of Illinois Citizens Utility Board*, Docket No. RM10-17-000 (May 13, 2010), pp. 16-17; *Comments of the Indicated New York Transmission Owners*, Docket No. RM10-17-000 (May 13, 2010), p. 3; *Comments of ISO New England Inc*, Docket No. RM10-17-000 (May 13, 2010), pp. 31-36; *Comment of the Joint Consumer Advocates*, Docket No. RM10-17-000 (May 13, 2010), p. 12; *Comment of Joint Public Interest Organizations*, Docket No. RM10-17-000 (May 13, 2010), at fn. 2; *Comments of the Midwest ISO Transmission Owners*, Docket No. RM10-17-000 (May 13, 2010), p.13; *Comments of Midwest TDUs*, Docket No. RM10-17-000 (May 13, 2010), p.11; *Comments of National Grid USA*, Docket No. RM10-17-000 (May 13, 2010); *Comments of New England Conference of Public Utilities Commissioners*, Docket No. RM10-17-000 (May 13, 2010), p.3; *Comments of the New England Power Generators Association*, Docket No. RM10-17-000 (May 13, 2010), attachment p.26; *Comments of the New York ISO*, Docket No. RM10-17-000 (May 13, 2010), p.8; *Comments of Occidental Chemical Corporation and Occidental Permian Ltd.*, Docket No. RM10-17-000 (May 13, 2010), p. 2; *Comments of the Pennsylvania Public Utilities Commission*; Docket No. RM10-17-000 (May 13, 2010), p. 1; *Comments of PJM Power Providers Group*, Docket No. RM10-17-000 (May 13, 2010), p. 38; *Comment of Public Utilities Commission of Ohio*,

Even among some commenters that support the payment of full LMP with no offset, there remain concerns that in many hours that payment will not yield net benefits to the system. Therefore, numerous commenters representing varied stakeholder sectors support the establishment of some measurable threshold or trigger to ensure that market prices are paid to DR providers when there will be an economic net benefit for consumers. The New York State Consumer Protection Board (“NYSCPБ”) noted, “[P]ayment of LMP to DR resources should apply to all hours when the net benefit to customers is positive. DR provides net benefits to customers as long as they reduce energy costs (through lower energy prices) by an amount that exceeds the costs of DR.”<sup>84</sup> The NYSCPБ recommends that individual ISO/RTOs develop and implement the tools to assess whether a net customer benefit would occur. The Illinois Citizens Utility Board also states, “Full LMP compensation should only be paid to demand resources that intentionally and directly reduce energy usage in response to the market price. Stated differently, only if the demand response truly avoids costs on the system should it be compensated.”<sup>85</sup>

The New England Consumer Advocates (the Massachusetts Attorney General and Maine Public Advocate) echo both this concern and recommendation – that the regions develop participation threshold mechanisms

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Docket No. RM10-17-000 (May 13, 2010), p.5; *Comments of RRI Energy, Inc.*, Docket No. RM10-17-000 (May 13, 2010), p. 6; *Comments of Southwest Power Pool, Inc.*, Docket No. RM10-17-000 (May 13, 2010), pp. 3-4; *Comment of Westar Energy, Inc., et. al.*, Docket No. RM10-17-000 (May 13, 2010), p. 3.

84 NYSCPБ comments, p 4.

85 Illinois Citizens Utility Board, p 19. Citation omitted.

that ensure LMP payments are made when it is cost effective for ratepayers.

They state,

Although demand response resources that clear as supply-side resources should be compensated at full LMP, allowing them to clear in all hours, as the Commission proposes, may lead to situations where the total cost paid by load actually increases as a result of demand response participation.<sup>86</sup>

Additionally, the New England Conference of Public Utility Commissioners

(“NECPUC”), representing the commissions in six states, explains,

While NECPUC supports improving competitiveness of the organized wholesale energy market by eliminating barriers to participation for demand response resources, the principle of providing net benefits to customers must be considered when considering the hours in which demand response resources are compensated. Providing incentives for demand response resources in all hours, as the Commission proposes, may not result in net benefits to all market customers.<sup>87</sup>

Demand response resources have the capability to benefit consumers by lowering clearing prices when more expensive resources are displaced. Conversely, supply-side treatment for demand response resources may also raise costs. Demand response resources provide net benefits when the positive benefits from lower clearing prices outweigh the price increase resulting from supply-side treatment. Thus, NECPUC respectfully submits that demand response resources should be provided an incentive to participate in organized wholesale energy markets when they provide net economic benefits to all market customers, including those who provide demand resources and those who do not.<sup>88</sup>

NECPUC supports payment of full LMP, but explains in detail the relationship between supply and demand reduction for the supply stack and dispatch, and why demand reduction during the highest-priced hours of the year

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<sup>86</sup> New England Consumer Advocates, p 11. Citation omitted. Of note, this filing points to an example threshold mechanism developed by Consumer Demand Response Initiative (“CDRI”) that utilizes a dynamically-set algorithm that would allow a demand response resource bid to clear only if it reduces the clearing price more than it increases the cost to load due to the decreased demand.

<sup>87</sup> NECPUC Comments, p 9.

<sup>88</sup> NECPUC Comments, p 10.

results in clearing price reductions that offer net benefits to demand. However, demand response at times when the supply curve is not very steep may not adequately reduce the clearing price. “[T]he Commission’s proposal to compensate demand response resources with the market price in all hours may increase costs to customers in some circumstances and this may be unjust and unreasonable.”<sup>89</sup> For this reason, NECPUC recommends that each ISO/RTO develop a price threshold mechanism that ensures net benefits. NECPUC uses a threshold based on a dynamic floor price for eligibility, which is equal to the product of a fuel price index and a heat rate from a representative marginal generation resource.<sup>90</sup> NECPUC’s comments are just an example of one type of threshold mechanism that could be developed at a regional level.

### **3. The Proposal Does Not Address Concurrent Development of Measurement and Verification Tools and Requirements**

Another widely established concern is that the NOPR does not address the accurate measurement and verification (“M&V”) of DR participation in the energy markets. While such tools are being discussed and under development currently, it is critical that they are implemented in direct relationship to a standardized compensation mechanism for economic DR. This consideration is emphasized in the recently issued National Action Plan for Demand Response, which noted,

Finally, development of measurement and verification standards is critically needed at both the wholesale and retail levels. Methods for measuring and verifying demand response reductions currently vary

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<sup>89</sup> NECPUC Comments, p 14-17 with graphic illustrations.

<sup>90</sup> Id., p 19.

significantly across the country, and measurement and verification standards will increase confidence in markets...The efforts of NAESB and NERC should provide valuable tools and standardization to ensure that demand response is accurately measured and verified.<sup>91</sup>

However, with no discussion or inclusion of such tools, the NOPR seeks to pay for something that is neither measured nor verified based on the parameters of the NOPR proposal. The Illinois Citizen Utility Board noted,

A lack of stringent measurement and verification can result in compensating demand resources when no verifiable usage reduction took place, or when a usage reduction occurred for reasons other than in response to the market price. Such occurrences can undermine the credibility and ultimately the viability of demand response programs.<sup>92</sup>

Additionally, Joint Consumer Advocates (“JCA”) representing four state consumer advocates in ISO-NE, PJM and Midwest-ISO, states,

JCA wishes to make clear that while it supports the broad deployment of demand response by way of compensation at full LMP, it also supports the responsible deployment of demand response through the establishment and enforcement of rigorous M&V standards. The lack of stringent M&V rules can result in compensating demand resources when no verifiable usage reduction took place, or when a usage reduction occurred for reasons other than in response to the market price. Such occurrences can undermine the credibility and ultimately the viability of demand response programs.<sup>93</sup>

JCA acknowledges that development of M&V requirements may be difficult, but doing so is critical and necessary in order to ensure DR participates responsibly and brings benefits to the system.

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91 National Action Plan on Demand Response, pp 66-67.

92 Illinois Citizens Utility Board Comments, p 16.

93 JCA Comments, p 12.

#### **4. Due to Expected Impacts to Consumers from the Proposal, Cost Allocation Issues Must Be Addressed**

Another concern that garnered an extensive amount of discussion is that the overcompensation that results if there is no retail or purchase offset creates a problem for cost allocation, as the ISO/RTO will not be revenue neutral if it must pay for a product that is not offset by any purchase or the exercise of an option on the system at any point. Additionally, cost issues generally impact how much DR is beneficial to the system and to consumers. The National Action Plan on Demand Response points out,

Determining the cost-effective mix of demand response programs is a central challenge to any demand response provider, regulator, or policymaker. Projections of long-term benefit streams (such as avoided resource costs), identification of relevant costs, and the accurate characterization of these costs are examples of the types of calculations that must be made in assessing a program's cost-effectiveness. The creation of cost-effectiveness tools is essential to determining the most efficient mix of demand response programs for a given service territory or region.<sup>94</sup>

Regarding the NOPR proposal in particular, OMS notes that the problem of cost allocation threatens the very promotion of consumer level demand response that the Commission seeks to support with this proceeding. OMS states,

LSEs and State Commissions are more likely to support the provision of demand response by ARCs in the RTO markets if non-participating customers do not have to bear additional costs as a result.

The OMS does not support the uplift of the costs of payments to ARCs. This would penalize states and LSEs which have implemented and or are planning to implement improved and innovative retail rate structures using smart metering technology.<sup>95</sup>

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94 The National Action Plan on Demand Response, p 74.

95 OMS Comments, pp. 6-7.

The Midwest TDUs also note this concern:

Although electricity is not tangible in the same way as an airline ticket, the analogy applies: the demand responder cannot both be paid LMP *and* receive the retail tariff savings realized by not consuming energy. Real, metered load cannot be served with a “negawatt.” There are important compensation and cost allocation considerations that arise as a consequence of this fact. Commission efforts to integrate demand response into organized market structures must allow each RTO to recognize and account for this, or will unintentionally undermine the very goals they are intended to advance.<sup>96</sup>

The TDUs explain that the extra payments made to DR providers associated with treating DR as energy requires a cost allocation methodology that recovers those costs. According to Midwest TDU, these methodologies should be developed by the ISOs/RTOs. “These decisions reflect the specific interplay between demand response resources and the retail and wholesale market structures within each region with which demand response regimes must work. Those market structures vary significantly between RTO regions.”<sup>97</sup>

The ISO-NE explains, “With respect to cost allocation, the NOPR and proposed rule do not address how the costs resulting from payments to demand response providers ought to be allocated among market participants. Analysis conducted by ISO-NE found that some cost allocation schemes raise the overall costs charged to end-use consumers more than other schemes.”<sup>98</sup> This concern stems from the issue that the RTOs, if paying DR full LMP in all hours, will not be revenue neutral and must assign costs to market participants in order to cover those additional costs. This concern could

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<sup>96</sup> Midwest TDUs Comments, p. 7.

<sup>97</sup> Midwest TDUs Comments, p. 10.

<sup>98</sup> ISO-NE Comments, p. 4.

be resolved if LMP payments are made only when the payments result in net benefits or if there is a purchase required to offset the sale of the MW (a version of this is the ISO-NE “buy the baseline” proposal). Without these assurances that DR will not cost the system additional money, then how cost allocation is handled must be addressed in the NOPR as it is the compensation proposal creating the additional costs to consumers.

#### **D. Legal Issues**

##### **1. The Commission Lacks the Authority to Require “Just and Reasonable” Compensation for the Provision of Non-Jurisdictional DR Services**

###### **a. Even Supporters of the NOPR Concede That Providing DR Does Not Involve a FERC-jurisdictional “Sale for Resale”**

Various supporters of the DR subsidies proposed in the NOPR concede, as they must, that providing DR does not involve a FERC-jurisdictional “sale for resale.”<sup>99</sup> The Commission’s regulations have explicitly defined DR as a reduction in consumption of electric energy by end-users,<sup>100</sup> or in other words, as a retail purchase that will not be or was not made. The Commission re-affirmed this finding recently in *EnergyConnect, Inc.*,<sup>101</sup> where it held that an entity that provides only DR services, without making sales

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<sup>99</sup> See, e.g., Comments Of EnerNOC In Response To Notice Of Proposed Rulemaking, pp. 7-9, Docket No. RM10-17-000 (filed May 13, 2010), DR Supporters Comments, pp. 17-18.

<sup>100</sup> In Section 35.28(b)(5) of its regulations, the Commission has broadly defined DR as:

[A] reduction in the consumption of electric energy by customers from their expected consumption in response to an increase in the price of electric energy or to incentive payments designed to induce lower consumption of electric energy.

18 C.F.R. § 35.28(b)(5) (2009).

<sup>101</sup> 130 FERC ¶ 61,031 (2010) (“*EnergyConnect*”).

of electric energy for resale, is not a “public utility” within the meaning of the FPA.<sup>102</sup> EPISA therefore agrees with these commenters that a necessary, and unavoidable, consequence of the Commission’s definition and holding in *EnergyConnect* is that the Commission cannot exercise jurisdiction over DR as a jurisdictional “sale for resale.”

**b. The Commission Cannot Set Rates for Non-Jurisdictional Services, Even if Such Rates May “Affect” Jurisdictional Rates**

While conceding that providing DR does not itself represent a FERC-jurisdictional wholesale sale, various advocates for the subsidies proposed in the NOPR argue that the Commission can nonetheless regulate compensation for this service as a practice that affects or relates to rates for wholesale sales. As explained in the EPISA Initial Comments, however, the Commission’s proposal to regulate DR compensation represents an impermissible “attempt[] to do indirectly what it could not do directly. . . .”<sup>103</sup> The Commission’s ratemaking and refund jurisdiction under Sections 205 and 206 of the FPA<sup>104</sup> are expressly limited to rates charged by FPA-defined “public utilities” for jurisdictional services.<sup>105</sup> To the extent that the Commission

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<sup>102</sup> In *EnergyConnect*, the Commission explained that:

[W]here an entity is only engaged in the provision of demand response services, and makes no sales of electric energy for resale, that entity would not own or operate facilities that are subject to the Commission’s jurisdiction and would not be a public utility that is required to have a rate on file with the Commission.

*Id.* at P 30.

<sup>103</sup> *Altamont Gas Transmission Co. v. FERC*, 92 F.3d 1239, 1248 (D.C. Cir. 1996) (“*Altamont*”).

<sup>104</sup> 16 U.S.C. §§ 824d, 824e (2006).

<sup>105</sup> See *Bonneville Power Administration v. FERC*, 422 F.3d 908, 918 (9<sup>th</sup> Cir. 2005) (“*BPA*”). As the *BPA* decision makes clear, the fact that DR compensation may be provided pursuant to FERC-approved tariffs does not alter the jurisdictional analysis. Indeed, notwithstanding the fact that the transactions at issue were indisputably wholesale sales in interstate commerce, that decision finds that the Commission lacked jurisdiction because those sales were made by “non-public utilities.” *Id.* at 911. The court was not

determines that inadequate DR compensation in organized energy markets may have caused Commission-jurisdictional rates to become unjust and unreasonable, its remedy, if any, may “operate only against the rate of jurisdictional sales.”<sup>106</sup>

The fact that some DR providers may be public utilities based on their other business activities does not compel a different result. Where a regulated entity provides both Commission-jurisdictional and non-jurisdictional services, the Commission may only exercise its ratemaking authority with respect to the jurisdictional services.<sup>107</sup> Thus, the Commission may not regulate the rates for non-jurisdictional DR services, whether the provider is a non-public utility or a public utility that, like the one in *EnergyConnect*, also makes jurisdictional sales.

Contrary to the claims of certain commenters,<sup>108</sup> the D.C. Circuit’s holding in *Connecticut Department of Public Utility Control v. FERC*<sup>109</sup> does not support the assertion of jurisdiction over DR compensation. There, the court held that, because the Commission had direct ratemaking jurisdiction over the capacity prices in question, it could also indirectly regulate capacity prices through setting the inputs that would affect the prices paid for capacity,<sup>110</sup> or in other words, that the power to set rates directly

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persuaded by the Commission’s claims that the sales at issue were made in markets administered by public utilities with “FERC-approved tariffs.” *Id.* at 918.

<sup>106</sup> *FPC v. Conway Corp.*, 426 U.S. 271, 279 (1976) (“*Conway*”).

<sup>107</sup> *See, e.g., Colorado Interstate Gas Co. v. FPC*, 324 U.S. 581, 588 (1945).

<sup>108</sup> *See, e.g.,* DR Supporters Comments, Attach. A at 13 n.41.

<sup>109</sup> 569 F.3d 477 (D.C. Cir. 2009) (“*Connecticut DPUC*”).

<sup>110</sup> In *Connecticut DPUC*, the Court of Appeals for the D.C. Circuit upheld a Commission order accepting ISO New England Inc.’s Installed Capacity Requirement” (the “ICR”), which the court described as “a key input into the market-based mechanism” for determining ISO-NE capacity prices. *Id.* at 478-79.

“include[s] the power to do so indirectly.”<sup>111</sup> Unlike the capacity prices at issue in *Connecticut DPUC*, however, the Commission lacks the authority to directly set rates for DR services. Thus, given that *Connecticut DPUC*'s antecedent condition is not satisfied, then its conclusion that the Commission may regulate such non-jurisdictional rates as a practice affecting jurisdictional rates does not follow.

Where the Commission is foreclosed from directly regulating non-jurisdictional rates, it may not circumvent the limits on its statutory authority simply by claiming the authority to do so based on the fact that such non-jurisdictional rates may “affect” jurisdictional rates. EPSA notes that, in this regard, DR is no different than any other non-jurisdictional input that may “affect” the price of jurisdictional rates (*e.g.*, steel, cement, coal, etc.). Even if an increase in DR compensation in energy markets would lower jurisdictional rates, this effect does not, in and of itself, empower the Commission to set rates for DR, any more than the Commission would be justified to reaching out to regulate rates for cement, steel, coal, or other goods or services affecting the price of electricity. To argue that it does would read out of the FPA the express restrictions on the Commission’s ratemaking authority and would thus violate one of the cardinal rules of statutory construction, namely, that a statute must be read to “avoid an interpretation ... that renders any part of it superfluous and does not give effect to all of the words used by Congress.”<sup>112</sup>

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111 *Id.* at 482.

112 *Beisler v. Commissioner*, 814 F.2d 1304, 1307 (9th Cir.1987).

Finally, EPSA notes that the NOPR does not appear to make any distinctions between the different types of DR service providers,<sup>113</sup> nor does it explain whether there are any differences in the manner in which the different types of DR service providers affect jurisdictional rates and the significance of these differences for the Commission's regulation. In particular, the Commission has not explained whether and to what extent these different types of DR service providers will be subject to other Commission rules and requirements, *e.g.*, whether either type of DR service provider would be required to obtain market-based rate authority or whether these service providers would be subject to ISO/RTO market power mitigation measures.

**c. The NOPR Fails to Establish that Jurisdictional Rates are Unjust and Unreasonable or That, If They Were, Increased DR Compensation Is the Appropriate Remedy**

Even assuming *arguendo* that the Commission could assert jurisdiction over DR compensation as a practice affecting FERC-jurisdictional wholesale rates, it would still be required to focus on the effect of DR compensation on wholesale rates and not the adequacy of that compensation as such. More importantly, the Commission would need to explain why and how existing rates are unjust and unreasonable and why and how the amount of DR compensation proposed will cause rates to be just and reasonable. Blanket assertions that increased DR compensation will lower jurisdictional rates and mitigate market power, even if true, utterly fail to answer these questions,

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<sup>113</sup> EPSA notes that there are at least two types of DR providers. First, there are large industrial customers that purchase directly from the ISOs/RTOs and that would provide DR services by agreeing to reduce their own consumption. These DR service providers likely would not be considered "public utilities" within the meaning of the FPA. Second, there are third-party DR service providers (*e.g.*, load-serving entities or retail aggregators) that will function as an intermediary between the ISOs/RTOs and multiple end-users (whether residential, industrial, or commercial) that have agreed to reduce their consumption under specified circumstances. An entity in this second class of DR service providers may or may not be public utilities, depending on whether it makes jurisdictional sales for resale.

much less to provide the substantial evidence and reasoned decision-making necessary to survive judicial review. Moreover, if the basis for the Commission's assertion of jurisdiction over DR compensation is its effect on jurisdictional rates, then the Commission may set such compensation only to the extent that DR compensation actually affects or relates to the justness and reasonableness of jurisdictional rates.<sup>114</sup> The Commission may not review such rates to determine whether the non-jurisdictional seller is receiving adequate or excessive compensation.<sup>115</sup>

EPISA notes that numerous commenters advocating the subsidies to DR proposed in the NOPR parrot the NOPR's conclusory claim that increased DR compensation will lower jurisdictional rates by providing additional mitigation of generator market power.<sup>116</sup> The underlying – and unsupported – assumptions appear to be that generators currently have the ability to exercise market power and that existing ISO/RTO mitigation is inadequate to address such market power. This argument ignores the fact that the Commission accepted the existing ISO/RTO market power mitigation measures because it found them to be just and reasonable on their own,<sup>117</sup> without reference to the level of DR compensation or participation. Moreover,

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<sup>114</sup> See, e.g., *Transmission Agency of Northern California v. FERC*, 495 F.3d 663 (D.C. Cir. 2007) (“*TANC*”). In *TANC*, the court affirmed the Commission's decision to review the justness and reasonableness of the transmission revenue requirement (“TRR”) of the City of Vernon, California (“Vernon”), a governmental entity excluded from the definition of public utility, because it found that the Commission had “sufficiently demonstrated that it is impossible to ensure that [the jurisdictional] rates are just and reasonable without reviewing Vernon's TRR under the same standard.” *Id.* at 672.

<sup>115</sup> See *id.* at 674 (holding that the Commission could not fix Vernon's TRR at a just and reasonable level by requiring refunds).

<sup>116</sup> See, e.g., Joint Comments Of Public Interest Organizations On Notice Of Proposed Rulemaking, p. 4, Docket No. RM10-17-000 (filed May 13, 2010); Viridity Reply Comments, p. 27.

<sup>117</sup> See, e.g., *Market-Based Rates for Wholesale Sales of Electric Energy, Capacity and Ancillary Services by Public Utilities*, Order No. 697-A, FERC Stats. & Regs. ¶ 31,268 at P 111 (2008) (adopting a

the ISOs/RTOs and their respective market monitors have consistently found that ISO/RTO energy markets are competitive and that suppliers are not capable of exercising market power.<sup>118</sup> Finally, given that existing mitigation has been found to be just and reasonable, the Commission's proposal may result in overmitigation, which, as the Commission has recognized, may be just as harmful to competition as undermitigation and can reduce regulated sellers' rates to unjust and unreasonable levels.<sup>119</sup>

Conversely, the NOPR completely ignores the risk that its proposal may facilitate the exercise of buyer market power<sup>120</sup> and fails to propose, or even suggest, measures to monitor or mitigate any increased buyer market power resulting from the proposal. EPSA submits that the risk of buyer market power is in fact heightened with respect to DR in light of the fact that many DR service providers will not be public utilities subject to the full scope of Commission requirements and sanctions for unlawful conduct.

In addition, these commenters ignore the fact that the NOPR makes no attempt to quantify the amount by which jurisdictional rates are excessive, the effect of increased DR compensation on lowering jurisdictional rates, or the net effect of the proposal on jurisdictional sellers' compensation. In particular, the NOPR fails to consider whether the Commission's proposal would lower jurisdictional rates to such a

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"rebuttable presumption that the existing [ISO/RTO] mitigation is sufficient to address any market power concerns.").

<sup>118</sup> See generally EPSA Initial Comments, pp. 15-19. This argument that increased DR compensation is necessary to lower prices is particularly troubling in light of the current market conditions in which electricity prices fell by half from 2008 to 2009 and are currently at the lowest levels since the inception of organized markets. See *id.*, p. 15.

<sup>119</sup> See, e.g., *Wisconsin Public Power, Inc. v. FERC*, 493 F.3d 239 (D.C. Cir. 2007) (affirming Commission decision not to impose additional mitigation where the additional mitigation may have reduced prices to a level below that necessary for generators to recover their fixed costs).

<sup>120</sup> For example, the Commission does not appear to have considered the possibility that DR service providers' ability to suppress demand and lower prices may itself be an exercise of market power.

degree that it would violate jurisdictional sellers' statutory and constitutional rights to just and reasonable compensation,<sup>121</sup> and if so, whether the Commission should loosen or eliminate other mitigation measures to ensure that the resulting rates are compensatory. By solely focusing on the potential for DR to lower prices, without regard to whether these rates are confiscatory or whether they strike the appropriate balance between consumers' and investors' interests, the NOPR's proposal, if adopted, would represent an abdication of the Commission's obligations under the FPA and the U.S. Constitution to ensure that the rates that jurisdictional public utilities receive for jurisdictional sales are just and reasonable.

## **2. The Commission's Proposal Violates the Rulemaking Requirements of the FPA and the APA**

### **a. Implementation of the NOPR's Proposal Would Require the Commission to Find that Existing ISO/RTO DR Compensation Provisions Are Unjust and Unreasonable**

The DR Supporters make the unsupported and erroneous assertion that the Commission may exercise its authority to adopt the regulations proposed in this NOPR

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<sup>121</sup> See generally *Smyth v. Ames*, 169 U.S. 466, 546 (1898); *Bluefield Waterworks & Imp. Co. v. Public Service Commission of W. Va.*, 262 U.S. 679, 690 (1923); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944) ("*Hope*"). In its reply comments, Viridity Energy, Inc. ("Viridity") suggests that concerns about price suppression depriving public utilities of their statutory and constitutional rights to just and reasonable compensation are "meritless," because the Commission's market-based rate approach allows "fundamental competitive market conditions [to] determine the return earned by market participants – not administratively set rates." Viridity Reply Comments, p. 23. Viridity misses the point. The Commission's shift to a market-oriented regulatory regime did not eliminate the statutory and constitutional right of suppliers to just and reasonable compensation. And, as the Commission and the courts have recognized, over-mitigation, like that which would result from subsidized DR layered on top of existing mitigation in organized markets, can result in rates that are not just and reasonable. See, e.g., *Wisconsin Pub. Power, Inc. v. FERC*, 493 F.3d 239 (D.C. Cir. 2007). See also generally EPSC Initial Comments, pp. 38-46.

without first finding that existing DR compensation approaches are unjust and unreasonable.<sup>122</sup> This is simply false.

The Commission proposes to require all ISOs/RTOs (with the apparent exception of the Southwest Power Pool, Inc.) to modify their existing, Commission-approved tariff provisions governing DR compensation. Under the FPA, the Commission's only power to require modifications to filed rate schedules and tariffs arises under Section 206 of the FPA,<sup>123</sup> which requires that the Commission find the existing rates to be unjust and unreasonable, or unduly discriminatory or preferential and the proposed modifications to be just and reasonable and not unduly discriminatory or preferential. The DR Supporters offer no precedent for their sweeping claim that the Commission is relieved of the requirements of the FPA when it is exercising a "legislative" function.<sup>124</sup> The Commission, like any other federal regulatory agency, "is a creature of statute, and . . . has only those authorities conferred upon it by Congress."<sup>125</sup> Although courts grant agencies a certain degree of deference in reviewing their policy decisions and interpretations of the law, agencies receive no deference when their action is not authorized by their enabling statute.<sup>126</sup> Where the Commission has issued legislative-

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122 DR Supporters Comments, p. 29.

123 See, e.g., *Exxon Mobil Corp. v. FERC*, 571 F.3d 1208, 1215 (D.C. Cir. 2009).

124 *Id.* Instead, to support this proposition the DR Supporters cite *Midwest Indep. Sys. Op., Inc. v. FERC*, 388 F.3d 903 (D.C. Cir. 2004), which affirmed the Commission's decision **not** to initiate a rulemaking. The cited case thus has no bearing on the question at issue, namely, whether a Commission may direct transmission providers, on a generic basis, to change existing tariff provisions without finding those provisions to be unlawful under Section 206 of the FPA.

125 *Nat'l Ass'n of Regulatory Util. Comm'n v. FERC*, 475 F.3d 1277, 1286 (D.C. Cir. 2007) (internal citations omitted).

126 Commission interpretations of the FPA are reviewed by applying the two-step analysis of *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 104 (1984) ("*Chevron*"). Under this analysis, the court first determines "whether Congress has directly spoken to the precise

type rules that modify rates on a generic basis, as it proposes to do in the NOPR, it has made the generic findings required under Section 206 of the FPA, through a rulemaking proceeding, that a given rate or practice is unlawful and that its proposed replacement is just and reasonable, and not unduly discriminatory and preferential.<sup>127</sup> Thus, Commission and judicial precedent are clear that the Commission must first make such findings supported by record evidence under FPA Section 206 **before** it may require ISOs/RTOs to change tariff provisions it has previously found to be lawful.

**b. The NOPR Does Not Provide Interested Parties a Meaningful Opportunity for Notice and Comment**

EPSA notes that the DR Supporters claim that the Commission need not “find that the various existing approaches to compensation for demand response are unjust and unreasonable in order to **initiate** this rulemaking proceeding.”<sup>128</sup> While it is true enough that the Commission was free to initiate this rulemaking proceeding without such a finding, that does not alter the fact that by doing so the NOPR fails to give interested parties the notice and opportunity for comment required by the Administrative

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question at issue.” *Id.* at 842. “If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.” *Id.* at 842-43. Under the *Chevron* doctrine, an “agency’s interpretation of [a] statute is not entitled to deference absent a **delegation of authority** from Congress to regulate in the areas at issue.” *Am. Library Ass’n v. FCC*, 406 F.3d 689, 699 (D.C. Cir 2005) (emphasis in original) (citation omitted)).

<sup>127</sup> *Transmission Access Policy Study Group v. FERC*, 225 F.3d 667, 686-690 (D.C. Cir. 2000), *aff’d sub nom. New York v. FERC*, 535 U.S. 1 (2002) (upholding the Commission’s authority to issue Order No. 888, which required transmission providers’ to provide transmission service under the Commission’s *pro forma* open access transmission tariff (“OATT”), pursuant to the Commission’s generic findings under Sections 205 and 206 of the FPA that certain industry practices were unduly discriminatory and that the proposed replacement, the *pro forma* OATT, was just and reasonable, and not unduly discriminatory or preferential). *See also Associated Gas Distributors v. FERC*, 824 F.2d 981, 998 (D.C. Cir. 1987) (upholding open access requirements for interstate pipelines based on generic findings of undue discrimination pursuant to Section 5 of the Natural Gas Act, 15 U.S.C. § 717d (2006)).

<sup>128</sup> *Id.* (emphasis added).

Procedures Act (“APA”).<sup>129</sup> To comply with this obligation, the Commission must identify the reasoning and record evidence upon which it has relied in reaching its decision, so that interested parties have an opportunity to rebut the evidence proffered by the Commission,<sup>130</sup> and it must do so before issuing its final rule,<sup>131</sup> e.g., in the NOPR.

The Commission has not pointed to any evidence whatsoever demonstrating that current DR compensation levels render jurisdictional rates unjust and unreasonable or that increasing DR compensation as proposed is necessary for such rates to become just and reasonable.<sup>132</sup> Moreover, this inadequacy is unsettling in light of the incorporation of the record from the PJM proceeding, which, as Commissioner Moeller correctly notes, “shows wide disagreement in the industry regarding the issue of demand response compensation.”<sup>133</sup> Even though the record in that proceeding shows divergent and even contradictory evidence regarding the appropriate level of DR compensation, the Commission made no effort in the NOPR to identify the evidence that supports its proposal or to refute the overwhelming evidence that does not.

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129 5 U.S.C. § 553 (2006).

130 See, e.g., *WJG Tel. Co., Inc. v. FCC*, 675 F.2d 386, 389 (D.C.Cir.1982); *Chamber of Commerce v. SEC*, 443 F.3d 890, 899 (D.C.Cir.2006).

131 *American Radio Relay League, Inc. v. FCC*, 524 F.3d 227, 237 (D.C. Cir. 2008) (emphasis added). See also *Connecticut Light and Power Co. v. NRC*, 673 F.2d 525, 530 (D.C. Cir. 1982), *cert. denied* 459 U.S. 835 (1982).

132 The EPSC Initial Comments explain that the only evidence cited by the Commission in support of its proposal – a report by the market monitor for PJM Interconnection, L.L.C. – stands for precisely the opposite proposition, namely, that changes in DR compensation were not responsible for reduced DR participation. See EPSC Initial Comments, pp. 27-28. Similarly, Commissioner Moeller concluded, “the NOPR lacks a thorough discussion of the evidence that they relied upon to substantiate their concerns.” NOPR, Commissioner Moeller Statement Concurring in Part and Dissenting in Part, p. 2 (“Commissioner Moeller Statement”).

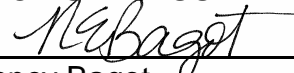
133 Commissioner Moeller Statement, p. 3.

### III. CONCLUSION

**WHEREFORE**, for the foregoing reasons, EPSA respectfully asks that the Commission consider these reply comments in formulating any final rule in this proceeding. The record that has been established in response to the NOPR is helpful in achieving the laudable goal of DR's participation in the wholesale markets, and should be instructive for finding practical solutions that will not create negative unintended consequences. The limited regulatory language in the NOPR opened the door for commenters to raise the additional steps and considerations that should be part of this proceeding. With all due respect to parties filing in support of the NOPR as issued, they do the cause of DR a disservice by not proposing regulatory language or solutions to the clear and agreed upon concerns that must accompany a compensation mechanism. EPSA looks forward to continuing this dialogue and working with all interested parties to craft an approach that is truly beneficial to the wholesale electricity markets and to consumers.

Respectfully submitted,

**ELECTRIC POWER SUPPLY ASSOCIATION**

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Dated: June 30, 2010

**CERTIFICATE OF SERVICE**

I hereby certify that I have served a copy of the Comments via email upon each person designated on the official service list compiled by the Secretary in this proceeding.

Dated at Washington, D.C., June 30, 2010.

A handwritten signature in cursive script that reads "Nancy Bagot".

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Nancy Bagot, VP of Regulatory Affairs