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

**Demand Response Compensation)
In Organized Wholesale Energy)
Markets)**

Docket No. RM10-17-001

**REQUEST FOR REHEARING OF
THE COMPETITIVE POWER SUPPLIER ASSOCIATIONS**

Pursuant to Section 313(a) of the Federal Power Act (the “FPA”),¹ and Rule 713 of the Rules of Practice and Procedure of the Federal Energy Regulatory Commission (the “Commission”),² the Electric Power Supply Association (“EPSA”),³ the Independent Power Producers of New York, Inc. (“IPPNY”),⁴ the Electric Power Generation Association (“EPGA”)⁵ and the New

¹ 16 U.S.C. § 825I(a) (2006).

² 18 C.F.R. § 385.713 (2010).

³ EPSA is the national trade association representing competitive power suppliers, including generators and marketers. Competitive suppliers, which, collectively, 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.

⁴ IPPNY is a not-for-profit trade association representing the independent power industry in New York State. Its members include nearly 100 companies involved in the development and operation of electric generating facilities and the marketing and sale of electric power in New York. The comments contained in this filing represent the position of IPPNY as an organization, but not necessarily the views of any particular member with respect to any issue.

⁵ EPGA is a regional trade association of electric generating companies that supply wholesale electric power in Pennsylvania and surrounding states. Collectively, EPGA member companies own and operate more than 145,000 megawatts of electric generating capacity, approximately half of which is located in the mid-Atlantic region. The comments contained in this filing represent the position of EPGA as an organization, but not necessarily the views of any particular member with respect to any issue.

England Power Generators Association, Inc. (“NEPGA”)⁶ (collectively, the “Competitive Supplier Associations”) respectfully request rehearing of the final rule on demand response (“DR”) compensation in organized wholesale energy markets issued on March 15, 2011, in the above-captioned proceeding.⁷

As trade associations dedicated to promoting competition, the Competitive Supplier Associations strongly support participation by diverse resources, including DR resources, in independent system operator (“ISO”) and regional transmission organization (“RTO”) markets, and appreciate the Commission’s desire to remove perceived barriers to DR participation in those markets. The Competitive Supplier Associations cannot, however, support the Final Rule. In what Commissioner Philip D. Moeller accurately describes as a “misguided attempt to encourage greater demand response participation,”⁸ the Commission has disregarded the statutory limits on its jurisdiction,⁹ its statutory and

⁶ NEPGA is the largest trade association representing competitive electric generating companies in New England. NEPGA’s member companies represent approximately 27,000 MW of generating capacity in the region. NEPGA’s mission is to promote sound energy policies which will further economic development, jobs, and balanced environmental policy. The comments contained in this filing represent the position of NEPGA as an organization, but not necessarily the views of any particular member with respect to any issue.

⁷ *Demand Response Compensation in Organized Wholesale Energy Markets*, Order No. 745, FERC Stats. & Regs. ¶ 31,322 (2011) (the “Final Rule”). The Competitive Supplier Associations also request clarification pursuant to Rule 212 of the Commission’s Rules of Practice and Procedure, 18 C.F.R. § 385.212 (2010), with respect to a discrete issue discussed in Part III.B.6(b) hereof.

⁸ Final Rule, FERC Stats. & Regs. ¶ 31,322, Dissenting Statement of Commissioner Moeller at 1 (“Moeller Dissent”).

⁹ Concerns regarding jurisdictional issues are set forth in a separate request for rehearing being filed jointly by EPSA, EPGA and other interested parties. See Joint Request For Rehearing of the the Electric Power Supply Association, the American Public Power Association, the Electric Power Generation Association and the National Rural Electric Cooperative Association, Docket No. RM10-17-001 (filed Apr. 14, 2011) (“Joint Rehearing Request”).

Constitutional duty to ensure that wholesale rates are just and reasonable as to jurisdictional public utilities, and the potentially devastating impacts that the Final Rule will have on the competitive markets that the Commission has worked hard to foster.

One of the most troubling aspects of the Final Rule is the Commission's failure to respond meaningfully to a massive record – developed through “nearly 3,800 pages of comments, a subsequent technical conference” and post-technical conference submissions¹⁰ – or at least to the largest part of that record, which flatly contradicts the Commission's position that DR resources should be paid the full locational marginal price (“LMP”). The Commission appears to have concluded this rulemaking with the same dubious “presumption” that paying DR resources full LMP is the “correct result” with which it “started.”¹¹ In adopting such a presumption, the Commission has violated the statutory constraints on its authority and unlawfully shifted the burden to the Competitive Supplier Associations and others opposed to that result. Moreover, the Final Rule gives no indication that these parties were even given the promised opportunity to “rebut[]” this unlawful presumption.¹² Such an approach cannot be reconciled with the most basic requirements applicable to agency decisionmaking.

For these and other reasons set forth herein, the Commission should grant rehearing of the Final Rule.

¹⁰ Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 1.

¹¹ *Demand Response Compensation in Organized Wholesale Energy Markets*, Transcript at 7:20-25, Docket No. RM10-17-000 (Sept. 13, 2010) (Chairman Wellinghoff) (“Tech. Conf. Tr.”).

¹² *Id.* at 8:2 (Chairman Wellinghoff).

I. STATEMENT OF ISSUES AND ERRORS

In accordance with Rule 713(c) of the Commission's Rules of Practice and Procedure,¹³ the Competitive Supplier Associations hereby list each error and each issue on which they seek rehearing of the Final Rule and provide representative precedent in support of their positions on these issues:

1. As discussed in a separate request for rehearing that EPSA and EPGA are filing jointly with the American Public Power Association ("APPA") and the National Rural Electric Cooperative Association ("NRECA"), the Final Rule is contrary to law, because the Commission has greatly exceeded the limits on its jurisdiction under the FPA in attempting to regulate DR compensation. See Joint Rehearing Request.
2. The Final Rule is contrary to law, because it will mandate unduly preferential treatment of DR resources and unduly discriminatory treatment of generation resources. See, e.g., 16 U.S.C. §§ 824d, 824e (2006); *Elec. Consumers Res. Council v. FERC*, 747 F.2d 1511, 1515-16 (D.C. Cir. 1984) ("ELCON").
3. The Final Rule is arbitrary and capricious and contrary to law, because the Commission has provided unduly preferential subsidies to a favored industry group, namely, DR providers, at the expense of generators and other market participants. See, e.g., *Woods Petroleum Corp. v. Dept. of Interior*, 18 F.3d 854, 859-60 (10th Cir. 1994) ("Woods Petroleum").
4. The Final Rule is arbitrary and capricious, and is not the product of reasoned decisionmaking, because the Commission failed to address the serious and legitimate objections raised by the Competitive Supplier Associations and other commenters that payment of full LMP would require unduly preferential treatment of DR and unduly discriminate against generators. See, e.g., *Canadian Ass'n of Petroleum Producers v. FERC*, 254 F.3d 289, 299 (D.C. Cir. 2001) ("CAPP").
5. The Final Rule is arbitrary and capricious, and is not the product of reasoned decisionmaking, because the Commission failed to address serious objections to its approach, and significant alternatives proposed (namely, payment of LMP with an offset for avoided retail costs), as recognized and described in the dissenting

¹³ 18 C.F.R. § 385.713(c) (2010).

statement of Commissioner Moeller. See, e.g., *American Gas Ass'n v. FERC*, 593 F.3d 14, 21 (D.C. Cir. 2010) (“AGA”).

6. The Final Rule is arbitrary and capricious, and is not the product of reasoned decisionmaking, because it is not supported by substantial evidence insofar as it is premised on numerous unsupported, unstated, and/or erroneous factual determinations and policy judgments regarding current market conditions and predictions regarding the effects of the Final Rule. See, e.g., *Columbia Gas Transmission Corp. v. FERC*, 628 F.2d 578, 593 (D.C. Cir. 1979) (“*Columbia Gas*”); *Mo. Pub. Serv. Comm’n v. FERC*, 234 F.3d 36, 41 (D.C. Cir. 2000) (“*MoPSC I*”).
7. The Final Rule is arbitrary and capricious, and is not the product of reasoned decisionmaking, because the Commission has failed to establish that the “problem” it purports to solve – allegedly inadequate DR participation – in fact exists, or that its proposed solution of increasing DR compensation is reasonably designed to solve that problem. See, e.g., *National Fuel Gas Supply Corp. v. FERC*, 468 F.3d 831, 843 (D.C. Cir. 2006) (“*National Fuel Gas Supply*”); *Mo. Pub. Serv. Comm’n v. FERC*, 337 F.3d 1066, 1076 (D.C. Cir. 2003) (“*MoPSC II*”).
8. The Commission’s determination that DR must be paid full LMP is arbitrary and capricious, and not the product of reasoned decisionmaking, because the Commission has failed to articulate any legitimate basis for its decision and has not drawn a “rational connection between the facts found and the choices made.” See, e.g., *Motor Vehicle Mfrs. Ass’n of the U.S. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (“*State Farm*”) (internal citations omitted); *MoPSC II*, 337 F.3d at 1076.
9. The Final Rule is contrary to law because it requires each ISO and RTO to change its existing, Commission-approved tariff provisions governing DR compensation without satisfying the requirements of FPA Section 206; namely, by establishing that the existing tariff provisions are unjust and unreasonable and that its proposed replacement is just and reasonable. See, e.g., 16 U.S.C. § 824e (2006); *Atlantic City Elec. Co. v. FERC*, 295 F.3d 1, 8 (D.C. Cir. 2002) (“*Atlantic City*”).
10. The Final Rule is contrary to law, because the Commission has no authority under Section 205 of the FPA to impose unilateral changes in rates and has not met, or even made any apparent effort to meet, the requirements of Section 206 of the FPA. See, e.g., 16 U.S.C. § 824d, 824e (2006).

11. The Final Rule is arbitrary and capricious, and is not the product of reasoned decisionmaking, because it will create inefficiencies that will distort production, consumption, and investment incentives, harm competitive markets, impose long-run costs on consumers exceeding its short-run benefits, and ultimately, threaten long-term reliability. Moreover, the Commission has not responded meaningfully to these serious objections to its proposed approach. See, e.g., *PPL Wallingford Energy LLC v. FERC*, 419 F.3d 1194, 1198-1200 (D.C. Cir. 2005) (“*PPL Wallingford*”).
12. The Final Rule is arbitrary and capricious and contrary to law because the Commission equates “just and reasonable” rates with lower prices, and, by focusing solely on lowering jurisdictional rates, without regard to whether the resulting rates are compensatory or confiscatory, the Commission has abdicated its duties under the FPA and the U.S. Constitution to ensure that regulated sellers receive just and reasonable compensation. See, e.g., U.S. Constitution amend. V, cl. 3; 16 U.S.C. §§ 824d, 824e (2006); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (“*Hope*”).
13. The Final Rule is arbitrary and capricious, and is not the product of reasoned decisionmaking, because it is an unexplained departure from Commission precedent on which market participants have placed substantial reliance that previously found and determined that subsidies are not necessary to incentivize DR participation. See e.g., *FCC v. Fox Television Stations, Inc.*, 129 S. Ct. 1800, 1811 (2009) (“*Fox*”); *Greater Boston Television Corp. v. FCC*, 444 F.2d 841, 852 (D.C. Cir. 1970) (“*Greater Boston*”); *PJM Industrial Customer Coalition v. PJM Interconnection, L.L.C.*, 121 FERC ¶ 61,315 (2007) (“*PJM ICC*”).
14. To the extent the Commission concluded that existing ISO/RTO mitigation measures are inadequate and must be supplemented by the Final Rule, this finding is contrary to law, because it requires ISOs/RTOs to change existing tariff provisions without satisfying the requirements of FPA Section 206. See, e.g., 16 U.S.C. § 824e (2006); *Atlantic City*, 295 F.3d at 8.
15. To the extent the Commission concluded that existing ISO/RTO mitigation measures are inadequate and must be supplemented by the Final Rule, its determination is arbitrary and capricious, and is not the product of reasoned decisionmaking, because it is not supported by substantial evidence and is an unexplained departure from precedent on which market participants have substantially relied that found that existing ISO/RTO mitigation to be adequate without reference to the level of DR compensation or participation. See, e.g., *Market-Based Rates for Wholesale Sales of Electric*

Energy, Capacity and Ancillary Services by Public Utilities, Order No. 697, FERC Stats. & Regs. ¶ 31,252, *clarified*, 121 FERC ¶ 61,260 (2007), *order on reh'g*, Order No. 697-A, FERC Stats. & Regs. ¶ 31,268 ("Order No. 697-A"), *clarified*, 124 FERC ¶ 61,055, *order on reh'g*, Order No. 697-B, FERC Stats. & Regs. ¶ 31,285 (2008), *order on reh'g*, Order No. 697-C, FERC Stats. & Regs. ¶ 31,291 (2009), *order on reh'g*, Order No. 697-D, 130 FERC ¶ 61,206 (2010); *Ill. Commerce Comm'n v. FERC*, 576 F.3d 470, 477 (7th Cir. 2009) ("ICC"); *Williams Gas Processing Gulf Coast Co. v. FERC*, 475 F.3d 319 (D.C. Cir. 2006) ("Williams").

16. The Final Rule is arbitrary and capricious, and is not the product of reasoned decisionmaking, because the Final Rule will result in over-mitigation, which the Commission has found to be just as harmful to competitive markets as under-mitigation, and because the net benefits test would facilitate, or even mandate, the exercise of buyer market power. Moreover, the Commission has not addressed arguments raising these serious objections to its proposed approach. See, e.g., *Wisconsin Pub. Power, Inc. v. FERC*, 493 F.3d 239, 262 (D.C. Cir. 2007) ("*Wisconsin Public Power*"); *Moraine Pipeline Co. v. FERC*, 906 F.2d 5, 9 (D.C. Cir. 1990) ("*Moraine Pipeline*"); *PPL Wallingford*, 419 F.3d at 1198-1200.
17. The Final Rule is arbitrary and capricious, is not the product of reasoned decisionmaking, and lacks a rational basis, because the Commission required ISOs/RTOs to use the net benefits test to determine the hours in which DR would be cost-effective, while at the same time acknowledging that the proposed test is not capable of performing the function for which it was adopted. See *PPL Wallingford*, 419 F.3d at 1198-1200.
18. To the extent the Final Rule would allow costs to be allocated to market participants that are self supplying energy, the Final Rule is arbitrary and capricious, and not the product of reasoned decisionmaking, because it would allocate costs associated with self-supplied energy to parties that do not receive any benefit, even in the short run, from lower LMPs resulting from dispatching DR, and is therefore inconsistent with the stated intent of the cost allocation methodology prescribed in the Final Rule. See, e.g., *State Farm*, 463 U.S. at 43.
19. To the extent that the Final Rule would allow costs to be allocated when market participants are self supplying, the Final Rule is arbitrary and capricious and contrary to law, because it conflicts with the stated purposes of the allocation rule and the very decisions cited in the Final Rule for the proposition that the Final

Rule is consistent with long-standing judicial precedent on cost allocation methodology and with the principle of cost causation. See, e.g., *State Farm*, 463 U.S. at 43; *ICC*, 576 F.3d at 477; *KN Energy, Inc. v. FERC*, 968 F.2d 1295, 1300 (D.C. Cir. 1992) (“*KN Energy*”).

20. The Final Rule is arbitrary and capricious, and is not the product of reasoned decisionmaking, because the payment of LMP to DR invites fraud and abuse, the evidence in the record, and the Commission’s previous determinations demonstrate that current measurement and verification standards and ISO/RTO rules are not sufficient to prevent manipulation or accurately determine whether and how much of an observed demand reduction is made in response to price signals. See, e.g., *MoPSC II*, 337 F.3d at 1076.
21. The Final Rule is contrary to law because the Commission has attempted to shift to commenters opposing the Commission’s proposal the Commission’s own burden under FPA Section 206 of demonstrating that the existing, Commission-approved ISO/RTO tariff provisions are unjust and unreasonable and that its proposed replacement is just and reasonable. See, e.g., 16 U.S.C. § 824e (2006); *Ala. Power Co. v. FERC*, 993 F.2d 1557, 1571 (D.C. Cir. 1993) (“*Alabama Power*”).
22. The Final Rule is arbitrary and capricious, and is not the product of reasoned decisionmaking, because the Commission’s decision to adopt a uniform, national rule for DR compensation represents an unexplained and unjustified departure from precedent on which market participants have substantially relied. See, e.g., *Wholesale Competition in Regions with Organized Electric Markets*, Order No. 719, FERC Stats. & Regs. ¶ 31,281 (2008) (“Order No. 719”), *order on reh’g*, Order No. 719-A, FERC Stats. & Regs. ¶ 31,292 (“Order No. 719-A”), *order on reh’g*, Order No. 719-B, 129 FERC ¶ 61,252 (2009); *Wis. Valley Improvement v. FERC*, 236 F.3d 738, 748 (D.C. Cir. 2001) (“*Wisconsin Valley*”).
23. The Commission’s determination to adopt a uniform national rule for DR compensation is arbitrary and capricious, and not the product of reasoned decisionmaking, because it failed to explain how regional differences in ISO/RTO compensation constitute a barrier to entry by DR or how such variations render existing, Commission-approved ISO/RTO DR compensation rules unjust and unreasonable. See, e.g., *State Farm*, 463 U.S. at 43; *CAPP*, 254 F.3d 289, 299.
24. The Final Rule is arbitrary and capricious, and is not the product of reasoned decisionmaking, because the Commission failed to

consider alternative DR compensation rules (such as LMP-G) that would avoid the serious legal problems raised by the Commission's proposed approach and are supported by a substantial number (if not a majority) of commenters, including all ISOs/RTOs, and by Commission Moeller in his dissenting statement, and that would have avoided the adverse effects of paying DR full LMP. See, e.g., *AGA*, 593 F.3d at 21; *Laclede Gas Co. v. FERC*, 873 F.2d 1494, 1498 (D.C. Cir. 1989) ("*Laclede Gas*").

25. The Final Rule is contrary to law and arbitrary and capricious, because the Commission failed to comply with the requirements of the Regulatory Flexibility Act of 1980 (the "RFA") to conduct a reasoned analysis of the impact of the Final Rule based on its erroneous conclusion that the Final Rule would affect only ISOs/RTOs, but not small entities, was erroneous. 5 U.S.C. §§ 601-612 (2006); *Thompson v. Clark*, 741 F.2d 401, 405 (D.C. Cir. 1984) ("*Thompson*").

II. BACKGROUND

A. The NOPR.

On March 18, 2010, the Commission issued a notice of proposed rulemaking (the "NOPR")¹⁴ in which it proposed to require ISOs/RTOs to pay DR¹⁵ resources¹⁶ participating in ISO/RTO-administered wholesale energy markets the LMP in all hours for demand reductions made in response to price signals. According to the Commission, the proposed changes were necessary "[t]o help ensure that wholesale prices in ISOs and RTOs remain just and reasonable,"¹⁷ because, in the Commission's view, existing DR programs had

¹⁴ *Demand Response Compensation in Organized Wholesale Energy Markets*, Notice of Proposed Rulemaking, FERC Stats. & Regs. ¶ 32,656 (2010) (the "NOPR").

¹⁵ The Commission's regulations define 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)(4) (2010).

¹⁶ A DR resource is "a resource capable of providing demand response." 18 C.F.R. § 35.28(b)(5) (2010).

¹⁷ NOPR, FERC Stats. & Regs. ¶ 32,656 at P 13.

resulted in “inadequate demand response participation,”¹⁸ which “may be the result of compensation that is no longer just and reasonable.”¹⁹ The NOPR went on to suggest that increasing DR compensation and participation is necessary for the Commission to “fulfill its mandate . . . to ensure that rates charged for energy are just and reasonable,”²⁰ because DR “can lower prices” and “mitigate generator market power.”²¹ The Commission claimed jurisdiction to regulate DR compensation pursuant to Section 205 of the FPA²² and the statement of congressional policy in Section 1252(f) of EPAAct 2005.²³

B. The Final Rule.

In the Final Rule, the Commission adopted the NOPR’s proposal to pay the full LMP to DR resources participating in ISO/RTO-administered wholesale energy markets, subject to two additional conditions not included in the NOPR, namely, that (1) the DR resource “has the capability to balance supply and demand as an alternative to a generation resource;”²⁴ and (2) “dispatch of that

¹⁸ *Id.* at P 10.

¹⁹ *Id.* The Commission added that “that the existing and varying levels of compensation generally fail to reflect the marginal value of demand response resources to ISO and RTO energy markets.” *Id.* See also *id.* at P 13 (“[t]he current wholesale compensation levels may therefore be leading to under-investment in demand response resources, resulting in higher, and unjust and unreasonable, prices in the organized electricity markets.”).

²⁰ *Id.* at P 5.

²¹ *Id.* at P 4.

²² See *id.* at P 5 (*citing* 16 U.S.C. § 824d (2006)).

²³ See NOPR, FERC Stats. & Regs. ¶ 32,656 at P 5 (*citing* Pub. L. No. 109-58, § 1252(f), 119 Stat. 594, 965 (2005)).

²⁴ Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 2.

[DR] resource is cost-effective as determined by the net benefits test.”²⁵ The Commission claimed that the Final Rule “is necessary to ensure that rates are just and reasonable in the organized wholesale energy markets,”²⁶ and declared that “payment by an RTO or ISO of compensation other than the LMP is unjust and unreasonable.”²⁷ According to the Final Rule, paying full LMP is necessary to address various barriers to entry by DR providers²⁸ – barriers that are acknowledged to exist either at the retail level or that are a result of the disconnect between wholesale and retail rates (and are therefore beyond the Commission’s jurisdiction).²⁹ The Final Rule directed all ISOs/RTOs to file the tariff revisions needed to implement the Final Rule’s DR compensation approach, including the net benefits test and the cost allocation mechanism, by July 22, 2011.³⁰

²⁵ *Id.* at P 2. According to the Commission, this “cost-effectiveness condition,” or “net benefits test,” is necessary to account for the fact that “dispatching demand response resources may result in an increased cost per unit (\$/MWh) to the remaining wholesale load associated with the decreased amount of load paying the bill,” where “customers are billed for energy based on the units, MWh, of electricity consumed.” *Id.* at P 3. To address this “billing rate effect,” the Commission required the use of the “net benefits test,” which is intended “to ensure that the overall benefit of the reduced LMP that results from dispatching demand response resources exceeds the cost of dispatching and paying LMP to those resources.” *Id.* In addition, the Final Rule also “sets forth a method for allocating the costs of demand response payments among all customers who benefit from the lower LMP resulting from the demand response.” *Id.* at P 5.

²⁶ *Id.* at P 2.

²⁷ *Id.* at P 47.

²⁸ *Id.* at P 58.

²⁹ *See id.* at P 57.

³⁰ *Id.* at P 6. In addition, the Commission directed each ISO/RTO to conduct a study of the feasibility of “implementing a dynamic approach which incorporates the billing unit effect in the dispatch algorithm” for the day-ahead and real-time energy markets, and to submit the results of this study to the Commission by September 21, 2012. *Id.* at P 7.

The Commission largely dismissed – and, in many cases, simply ignored – comments opposing the approach proposed in the NOPR, insisting that “issues of rate design are fairly technical and, insofar as they are not technical, involve policy judgments that lie at the core of the regulatory mission”³¹ and that, “in making such judgments, the Commission is not limited to textbook economic analysis.”³² In a cursory response to challenges to its jurisdiction to set rates for DR compensation, the Commission stated that Section 205 of the FPA gives it the responsibility to “ensur[e] that all rates and charges for or ‘in connection with’ Commission-jurisdictional transmission service or wholesale electric energy” are just and reasonable,³³ and asserted that it has jurisdiction over DR compensation in ISO/RTO-administered markets “because it directly affects wholesale rates.”³⁴ The Commission also invoked the statement of congressional policy in EPCA Section 1252(f) as supporting its claim of jurisdiction to set rates for DR compensation.³⁵

C. Commissioner Moeller’s Dissent

In a strongly worded and carefully considered dissent, Commissioner Moeller spotlighted many of the problems with the Final Rule. Commissioner Moeller correctly recognized that the Final Rule is:

³¹ *Id.* at P 46 (internal citations omitted).

³² *Id.* (internal citations omitted).

³³ *Id.* at P 112 (*citing* 16 U.S.C. § 824d (2006)).

³⁴ Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 112 (*citing* Order No. 719-A, FERC Stats. & Regs. ¶ 31,292 at P 47).

³⁵ Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 113. In addition, the Commission emphasized that the Final Rule “is not intended to usurp state authority or impede states from taking any actions within their authority.” *Id.* at P 115.

a misguided attempt to encourage greater demand response participation ... [that] imposes a standardized and preferential compensation scheme that conflicts both with the Commission's efforts to promote competitive markets and with its statutory mandate to ensure supplies of electric energy at just, reasonable, and not unduly discriminatory or preferential rates.³⁶

Commissioner Moeller noted the “troubling” way in which the Final Rule appears to be “equating the concept of a just and reasonable rate with a lower price.”³⁷ He also took the majority to task for implying “that the current approach is no longer adequate to ensure that rates remain just and reasonable,”³⁸ without finding that “the existing region-by-region approach to compensation is unjust and unreasonable.”³⁹

In addition, Commissioner Moeller observed that the Final Rule “never clearly explains how the existence of barriers, in turn, justifies a payment of full LMP” to DR resources.⁴⁰ He emphasized that generation and DR “are not perfect equivalents” and that the two differ “both in terms of physics and in economic impact.”⁴¹ According to Commissioner Moeller, the payment of full LMP to DR actually “overcompensat[es]” DR, which receives LMP plus the avoided cost of retail purchases (or “G”), a result that is “economically inefficient,

³⁶ Moeller Dissent at 1.

³⁷ *Id.* at 7.

³⁸ *Id.* at 2.

³⁹ *Id.*

⁴⁰ *Id.* Commissioner Moeller observed that “the lack of dynamic prices at the retail level is the **primary** barrier” to DR participation and that the Final Rule “does not remedy this barrier and customers who pay fixed retail rates will not benefit from lower wholesale market prices.” *Id.* at 10 (emphasis added).

⁴¹ *Id.* at 3.

preferential to demand resources, and unduly discriminatory towards other market resources.”⁴² He further noted that the “net benefits” test, which was opposed by “[a] clear majority of the witnesses (representing a spectrum of interests that included demand response advocates, economists, generators, and the RTOs and ISOs),”⁴³ adds additional, unnecessary complexity that could have been readily avoided under alternative compensation schemes such as LMP-G.⁴⁴

Commissioner Moeller elaborated on his concerns at the Commission’s March 17, 2011 open meeting. There, Commissioner Moeller expressed particular concern that the Commission had ignored the uniform opposition of ISOs/RTOs – “the people who don’t have the vested interest” in being paid, or paying, more or less and “who regulate our organized markets”⁴⁵ – to two central elements of the Final Rule. He remarked that what all of the ISOs and RTOs asked was “number one ... don’t standardize this across the United States, and yet that’s what the rule does. Secondly, they said ***please, please, please*** don’t give us a net benefits test, because we don’t know how to do it. Yet that’s what the rule did.”⁴⁶

⁴² *Id.* at 4.

⁴³ *Id.* at 6.

⁴⁴ *Id.* at 7. Commissioner Moeller added that, while he opposed standardization of DR compensation, if he “were to now support any standardization of demand response compensation, it would be the LMP-G approach, which in my opinion, is the only economically efficient outcome for the markets.” *Id.* at 11.

⁴⁵ March 17, 2011 Commission Meeting Tr. at 13:4-6.

⁴⁶ *Id.* at 13:8-12 (emphasis added).

“[U]nencumbered by ‘textbook economic analysis of the markets subject to [the Commission’s] jurisdiction,’”⁴⁷ the Final Rule adopted an approach that will, in Commissioner Moeller’s view, “result in customers experiencing a short-term benefit by way of a lower LMP, but will also impose long-term costs on the energy markets.”⁴⁸ He added that “the corrosive effect of overcompensating demand resources over time will come at the expense of other resources, particularly generation resources that will have less to invest in maintaining existing facilities and financing new facilities.”⁴⁹

As discussed below, the Competitive Supplier Associations share Commissioner Moeller’s concerns.

III. REQUEST FOR REHEARING

As discussed in a separate request for rehearing that EPSA and EPGA are filing jointly with APPA and NRECA, the Commission must grant rehearing of the Final Rule, because the Commission has overstepped its jurisdiction under the FPA in attempting to regulate DR compensation.⁵⁰ Even assuming *arguendo* that the Commission possesses such jurisdiction (and it does not), the Final Rule must be reversed, because it is contrary to law, unsupported by substantial evidence, and not the product of reasoned decisionmaking. Among other things,

⁴⁷ Moeller Dissent at 9 (*citing* Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 46).

⁴⁸ Moeller Dissent at 9-10.

⁴⁹ *Id.* at 10. In his statement at the March 17, 2011 open Commission meeting, Commissioner Moeller added that his concern with the Final Rule is that, if DR is over-compensated, “especially at a time when we are coming out of an economic downturn, we could have job-killing results, and that’s not what I, I don’t think anyone wants.” March 17, 2011 Commission Meeting Tr. at 12:8-11.

⁵⁰ See Joint Rehearing Request.

as discussed below, the Final Rule embraced a blatantly preferential approach to ratemaking and subordinated the indisputable rights of jurisdictional public utilities to just and reasonable compensation for jurisdictional services to some imagined right on the part of non-jurisdictional entities to compensation for non-jurisdictional services. The Commission has also utterly failed to respond meaningfully to any number of substantial objections raised in response to the NOPR.

A. The Final Rule Is Contrary To Law And Arbitrary And Capricious, Because It Mandates Unduly Preferential Treatment Of DR Resources And Undue Discrimination Against Generators.

As Commissioner Moeller correctly stated, the Final Rule, by requiring ISOs/RTOs to pay DR full LMP, “results in overcompensation that is economically inefficient, preferential to demand resources, and unduly discriminatory towards other market resources.”⁵¹ DR resources and generation are not “equivalent,” or similarly situated, in terms of their physical characteristics, economics, performance requirements and penalties, and the value of the service provided by DR resources is indisputably inferior to that provided by dispatchable generation for operational and reliability purposes.⁵² In light of these significant differences, it was unduly preferential and unduly discriminatory for the Commission to require DR resources and generators to

⁵¹ Moeller Dissent at 4.

⁵² As PJM Power Providers Group (“P3”) explains in its comments, DR resources cannot “be relied upon for reliability, planning and operational security purposes by the RTO on an equivalent basis to dispatchable generation” because, unlike generation, DR providers “are not forced to reduce their load during peak periods or at any other times.” Comments of the PJM Power Providers Group at 2-3, Docket No. RM10-17-000 (filed May 12, 2010) (“P3 Comments”).

receive the same compensation.⁵³ The Final Rule, however, went even further by requiring DR providers to be ***paid more*** for providing a ***lower quality***, non-jurisdictional service than generators receive for jurisdictional sales.⁵⁴ And to add insult – or, to be more precise, additional injury – to injury, the Final Rule again discriminated against generators by requiring them to foot the bill (through suppressed energy prices and in other ways⁵⁵) for the subsidy that the Commission has required ISOs/RTOs to pay to DR resources.⁵⁶

1. DR Resources And Generation Are Not “Equivalent,” Nor Do They Have The Same Marginal Value.

The Commission’s determination that DR resources and generation are equivalent or have the same marginal value⁵⁷ is both factually incorrect and logically inconsistent. There are significant differences between DR resources

⁵³ See, e.g., *Ala. Elec. Coop., Inc. v. FERC*, 684 F.2d 20, 254 (D.C. Cir. 1982) (explaining that charging the same rate to customers that are not similarly situated “may be considered discrimination,” just as charging “different rates to customer classes which are similarly situated” may be unduly discriminatory).

⁵⁴ See *ELCON*, 747 F.2d at 1515-16 (finding rate design to be unduly discriminatory where the Commission and the filing utility failed to provide evidence justifying differences in rates to otherwise similarly situated customers that resulted in high-load factor customers subsidizing low-load factor customers).

⁵⁵ In addition to the suppression of LMPs, generators may also be forced to subsidize DR to the extent they are net energy buyers in the real-time energy market. For example, there is no assurance that a fast start resource whose offer clears in the day-ahead energy market will actually be dispatched in the real-time energy market. Under existing ISO/RTO market rules, this typically means that the fast start resource pays no more than its energy offer price for any shortfall. Under the Final Rule, however, it appears that this resource could also be allocated uplift costs that would cause the owner of the fast start resource to pay more than its own self-supply cost, despite being economic.

⁵⁶ See, e.g., Comments of the Edison Electric Institute at 22-23, Docket No. RM10-17-000 (filed May 13, 2010) (“EEI Comments”) (arguing that the subsidy inherent in the Final Rule “constitutes undue discrimination” because the suppression of LMPs caused by the subsidy will “merely benefit Buyers at the expense of Sellers [and] are not an economic benefit”).

⁵⁷ Final Rule, FERC Stats. & Regs. ¶ 31,322 at PP 47, 67.

and generation in terms of their physical characteristics, economic value, and the services they provide.⁵⁸ As ISO New England Inc. (“ISO-NE”) observed, the Commission’s proposal in the NOPR was apparently “based on the false assumption that demand resources and generators are equivalent,”⁵⁹ and it ignored the fact that non-generator based DR resources “are physically different from generators – demand resources reduce consumption whereas generators serve consumption.”⁶⁰ In fact, non-generator based DR “is not a ‘resource’ like generation, in that it cannot actually power residences, commercial establishments or industrial facilities.”⁶¹

⁵⁸ A substantial amount of DR is provided by “backup” or “behind-the-meter” generators, most of which are diesel units that lack emissions controls and that have a heat rate substantially higher than the system average. Such generator-based DR resources reduce the amount of demand that must be met through ISO/RTO-administered energy markets, but they do not reduce the customer’s overall consumption; instead, they simply shift demand off the ISO/RTO system. See Comments of the Electric Power Supply Association, Docket No. RM10-17-000 (filed May 13, 2010) (“EPSA Comments”), Attachment 1, William W. Hogan, Implications for Consumers of the NOPR’s Proposal to Pay the LMP for all Demand Response at 8-9 (“Hogan Policy Paper”).

⁵⁹ Comments of ISO New England Inc. at 3, Docket No. RM10-17-000 (filed May 13, 2010) (“ISO-NE Comments”).

⁶⁰ *Id.*; see also *id.* at 35 (“[i]n contrast to generation resources that physically inject energy into the wholesale power grid, demand resources physically reduce the withdrawal of energy from the wholesale power grid.”).

⁶¹ Comments of the American Public Power Association and the National Rural Electric Cooperative Association at 12, Docket No. RM10-17-000 (filed May 13, 2010) (“APPA/NRECA Comments”). Generator-based DR resources are “resources” capable of serving retail load. While these resources are physically similar to other generators (apart from the fact that they are, on average, less efficient and more polluting), they are not similarly situated in terms of economics, compensation, or treatment under ISO/RTO rules. In particular, a customer with behind-the-meter distributed generation (“DG”) units can use the DG unit’s output **both** to serve its own (unreduced) load **and**, at the same time, sell the output as price-responsive DR. By contrast, a generator located on the ISO/RTO side of the meter would have to either sell the output as generation **or** use the generation to serve the customer’s load, and receive correspondingly lower compensation. Hogan Policy Paper at 7-9.

The economics and financial incentives of generators and DR resources are also fundamentally different. As the Illinois Commerce Commission (the “ICC”) correctly observed: “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.”⁶² NEPGA described the economic differences between the two as follows:

There is no need to deduct costs from the LMP payments made to generators, because generators actually incur those costs to deliver power. When they receive LMP, they earn the net amount equal to LMP minus their costs. Demand response providers, in contrast, would be paid, under the NOPR, to not do something – to not consume power. And in the normal course, the reward for not buying something is avoiding paying for what you do not buy.⁶³

If generation and DR resources in fact had the same marginal value, then LSEs and ISOs/RTOs would be indifferent between dispatching a DR resource and generation. This is not the case, however, because ISOs/RTOs incur a net loss when paying DR LMP, whereas they break even when paying generators LMP.⁶⁴ Moreover, the fact that the Commission felt compelled to bolt a net benefits test and a cost allocation mechanism on to its initial proposal is further evidence, if

⁶² Comments of the Illinois Commerce Commission at 2, Docket No. RM10-17-000 (filed May 13, 2010) (“ICC Comments”) (emphasis in the original).

⁶³ Comments of the New England Power Generators Association, Inc. at 4-5, Docket No. RM10-17-000 (filed May 13, 2010) (“NEPGA Comments”). See also ISO-NE Comments at 19 (“[t]he primary motivation of a wholesale generator is to earn revenue in excess of costs, while the primary motivation of a participant with a demand resource is to reduce its net energy bill.”).

⁶⁴ See Comments of the New York Independent System Operator, Inc. at 10, Docket No. RM10-17-000 (filed May 13, 2010) (“NYISO Comments”).

any were needed, that a one MW reduction in demand is not economically equivalent to a one MW increase in supply.⁶⁵ This disparate treatment is neither comparable nor efficient, because it values a “negawatt” more than a megawatt and will harm efficiency and competition in organized markets.⁶⁶

The operational and reliability benefits of DR are also fundamentally different from those provided by generation under current ISO/RTO market rules, because DR resources are not obligated to reduce their load during peak periods or, indeed, at any other times, which means that DR resources cannot be relied upon for reliability, planning, and operational security purposes by the ISO/RTO in the same way as generation resources.⁶⁷ Unlike generation, DR resources may be called on only a limited number of times per year for reliability purposes, whereas generators must be available for dispatch every day of the year,⁶⁸ and DR resources can provide balancing service only for relatively short periods.⁶⁹

⁶⁵ The Commission explained that the net benefits test is needed in cases where “the next unit of generation is not sufficiently more expensive than the demand response resource” because:

In this situation, dispatching the demand response resource would result in a higher price to remaining customers than the dispatch of the next unit of generation in the bid stack. While the demand response resource appears cost competitive in the dispatch order, selection of the demand response resource increases the total cost per unit to remaining load, and it would not be cost-effective to dispatch the demand response resource.

Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 52. Thus, a one MW increase in supply will frequently be more cost-effective than a one MW decrease in demand. In these situations, DR and generation are **not** economically equivalent.

⁶⁶ Moeller Dissent at 5.

⁶⁷ See P3 Comments at 2-3.

⁶⁸ Comments of the PSEG Companies at 8, Docket No. RM10-17-000 (filed May 13, 2010).

⁶⁹ Comments of American Electric Power Service Corporation at 7-8, Docket No. RM10-17-000 (filed May 13, 2010).

Nor is a reduction in consumption comparable to an increase in production for the purposes of balancing supply and demand “when neither the DR provider, nor the LSE with the obligation to serve the load behind the [DR resource] has a day-ahead position.”⁷⁰ Moreover, the Final Rule ignored the fact that the marginal value of DR is likely to **decrease** as its participation levels increase and DR becomes a progressively worse substitute for generation as it approaches the “saturation” point.⁷¹

In addition, the Commission’s determination is arbitrary and capricious, because its rationale for adopting the Final Rule is internally inconsistent. On the one hand, the Commission claimed that DR is different from generation, and, therefore, requires greater compensation to eliminate barriers to entry and other

⁷⁰ Comments of the Midwest Independent Transmission System Operator, Inc. at 10-11, Docket No. RM10-17-000 (filed May 13, 2010) (“Midwest ISO Comments”). The Midwest Independent Transmission System Operator, Inc. (the “Midwest ISO”) offered the following example to demonstrate the point:

Suppose we expect load to increase by 20 MW in the next five minute interval and suppose that we dispatch a [DR resource] to meet that load increase. If the load behind the [DR resource] was going to start withdrawing energy over the next five minute interval but had not prior to the dispatch, then deploying the [DR resource] does not ensure meeting the energy balance. The RTO would still have to call on additional generation to meet that load increase.

Id. at 11.

⁷¹ See P3 Comments at 33-34. While the Final Rule does not even acknowledge that there may be an upper limit on the level of DR participation, much less attempt to estimate what the saturation point would be, ISOs/RTOs such as PJM Interconnection, L.L.C. (“PJM”) have begun to study the issue as a result of the massive increase in DR participation in recent years. See, e.g., PJM Resource Adequacy Planning Department, Demand Resource Saturation Analysis (dated May 2010), *available at*: <http://www.pjm.com/~media/committees-groups/committees/mrc/20100518/20100518-item-05-dr-saturation-report.ashx>. PJM noted that it currently limits DR to 7.5 percent of forecasted unrestricted peak load and that DR participation has dramatically increased in recent years, from 1.2 percent of load in 2006/2007 to 6.3 percent in 2010/2011. *Id.* at P 3. DR participation in PJM is thus already rapidly approaching the current assumed saturation limits.

market imperfections (e.g., in rejecting the “LMP-G” alternative).⁷² On the other hand, the Commission insisted that DR must be treated the same as generation, erroneously claiming that the Commission does not consider costs in setting rates for participants in ISO/RTO-administered markets “[i]n the absence of market power concerns.”⁷³ Leaving aside the dubious accuracy of the last qualifier,⁷⁴ the Commission’s reasoning fails, because it rests on the contradictory propositions that DR is both different from, and the same as, generation, with the only unifying “principle” being the conclusion that DR should be paid full LMP.

2. DR Resources Are Not Comparable And Are Not Entitled To The “Same” Compensation As Generators, Much Less The Unduly Preferential Compensation Required By The Final Rule.

The Commission also failed to establish that DR resources and generation should receive the same compensation,⁷⁵ even in the limited range of circumstances where they may be substitutes, e.g., for the provision of balancing

⁷² Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 61.

⁷³ *Id.* at P 62 (claiming that, “[i]n the absence of market power concerns, the Commission does not inquire into the costs or benefits of production for the individual resources participating as supply resources in the organized wholesale electricity markets and will not here, ... single out demand response resources for adjustments to compensation.”).

⁷⁴ Screens based on generator costs are often applied to determine whether an individual generator is exercising market power, an assessment that will frequently occur when there are no identified market power concerns.

⁷⁵ The Final Rule does not, in fact, require the same or “comparable” compensation for DR resources and generation, notwithstanding the Commission’s statements to the contrary. Generators receive LMP (minus fuel and other variable costs), whereas DR resources would receive LMP, plus a subsidy equal to the avoided costs of foregone retail purchases.

services,⁷⁶ and certainly not across the full range of the supply and demand curves.⁷⁷ As the Edison Electric Institute (“EEI”) explains:

Because generators deliver energy to the market and Demand Response Resources do not, their respective products are not fungible, [and] therefore do not have comparable economic values. Furthermore, because demand response is not energy it cannot be traded in the energy market; consequently, the fact that generators are paid LMP in any given hour provides insufficient information regarding what Demand Response Resources should be paid for reducing load in that same hour.⁷⁸

⁷⁶ The Commission asserted that commenters opposing this finding “do not adequately recognize a distinctive and perhaps unique characteristic of the electric industry,” which “requires instantaneous balancing of supply and demand at all times to maintain reliability.” Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 56. See also *id.* at P 23 (discussing comments including those of American Electric Power Service Corporation (“AEP”) and Calpine Corporation (“Calpine”)). The Commission’s reliance on such a patently false assertion — that sophisticated market participants such as AEP and Calpine are unaware of the unique features of the industry in which they operate — does not pass the laugh test, much less satisfy the Commission’s duty to engage in reasoned decisionmaking. See, e.g., *MoPSC II*, 337 F.3d at 1076 (“[r]eliance on facts that an agency knows are false at the time it relies on them is the essence of arbitrary and capricious decisionmaking.”).

⁷⁷ To the extent that DR is providing a balancing service on a comparable basis, it should be compensated as such (although, as discussed above, a decrease in consumption is not comparable to an increase in supply in the absence of an advance purchase obligation). As EPSA explained in its reply comments, however, balancing services have wholly different compensation algorithms from generation resources. See Reply Comments of the Electric Power Supply Association at 33, Docket No. RM10-17-000 (filed June 30, 2010) (“EPSA Reply Comments”). In most markets, balancing services are compensated relative to opportunity costs. PJM, ISO-NE, the Midwest ISO, and the New York Independent System Operator, Inc. (the “NYISO”) all have fully functioning ancillary services markets that buy and sell balancing services to the grid. 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>. Under these compensation regimes, however, compensation is not a direct reflection of the supply of electricity because DR bids cannot abide by all of the parameters and requirements of supply, as discussed in more detail below.

⁷⁸ EEI Comments at 15. See also Midwest ISO Comments at 6 (“[b]ecause demand response does not deliver energy, prices in the energy markets are not

Given the qualitative differences between the quality and types of services provided by DR resources and generation described above,⁷⁹ “comparable” compensation does not mean the two must receive the “same” compensation, and it certainly does not justify providing more compensation for the inferior product.⁸⁰ Finally, to the extent the Commission relied on Order No. 890⁸¹ in support of the DR compensation approach adopted in the Final Rule, its reliance is misplaced. There, the Commission required transmission providers to provide “comparable” compensation for generation and transmission solutions, but did

indicative of the compensation that DR providers should receive for their so-called ‘Negawatts.’”).

⁷⁹ As discussed in Section III.C.3 below, however, each ISO/RTO offers several DR products with differing prices and technical requirements, and the Commission has failed to establish why all of these heterogenous DR products must receive the same compensation, much less why all of these disparate DR products must receive higher compensation than generation.

⁸⁰ If rehearing is not granted, the Final Rule will give customers the incentive to move or install generator-based DR resources behind-the-meter so that output can serve customer load (without any reduction in consumption), and the customer can simultaneously sell the same output as price responsive DR. By contrast, if the generator is located on the ISO/RTO side of the meter, it would have to **either** sell the output as generation **or** use the generation to serve the customer’s load, and receive correspondingly lower compensation. Hogan Policy Paper at 7-8. The Final Rule thus not only subsidizes generator-based DR units that are less efficient and more polluting than other generators, but the subsidy ensures that these units will run more frequently when installed behind-the-meter than they would if installed on the ISO/RTO side of the meter because the DG unit will be “cost-effective” whenever its costs are **less than or equal to LMP plus the retail rate**, whereas the latter generator would be dispatched only when its costs are less than or equal to LMP. See Hogan Policy Paper at 9-10.

⁸¹ *Preventing Undue Discrimination and Preference in Transmission Service*, Order No. 890, FERC Stats. & Regs. ¶ 31,241 (“Order No. 890”), *order on reh’g*, Order No. 890-A, FERC Stats. & Regs. ¶ 31,261 (2007) (“Order No. 890-A”), *order on reh’g*, Order No. 890-B, 123 FERC ¶ 61,299 (2008), *order on reh’g*, Order No. 890-C, 126 FERC ¶ 61,228 (2009) *order on reh’g*, Order No. 890-D, 129 FERC ¶ 61,126 (2009).

not require that the two receive the “same” compensation.⁸² And it certainly did not require that inferior solutions receive higher compensation.

The Commission’s decision to require ISOs/RTOs to pay non-jurisdictional DR providers more than jurisdictional generators for a demonstrably inferior service raises serious concerns that the Commission’s Final Rule is improperly subsidizing a favored industry group (namely DR providers) at the expense of generators and other customers.⁸³ Rulemaking on that basis is clearly unlawful, because it not only lacks any justification in the FPA, but in fact contravenes the governing statute, which prohibits granting “any undue preference or advantage to any person” or subjecting “any person to any undue prejudice or disadvantage.”⁸⁴

3. The Commission’s Decision Is Arbitrary And Capricious, Because It Fails To Address Serious Objections That Its Proposed Approach Is Unduly Preferential And Unduly Discriminatory.

The Final Rule is arbitrary and capricious, because the Commission has failed to offer any meaningful response to the arguments made by commenters

⁸² See Order No. 890, FERC Stats. & Regs. ¶ 31,241 at P 495 (clarifying that the requirement to give comparable treatment to DR resources and generation does not mean “that each and every transmission customer should be treated the same.”). See also Order No. 890-A, FERC Stats. & Regs. ¶ 31,261 at P 216 (concluding that treating similarly-situated generation and DR resources “on a comparable basis does not necessarily mean that the resources are treated the same.”). Similarly, in acting on the Order No. 719 compliance filings, the Commission has held that “‘comparability’ is not achieved by setting conditions for demand response resources the same as those set for generating resources.” *PJM Interconnection, L.L.C.*, 129 FERC ¶ 61,250 at P 46 (2009). See also *New York Indep. Sys. Operator, Inc.*, 129 FERC ¶ 61,164 at P 67 (2009), *on reh’g*, 131 FERC ¶ 61,174 (2010) (same); *California Indep. Sys. Operator Corp.*, 129 FERC ¶ 61,157 at P 42 (2009), *on reh’g*, 131 FERC ¶ 61,110 (2010) (same).

⁸³ See *Woods Petroleum*, 18 F.3d at 859-60.

⁸⁴ See 16 U.S.C. § 824d(b)(1) (2006).

and Commission Moeller that the Final Rule is unduly preferential to DR providers and unduly discriminates against generators.⁸⁵ In particular, the Commission ignored serious objections that DR resources should receive comparable compensation to generators “only if both are subject to the same market participation rules, penalty structures, testing requirements, and market monitoring provisions,”⁸⁶ which they are not. The Commission’s suggestion that ISOs/RTOs “already consider comparability between [DR] and generation in terms of market rules” and will continue to do so in the future would seem to obviate the need for the rule.⁸⁷ That is to say, if ISOs/RTOs already treat DR and generation comparably, then why is it necessary to increase DR compensation to ensure comparable treatment?⁸⁸

B. The Commission’s Determination That The Final Rule Is Necessary To Make ISO/RTO Rates Just And Reasonable Is Contrary To Law, Arbitrary And Capricious, And Not Supported By Substantial Evidence.

The Commission has failed to explain why and how existing ISO/RTO provisions that provide for differing DR compensation are unjust and unreasonable⁸⁹ and why and how payment of LMP will cause rates to be just and

⁸⁵ See, e.g., *CAPP*, 254 F.3d at 299; *AGA*, 593 F.3d at 21.

⁸⁶ Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 66.

⁸⁷ *Id.* at P 67.

⁸⁸ In many respects, DR is treated better than generation under existing ISO/RTO market rules, because it generally receives the same or higher compensation for a lower value product with fewer obligations. This is particularly true in capacity markets.

⁸⁹ See Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 47 (“payment by an RTO or ISO of compensation other than LMP is unjust and unreasonable.”).

reasonable⁹⁰ in order to satisfy the requirements of the FPA.⁹¹ As an initial matter, although the Final Rule does not contain even a single citation to Section 206 of the FPA, one can only assume that this is the claimed source of authority for the Final Rule, because it is the **only** provision of the FPA under which the Commission, acting *sua sponte*, could order modifications to ISO/RTO tariffs, such as those contemplated by the Final Rule. If and to the extent that the Commission acted under Section 205 of the FPA,⁹² the Final Rule is plainly contrary to law, because, as the courts have repeatedly emphasized, the Commission “has no power to force public utilities to file particular rates unless it first finds the existing filed rates unlawful,”⁹³ something it can do only under Section 206 of the FPA.⁹⁴

⁹⁰ See *id.* (“payment of LMP to these resources will result in just and reasonable rates for ratepayers.”).

⁹¹ 16 U.S.C. § 824e (2006).

⁹² The Commission implicitly conceded the inapplicability of FPA Section 205 when it stated that the “tariff changes directed herein should be submitted as compliance filings pursuant to this Final Rule, not pursuant to section 205 of the [FPA].” Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 6.

⁹³ *Atlantic City*, 295 F.3d at 8 (citing *Pub. Serv. Comm’n v. FERC*, 866 F.2d 487, 488-89 (D.C. Cir. 1989)).

⁹⁴ In a case discussing Sections 4 and 5 of the Natural Gas Act (the “NGA”), which are analogous to, and which may be “cite[d] interchangeably” with, Sections 205 and 206 of the FPA, *Arkansas La. Gas Co. v. Hall*, 453 U.S. 571, 577 n.7 (1981) (“*Arkla*”), the D.C. Circuit made clear its frustration with past Commission failures to respect the difference between the two means of changing rates, stating:

This court “has consistently disallowed attempts to blur the line between §§ 4 and 5.” *Public Serv. Comm’n v. FERC*, 866 F.2d 487, 491 (D.C.Cir.1989). As we complained four years ago, “[o]n four occasions in the last three years this court has reviewed Commission efforts to compromise § 5’s limits on its power to revise rates. On each the court has repelled the Commission’s gambit. This is number five.” *Id.* at 488-89. We now make it an even six.

Western Resources, Inc. v. FERC, 9 F.3d 1568, 1578 (D.C. Cir. 1993).

The Final Rule falls well short of satisfying the requirements of Section 206. Blanket assertions that increased DR compensation will lower jurisdictional rates and mitigate market power, even if true, do not satisfy the requirements of Section 206 or provide for the substantial evidence and reasoned decisionmaking necessary to survive judicial review.

Moreover, the Commission must establish a rational connection between the perceived problem (*i.e.*, barriers to DR entry that, according to the Commission, have limited DR participation and may cause jurisdictional rates to become unjust and unreasonable) and its chosen solution of adopting a uniform, national rule requiring increasing wholesale DR compensation.⁹⁵ As Commissioner Moeller correctly observed, the Final Rule “never clearly explains how the existence of barriers, in turn, justifies a payment of full LMP to [DR] resources,”⁹⁶ nor could it, as there is simply nothing it could say that would justify the Commission’s assertion of ratemaking jurisdiction over DR compensation in the Final Rule. Instead, the Commission appears to have assumed the conclusion that it must prove, insofar as it adopted a “presumption” that payment of full LMP is the “correct result,” and thereby shifted to commenters the burden of rebutting that presumption.⁹⁷ The Final Rule should therefore be reversed for

⁹⁵ See, *e.g.*, *State Farm*, 463 U.S. at 43 (explaining that an agency action is “arbitrary and capricious” where it fails to “articulate a satisfactory explanation for its action including a ‘rational connection between the facts found and the choices made.’”) (*quoting Burlington Truck Lines v. U.S.*, 371 U.S. 156, 168 (1962)).

⁹⁶ Moeller Dissent at 2.

⁹⁷ At the September 13, 2010 Technical Conference, Chairman Wellinghoff described the starting point for the Commission’s consideration of comments on the NOPR’s proposal:

failing to demonstrate that the “problem” that the rule purports to address actually exists or that the Commission’s chosen solution is capable of addressing that problem.⁹⁸

In addition, the Commission dismissed or ignored altogether the objections submitted by a wide spectrum of commentators (including not only generator interests, but also ISOs/RTOs, market monitors, State commissions, LSEs, and consumer groups) who opposed the Final Rule’s mandate to pay DR full LMP, as well as those of Commissioner Moeller, who accurately described the Final Rule as “a misguided attempt to encourage greater demand response participation.”⁹⁹ By “fail[ing] to acknowledge, much less substantively address,”¹⁰⁰ the serious concerns raised by Commissioner Moeller and commenters, the Commission has failed to fulfill its duty to engage in reasoned decisionmaking.

I think this is an extremely important meeting we are having here. . . . [T]he **presumption** here is that there should be equivalent compensation for equivalent services, and that’s where the Commission started here. **We started with giving the full LMP to Demand Response for bidding into these markets.**

And I still believe that’s the correct result. It’s a presumption. It’s a presumption certainly that is subject to being rebutted. We want to hear today from those people who support that presumption, and those here today who have some evidence and information that might rebut that.

Tech. Conf. Tr. at 7:19-8:5 (emphasis added).

⁹⁸ See, e.g., *National Fuel Gas Supply*, 468 F.3d at 843 (“Professing that an order ameliorates a real industry problem but then citing no evidence demonstrating that there is in fact an industry problem is not reasoned decisionmaking.”).

⁹⁹ Moeller Dissent at 1.

¹⁰⁰ *AGA*, 593 F.3d at 21.

1. The Final Rule Is Based On Numerous Erroneous And/Or Unsupported Assumptions And Policy Judgments.

The Final Rule rests on a number of erroneous and/or unsupported assumptions and policy judgments, including assumptions and judgments to the effect that (1) current levels of DR participation are inadequate due to inadequate or varying levels of compensation; (2) current levels of DR compensation are inadequate; (3) increasing wholesale DR compensation by subsidizing DR will eliminate or mitigate barriers to entry by DR; and (4) the amount of the required subsidy should be equal to the avoided costs of retail purchases.¹⁰¹ In addition to relying on these flawed premises, the Final Rule rests on faulty logic and rank speculation to the effect that the Final Rule is the only solution to the “problem” of inadequate DR participation. Consequently, the Final Rule is not supported by substantial evidence and is not the product of reasoned decisionmaking.¹⁰² Compounding the problem is the fact that certain of these critical premises are not expressly set forth in the Final Rule but can only be inferred from the relatively sparse reasoning of the order.¹⁰³ This is yet another respect in which the Final Rule is arbitrary and capricious, because the Commission has failed to “articulate the critical facts on which it relie[d]” or to “fully explain the assumptions

¹⁰¹ In addition, the Final Rule relied on two other assumptions – namely, that DR resources and generation are “equivalent” and that they therefore deserve the “same” compensation – both of which are erroneous, for the reasons discussed in Section III.A.1 and III.A.2, *supra*.

¹⁰² See, e.g., *MoPSC II*, 337 F.3d at 1072-75 (vacating and remanding Commission orders because it found, among other things, that the Commission had failed to articulate the actual reasons for its decision, and the reasons it did cite were “speculative,” unsupported by record evidence, and did not support its decision).

¹⁰³ See *infra* n.105.

on it relied on to resolve unknowns and the public policies behind those assumptions.”¹⁰⁴

First, the Final Rule is predicated on an apparent conclusion that current levels of DR participation are inadequate due to existing, inadequate compensation rules,¹⁰⁵ but there is no evidence to support this conclusion or any Commission finding as to what the appropriate or “optimal” level of DR participation should be. Nor did the Commission “explain how the lack of a uniform compensation approach in each RTO-run market is a barrier to demand response”¹⁰⁶ or how differences in compensation among ISOs/RTOs may have caused DR participation levels to be sub-optimal.¹⁰⁷ Tellingly, in the Final Rule, the Commission did not rely on the “case study” cited in the NOPR as demonstrating that a decrease in DR compensation caused a decrease in DR

¹⁰⁴ *Columbia Gas*, 628 F.2d at 593. See also *Connecticut Light & Power Co. v. NRC*, 673 F.2d 525, 530 (D.C. Cir. 1982) (explaining that the Commission must “provide an accurate picture of the reasoning that has led the agency to [a] proposed rule”).

¹⁰⁵ In the NOPR, the Commission stated that, after observing DR participation levels in ISOs/RTOs with differing DR structures it was concerned “that some existing, inadequate compensation structures have hindered the development and use of demand response.” NOPR, FERC Stats. & Regs. ¶ 32,656 at P 9. While the Commission did not repeat these claims in the Final Rule, the Final Rule “implied” that the Commission continues to believe that “the current approach is no longer adequate to ensure that rates remain just and reasonable,” as Commissioner Moeller correctly notes. Moeller Dissent at 2. Had the Commission reached a different conclusion, *i.e.*, that DR participation and compensation are in fact adequate, it would have been compelled to admit that the Final Rule is unnecessary and unjustified.

¹⁰⁶ APPA/NRECA Comments at 4.

¹⁰⁷ Moreover, the Commission reached this conclusion without addressing issues such as what the appropriate maximum limit of DR participation should be (*i.e.*, the “saturation point” or “fatigue point”). See Post-Conference Comments of the Electric Power Supply Association at 9, Docket No. RM10-17-000 (filed Oct. 13, 2010). This is a significant issue because, as explained above in Section III.A.1, the marginal value of DR resources decreases as DR penetration approaches the “saturation” point, further undermining the Commission’s claim that generation and DR resources have the same marginal value.

participation,¹⁰⁸ presumably because that study expressly rejects the proposition for which it was cited.¹⁰⁹ The Commission also utterly failed to respond to evidence submitted by the Competitive Supplier Associations and others demonstrating that the decreases in DR participation in economic DR programs from 2008 to 2009 were the result of generally lower energy prices, as opposed to deficiencies in the DR compensation mechanisms in place in these markets.¹¹⁰ The Commission has thus set a policy goal of increasing DR participation, without making any determination as to what the target level of participation

¹⁰⁸ See NOPR, FERC Stats. & Regs. ¶ 32,656 at P 10 (*discussing* Monitoring Analytics, LLC Barriers to Demand-side Response in PJM (dated July 1, 2009), (“PJM IMM Barriers to Entry Report”), *available at* <http://www.monitoringanalytics.com/reports/Reports/2009.shtml>).

¹⁰⁹ Monitoring Analytics, LLC (“Monitoring Analytics”), the Independent Market Monitor (“IMM”) for PJM, concluded that: “[t]he evidence does not support the claim that the removal of the incentive program resulted in a reduction of activity in the Economic Program” and that demand-side subsidies do not directly address the root problem – the lack of real time price information at the retail level. PJM IMM Barriers to Entry Report at 22, 27. See also Monitoring Analytics, LLC, *2009 State of the Market Report for PJM* at 17 (dated Mar. 11, 2010), *available at* http://www.monitoringanalytics.com/reports/PJM_State_of_the_Market/2009/2009-som-pjm-volume1.pdf (“[t]here were many factors that contributed to lower levels of participation and lower revenues in the Economic Program, including lower price levels in 2009, lower load levels, and improved measurement and verification.”).

¹¹⁰ See EPSA Comments at 15; APPA/NRECA Comments at 4 (“[w]hile participation in economic demand response programs in several RTO-run markets has declined in 2009, compared to 2008, this reflects the decline in RTO prices during that timeframe, and it is not, in itself, a reason to prescribe a uniform compensation approach based on paying full LMP to demand response resources.”). See also Federal Energy Regulatory Commission, *State of the Markets Report 2009* at 7 (Apr. 15, 2010) (“Commission 2009 SOM Report”), *available at* <http://www.ferc.gov/market-oversight/st-mkt-ovr/som-rpt-2009.pdf> (“[w]ith lower electricity prices and lower fuel costs, electricity prices fell by half” from 2008 to 2009); Monitoring Analytics, LLC, *2010 State of the Market Report for PJM* at 30 (March 10, 2011) (“PJM 2010 SOM Report”), *available at* http://www.monitoringanalytics.com/reports/PJM_State_of_the_Market/2010/2010-som-pjm-volume1.pdf (“[p]articipation levels through calendar year 2009 and through the first three months of 2010 were generally lower compared to prior years due to a number of factors, including lower price levels, lower load levels, and improved measurement and verification, but have showed strong growth through the summer period as price levels and load levels have increased.”).

should be. As a result, there is no benchmark that the Commission, ISOs/RTOs, State commissions, or market participants can use to measure progress towards attaining this goal or to determine when the target has been reached, suggesting that the Commission-mandated subsidies for DR would remain in place indefinitely.

Second, the Commission has not identified any convincing evidence that current levels of DR compensation are in fact inadequate. Instead, the only supporting evidence, if it can be called evidence, lies in the self-serving statements of various DR providers.¹¹¹ In addition, the Commission's reasoning on this point is completely circular, and boils down to a theory that DR compensation must be inadequate because DR participation is inadequate.¹¹²

But the record evidence, including the comments from experts at the Federal Trade Commission (the "FTC") and ISOs/RTOs, demonstrates that current levels of DR compensation are adequate, and that the Final Rule will

¹¹¹ See, e.g., Comments of Viridity Energy, Inc. at 4, Docket No. RM10-17-000 (filed May 13, 2010) ("[t]he near absence of [DR] service from the energy markets ... is power empirical proof that the current level of compensation is inadequate"); Comments of EnerNOC in Response to Notice of Proposed Rulemaking at 2, Docket No. RM10-17-000 (filed May 13, 2010) ("[c]urrent compensation to demand response in organized wholesale markets is inadequate and undervalues demand response as a resource."); Comments of the Demand Response and Smart Grid Coalition at 5, Docket No. RM10-17-000 (filed May 13, 2010) ("[t]he Commission has rightly concluded that the current compensation provided for demand response resources is inadequate in most of the organized markets and that LMP is the proper payment required to ensure adequate demand response.").

¹¹² See, e.g., NOPR, FERC Stats. & Regs. ¶ 32,656 at P 13 ("current compensation levels appear to have become unjust and unreasonable.") Again, the Commission did not repeat its claims from the NOPR that DR compensation is inadequate or that it has become unjust and unreasonable, but if it had not concluded that DR compensation is inadequate, it would have had no reason to adopt the Final Rule requiring ISOs/RTOs to increase DR compensation. As such, the Commission acted arbitrarily and capriciously by failing to articulate the critical facts and assumptions on which it relied. See, e.g., *Columbia Gas*, 628 F.2d at 593.

overcompensate¹¹³ DR resources by subsidizing DR at the expense of other market participants and competing suppliers.¹¹⁴

As detailed in EPSA's reply comments,¹¹⁵ there was basic agreement across the spectrum of stakeholders (including ISOs/RTOs, federal and State regulators, LSEs, generators, and consumer groups) that the efficient level of DR compensation is LMP with an offset to reflect the avoided costs of retail energy purchases (or "G").¹¹⁶ With the exception of the Southwest Power Pool, Inc.

¹¹³ See, e.g., Comment of the Federal Trade Commission at 6, Docket No. RM10-17-000 (filed May 13, 2010) ("FTC Comments") (agreeing that commenters' "concern about overcompensation is well founded."); Comment of the Federal Trade Commission at 4, Docket No. RM10-17-000 (filed Oct. 13, 2010) (noting that even commenters supporting the proposal in the NOPR "implicitly recognize that the payment of full LMP constitutes overcompensation for demand response providers who pay flat retail rates."); Moeller Dissent at 4 (noting that under the Final Rule a DR Resource would receive "total compensation of LMP+G"); Comment on Notice of Proposed Rulemaking of PJM Interconnection, L.L.C. at 2, Docket No. RM10-17-000 (filed May 13, 2010) ("PJM Comments"). Several other commenters characterized payment of full LMP as the equivalent of providing DR customers with a free call "option to sell power they never purchased at a full LMP market price." PJM Comments at 6. See also Midwest ISO Comments at 6-7; EEI Comments at 4.

¹¹⁴ See, e.g., NYISO Comments at 7 (payment of full LMP overcompensates DR "at the expense of non-participating customers and other competing technologies not eligible for the subsidy"). At least one DR provider publicly admitted that payment of full LMP can be a subsidy, albeit one that it considers appropriate. See, e.g., Comments of CPower, Inc. at 2-3, Docket No. RM10-17-000 (filed May 13, 2010).

¹¹⁵ See EPSA Reply Comments at 31-33.

¹¹⁶ See, e.g., APPA/NRECA Comments at 9-10; Comments of Samuel Newell, Kathleen Spees and Philip Q. Hanser at 5, Docket No. RM10-17-000 (filed May 13, 2010); Comments of Calpine Corporation at 3, Docket No. RM10-17-000 (filed May 13, 2010) ("Calpine Comments"); Comments of Exelon Corporation at 6, Docket No. RM10-17-000 (filed May 13, 2010) ("Exelon Comments"); FTC Comments at 2; Comments of Independent Power Producers of New York, Inc. at 3, Docket No. RM10-17-000 (filed May 13, 2010) ("IPPNY Comments"); Comments of the Organization of MISO States at 4, Docket No. RM10-17-000 (filed May 13, 2010) ("OMS Comments"); P3 Comments at 3; Comments of the Public Utilities Commission of Ohio at 3, Docket No. RM10-17-000 (filed May 13, 2010) ("PUC Ohio Comments"). Notably, all of the ISOs/RTOs and their independent or external market monitors agreed that payment of full LMP would overcompensate DR and/or that the Commission should permit ISOs/RTOs to include a retail offset. See Comments of the California Independent System Operator Corporation at 3, Docket No. RM10-17-000 (filed May 13, 2010) ("CAISO Comments"); ISO-NE

(which does not currently have an economic DR program), all ISOs/RTOs pay DR at least this amount, if not more.¹¹⁷ Moreover, while the Commission assumes that increasing compensation will necessarily increase investment and thereby participation of DR,¹¹⁸ the Commission has not established that “the overpayment inherent in” paying full LMP “will foster further investment rather than act as a mere windfall” to DR providers.¹¹⁹ Further, as discussed in more detail below, the Final Rule’s net benefits test and cost allocation mechanism are

Comments at 3-4; Midwest ISO Comments at 3-4, 9; NYISO Comments at 1; Comments of Potomac Economics, Ltd. at 4, Docket No. RM10-17-000 (filed May 13, 2010) (“Potomac Economics Comments”); PJM Comments at 6; Comments of the Independent Market Monitor for PJM at 2, Docket No. RM10-17-000 (filed May 13, 2010) (“PJM IMM Comments”).

¹¹⁷ Specifically, PJM and the Midwest ISO pay LMP with an offset for avoided retail costs, while the California Independent System Operator Corporation (the “CAISO”), ISO-NE, and the NYISO pay LMP under certain circumstances. See, e.g., NOPR, FERC Stats. & Regs. ¶ 32,656 at P 8; Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 14. While the CAISO and the NYISO currently pay DR LMP at the wholesale level, both support the use of an offset for avoided retail costs. As explained by the CAISO, the California Public Utilities Commission (the “CPUC”), the CAISO and stakeholders recognized the need for a retail offset to address the “double payment” and “missing money” problems at the retail level, but decided that these issues are best addressed by the relevant retail regulatory authority. Consequently, the CAISO DR compensation rules provide that issues such as the retail offset are to be addressed through bilateral agreements or by retail regulatory authorities, rather than through the CAISO settlement process. See Comments of the California Independent System Operator Corporation at 4-7, Docket No. RM10-17-000 (filed Oct. 13, 2010); *California Indep. Sys. Operator Corp.*, 132 FERC ¶ 61,045 at PP 27-29 (2010) (order conditionally accepting and describing the CAISO’s currently effective DR compensation rules). Similarly, while the NYISO currently pays DR full LMP, subject to a \$75/MWh minimum bid requirement, the NYISO supported the LMP-G alternative and urged the Commission to permit each ISO/RTO to work with its stakeholders to develop the details for implementing this approach to DR compensation. See NYISO Comments at 3.

¹¹⁸ Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 59.

¹¹⁹ NYISO Comments at 3. This concern is particularly credible with respect to third-party DR providers that may not be required to use the increased DR revenues to lower their customers’ bills.

inevitable results of its decision to overcompensate DR by paying full LMP, a point that the Commission did not, and cannot, dispute.¹²⁰

Moreover, the Final Rule ignored the arguments made by a number of commenters that DR revenues from participation in capacity and other markets must be taken into account in assessing the adequacy of DR compensation. DR participation and compensation in capacity markets has increased dramatically in recent years.¹²¹ For example, since 2006 the amount of DR capacity participating in PJM's markets has increased seven-fold,¹²² and capacity payments to DR resources increased more than 100 percent just from 2008 to 2009.¹²³ The CAISO, ISO-NE, and the NYISO have also seen substantial increases in DR participation and capacity revenues.¹²⁴ In any case, capacity markets are likely to be much more significant revenue sources for DR than energy or ancillary services markets, because DR resources will not, and cannot,

¹²⁰ While the Commission described the net benefits test using different terms, at bottom, the purpose of the test is to assure that the amount of uplift paid by energy buyers to overcompensate DR resources does not exceed the savings from DR's suppression of LMPs. See, e.g., Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 53 ("the Commission requires the use of the net benefits test described herein to ensure that the overall benefit of the reduced LMP that results from dispatching demand response resources exceeds the cost of dispatching those resources.").

¹²¹ *Id.* at P 85.

¹²² As of May 2010 (*i.e.*, date comments submitted), DR capacity participating in PJM's capacity market has increased seven-fold since 2006, from 1,245 to 7,294 MWs, while the number of DR providers in PJM has increased to 60. PJM Comments at 4.

¹²³ While payments from PJM's Economic Load Response Program decreased by \$26 million from 2008 to 2009 (from \$27.7 million to \$1.2 million), DR capacity market revenue increased from \$141 million in 2008 to \$303 million in 2009 (a 114 percent increase). Total DR payments from energy, capacity, and ancillary services increased 77 percent from 2008 to 2009, from \$174 million to \$308 million. See PJM IMM Comments at 10.

¹²⁴ In ISO-NE, the amount of DR resources increased by 17 percent in 2009, while total compensation increased by more than 25 percent. See EPSC Reply Comments at 14-16.

be dispatched as frequently as generators.¹²⁵ The Final Rule, however, simply ignored arguments that the Commission should take into account DR revenues from other markets in assessing the adequacy of current DR compensation,¹²⁶ and is, therefore, not the product of reasoned decisionmaking.¹²⁷

Third, the Commission claimed that “paying LMP can address the identified barriers to potential demand response providers.”¹²⁸ The Commission did not, however, demonstrate how or why overcompensating DR at the wholesale level would eliminate these barriers to entry, which, as even the Commission acknowledged, are at the retail level or are due to the disconnect between wholesale and retail rates.¹²⁹ The Final Rule will do nothing to eliminate what PJM’s IMM describes as the “fundamental barrier” to entry, namely, that customers “do not know and do not pay the market price for

¹²⁵ See, e.g., CAISO Comments at 9 (“the economics of [DR] [are] largely driven by capacity payments, not energy rents.”).

¹²⁶ The Commission addressed comments regarding DR’s capacity market revenues solely in the context of the net benefits test namely, in rejecting comments that the net benefits test should account for effects in capacity markets. See Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 85. The Commission never responded to commenters that, like EPSCA, urged the Commission to look at all DR revenue sources in considering the adequacy of existing ISO/RTO rules governing DR compensation.

¹²⁷ See, e.g., *CAPP*, 254 F.3d at 299 (“[u]nless the Commission answers objections that on their face seem legitimate, its decision can hardly be classified as reasoned.”).

¹²⁸ Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 58. See also *id.* at P 59 (“[r]emoving barriers to demand response will lead to increased levels of investment in and thereby participation of demand response resources (and help limit potential generator market power), moving prices closer to the levels that would result if all demand could respond to the marginal cost of energy.”).

¹²⁹ See *id.* at P 57 (internal citations omitted) (“Barriers to demand response participation at the wholesale level identified by commenters include the lack of a direct connection between wholesale and retail prices, lack of dynamic retail prices ..., the lack of real-time information sharing, and the lack of market incentives to invest in enabling technologies ...”). See also Moeller Dissent at 10 (emphasis added) (“the lack of dynamic prices at the retail level is the **primary** barrier to [DR] participation.”).

wholesale power,” and instead “pay a retail price that frequently bears only an attenuated relationship to the real time hourly LMP.”¹³⁰ The Final Rule will not change this fact for the vast majority of retail customers (primarily, residential and commercial customers), who pay fixed retail rates and therefore are not exposed to LMPs.

In fact, the Final Rule may hinder efforts to overcome barriers to DR entry at the retail level by interfering with the development and implementation of more cost-effective and targeted retail reforms such as price-responsive demand (“PRD”) that would eliminate the disconnect between retail and wholesale prices¹³¹ and, consequently, the need for DR programs at the wholesale level altogether.¹³² By retarding the development of PRD, the Final Rule threatens to frustrate the shared goal of facilitating DR deployment and to perpetuate indefinitely the federal intrusion into State retail ratemaking. The Final Rule contains no explanation as to why the Commission chose such a blunt, and

¹³⁰ PJM IMM Comments at 4.

¹³¹ See also, e.g., Midwest ISO Comments at 15 (explaining that “[e]conomic demand response programs only exist to compensate for the disconnect between retail and wholesale rates. Fixing retail tariffs is an obvious and more cost-effective alternative to economic demand response programs.”).

¹³² See, e.g., PJM IMM Comments at 5 (explaining that “[t]he entire demand side program exists only because of the disconnect between wholesale and retail rates. The assertion that the program design 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”); Comments of the Pennsylvania Public Utilities Commission at 1, Docket No. RM10-17-000 (filed May 13, 2010) (“Pennsylvania PUC Comments”) (noting that payments to DR “by ISOs and RTOs and associated ISO/RTO administrative measurement and verification structures are inherently interim measures. The ultimate goal of these interim measures is the development of fully competitive wholesale and retail markets that permit end-use customers to see and react directly to market prices without centralized measurement, verification, supervision and control.”).

ineffective, instrument to promote DR participation, rather than identifying specific barriers to entry at the wholesale level and individually mandating their removal.

Fourth, the Final Rule suggested that paying DR full LMP is necessary to overcome barriers to entry by DR resources,¹³³ but the Commission has provided no explanation, and has cited no evidence, establishing that the amount of the subsidy being provided is tailored to, or, indeed, has any connection with, what is needed to overcome those barriers. Nor has the Commission explained why setting the subsidy at this level would overcome these barriers to entry, which, as noted above, are at the retail level and are due to the disconnect between wholesale and retail rates. Moreover, while many of these barriers to entry appear to be transient in nature,¹³⁴ the Final Rule contains no mechanism for decreasing the subsidy – and the corresponding burden on other market participants – as these barriers fall.

2. The Commission Has Failed To Establish That The Final Rule Will Produce Just And Reasonable Rates Or To Respond To Objections Concerning The Detrimental Impacts Of The Final Rule.

The Commission has also failed to demonstrate that its proposed solution to the “problem” of inadequate DR compensation — paying DR full LMP — is just

¹³³ See Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 58 (“[t]he Commission concludes that paying LMP can address the identified barriers to potential demand response providers.”).

¹³⁴ See NOPR, FERC Stats. & Regs. ¶ 32,656 at P 22 (acknowledging that “markets, and the types of demand response participating in them, continue to evolve” and that it may, therefore, “be necessary in the future for industry and the Commission to reassess the appropriate method for compensating demand response resources in organized wholesale energy markets”). See also *id.* at P 18-19 & n.46 (describing the “**current** barriers to demand response” and the “**evolving** nature of the technology enabling demand response” and characterizing full LMP as the “correct approach **at this time**”) (emphasis added).

and reasonable, which may be because the starting point for the Commission's analysis was a "presumption" that payment of full LMP is the "correct result."¹³⁵ Nor has it adequately responded to, or rebutted, the overwhelming evidence that the Final Rule conflicts "with the Commission's efforts to promote competitive markets and with its statutory mandate to ensure" that jurisdictional rates are just and reasonable.¹³⁶ Moreover, as the Competitive Supplier Associations and other commenters emphasized, by overcompensating DR and suppressing LMPs, the Final Rule will produce perverse incentives, distort consumption and production decisions in the short-term and investment decisions in the long-term, and, ultimately, increase costs to consumers and harm reliability. By failing to respond meaningfully to the legitimate concerns raised by commenters and by Commissioner Moeller in his dissenting statement, the Commission failed to fulfill its duty to engage in reasoned decisionmaking.¹³⁷

While the Commission acknowledged in the Final Rule that payment of full LMP in all hours would not be cost-effective,¹³⁸ and that the increased costs from overcompensating DR must be allocated to other market participants,¹³⁹ its proposed fixes – the net benefits test, cost allocation mechanism, and

¹³⁵ See, e.g., Tech. Conf. Tr. at 7:19-8:5 (Chairman Wellinghoff).

¹³⁶ Moeller Dissent at 1.

¹³⁷ See, e.g., AGA, 593 F.3d 14, 20-21.

¹³⁸ See Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 53 (finding that, due to the "billing unit effect," it would not be cost-effective to pay DR LMP in all hours, and that the Commission will "require[] the use of the net benefits test described herein to ensure that the overall benefit of the reduced LMP that results from dispatching those resources.").

¹³⁹ See *id.* at P 99 (explaining that increasing DR compensation will produce a "negative balance" in ISOs/RTOs net revenues "that must be addressed through cost allocation.").

measurement and verification standards – will create a host of new problems that could have easily been avoided through adopting the efficient pricing mechanism advocated by all of the ISOs/RTOs and many other commentators (*i.e.*, LMP with an offset for the avoided costs of foregone retail purchases). The need for these fixes is an inevitable consequence of the Commission’s decision to overcompensate DR resources,¹⁴⁰ which increases total resource costs for serving load that must then be allocated to other customers.¹⁴¹ As the FTC explained:

[T]here is no need for a net benefits test so long as [the Commission] utilizes efficient prices in compensating demand response providers, because efficient prices will elicit efficient levels of demand response. ... The proposal to implement a net benefits test as a screen arises as a policy issue only if [the Commission] sets inefficiently high compensation levels for demand response.¹⁴²

The Midwest ISO reached a similar conclusion:

[O]vercompensating DR will result in an artificial market construct in which LMP is suppressed below the price at which generation resources will voluntarily bid into the energy market. This will not only reduce the economic efficiency of the wholesale market, it will also unfairly shift the costs resulting from the inefficient curtailment to those retail customers who do not participate in DR (typically small residential and commercial customers).¹⁴³

¹⁴⁰ See, *e.g.*, PJM Comments at 9-11 (explaining that payment of full LMP results in large cost shifts among market participants and necessitates cost allocation mechanisms).

¹⁴¹ See, *e.g.*, *id.* at 8-9; ISO-NE Comments at 3.

¹⁴² FTC Comments at 1.

¹⁴³ Comments of the Midwest Independent Transmission System Operator, Inc. at 3, Docket No. RM10-17-000 (filed Oct. 13, 2010) (“Midwest ISO Post-Conference Comments”).

Moreover, as discussed in further detail in Section III.B.7 below, current measurement and verification standards are not sufficient to ensure that DR providers have actually reduced consumption in response to price signals, or to prevent DR providers from fraudulently collecting DR payments through “load shifting” and similar manipulative strategies.

Over and above the problems that the Commission acknowledged, its approach creates a number of other problems that are not addressed in the Final Rule. In particular, paying DR LMP, without a retail offset, is inefficient, conflicts with least-cost dispatch (which is a fundamental market design element of all ISO/RTO markets), harms long-run reliability, and will hinder the development of more cost-effective retail reforms such as PRD. Commenters across the spectrum recognized that any short-run cost savings from the suppression of LMPs would likely be more than outweighed by cost increases over the long-run, and would therefore ultimately harm consumers. As Commissioner Paul Centolella of the Ohio Public Utilities Commission put it:

Any unnecessarily large incentives for demand response have a cost. The amount of any incentives will be recovered from other consumers. While the discussion of a “net benefits” test has focused on the potential for additional demand response to lower prices in energy markets, lower energy market prices do not necessarily mean lower total costs to consumers. RTO capacity prices typically include an offset for energy and ancillary service revenues. Lower energy market prices will tend to increase capacity prices.¹⁴⁴

¹⁴⁴ Comments of Commissioner Paul A. Centolella of the Public Utilities Commission of Ohio Supplementing His Technical Conference Remarks at 9-10, Docket No. RM10-17-000 (filed May 13, 2010).

Commissioner Moeller echoed these concerns in his dissenting statement, concluding that the Commission's determination, which is "unencumbered by 'textbook economic analysis of the market subject to [its] jurisdiction,'"¹⁴⁵ will create "inefficiencies [that] will result in customers experiencing a short-term benefit by way of a lower LMP, but will also impose long-term costs on the energy markets."¹⁴⁶ ISO-NE conducted an analysis of the Final Rule's long-term effects on capacity markets, and found "that capacity price increases from the suppression of energy prices driven by paying demand response the full LMP can fully offset energy price reductions, making consumers worse off in the end."¹⁴⁷ Moreover, by suppressing LMPs below the efficient levels, the Final Rule will distort investment incentives and harm reliability in the long-run by encouraging existing supply to exit and discouraging new entry.¹⁴⁸ The Commission did not even begin to respond to these arguments, rendering its determination arbitrary and capricious.¹⁴⁹

¹⁴⁵ Moeller Dissent at 9 (*quoting* Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 46).

¹⁴⁶ *Id.* at 9-10.

¹⁴⁷ ISO-NE Comments at 15. *See also* Comments of Midwest TDUs at 7, Docket No. RM10-17-000 (filed May 13, 2010) ("Midwest TDUs Comments") ("resulting distortions in the markets, and the potential that this LMP reduction would be offset by increased capacity costs, making consumers worse off"); EEI Comments at 2-3 ("overusing demand response to artificially depress market energy prices through subsidies will yield temporary benefits for LSEs and some large commercial and industrial customers but ultimately will raise wholesale market prices.").

¹⁴⁸ ISO-NE Comments at 29. According to ISO-NE, payment of full LMP will distort investment incentives by discouraging investment in renewable generation technologies like wind that have low or no fuel costs and in high capacity-factor DR resources like energy efficiency. *Id.* at 30.

¹⁴⁹ *See, e.g., PPL Wallingford*, 419 F.3d at 1199-1200 (vacating and remanding orders for Commission's failure to respond to "answer objections that on their face seem legitimate") (*quoting CAPP*, 254 F.3d 299). As noted above, the Commission brushed aside arguments that the net benefits test should consider the impact of the rule on

Overcompensating DR threatens to distort consumption and production decisions as well, both in wholesale power markets and in the broader economy, increasing total resource costs and reducing economic output and social welfare. As ISO-NE observed, “[b]y dispatching higher-cost [DR] resources, lower-cost generating resources are displaced, which is inefficient and increases total resource costs in the energy market.”¹⁵⁰ This is not only inefficient, but it “runs counter to the fundamental least-cost resource dispatch procedure of the energy markets, and will ultimately raise consumer costs,”¹⁵¹ and is thus inconsistent with one of the central features of the competitive market design. Notably, market monitors for **all** of the ISOs/RTOs with economic DR programs raised serious concerns regarding the market inefficiencies that would result from the Commission’s proposal in the NOPR.¹⁵²

The approach adopted in the Final Rule will distort price signals in a manner that will cause some customers to reduce consumption below optimal levels and others to increase consumption above optimal levels. Commissioner Moeller explained that, as a result of the suppressed LMPs, “the price signal sent to customers will be that the cost of power is cheaper so they may decide to use

capacity markets by stating that the Final Rule “is focused on only on organized wholesale energy markets, not capacity markets.” Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 85. The Commission did not, however, specifically respond to concerns that payment of LMP – in and of itself and without regard to the implementation of a net benefits test – will distort long-term investment incentives and result in increased costs to consumers in the long run.

¹⁵⁰ ISO-NE Comments at 3.

¹⁵¹ *Id.* at 2.

¹⁵² See Comments of the ISO New England Inc. Independent Market Monitor at 5-7, Docket No. RM10-17-000 (filed May 13, 2010) (“ISO-NE IMM Comments”); PJM IMM Comments at 2; Potomac Economics Comments at 9-10.

more power even though the real cost of producing that power is now higher.”¹⁵³

The FTC elaborated on this theme, explaining that:

Customers who pay for the power they consume, but not the power that they sell back to the grid, will have an incentive to consume power not when the marginal benefit exceeds the marginal cost, but when the marginal benefit exceeds the sum of the marginal cost and the retail price. Simple algebra shows that buying when the difference between the marginal benefit and the retail price exceeds the marginal cost is equivalent to buying when the marginal benefit exceeds the sum of the retail price and the marginal cost. Thus, giving away for free the power that customers resell implicitly raises the price of consuming power above the efficient level. This will lead firms to provide too much demand response.¹⁵⁴

The resulting market distortions will extend beyond the power markets. APPA

and NRECA asked:

[W]hether it is always best from a societal standpoint for industrial plants to cease production and commercial activities to be curtailed so that demand response revenues can be earned, especially when the incentive rates they are responding to are not economically efficient in the first instance. These actions may be profit-maximizing for the individual industrial/commercial concerns in question, but may come at the price of decreased wages, less desirable working hours and a lower level of economic activity in the affected communities.¹⁵⁵

Putting it somewhat more bluntly, but no less accurately, Commissioner Moeller warned that the Final Rule “could have job-killing results.”¹⁵⁶

¹⁵³ Moeller Dissent at 9. See also ISO-NE Comments at 30.

¹⁵⁴ FTC Comments at 7.

¹⁵⁵ Post-Technical Conference Comments of the American Public Power Association at 3, Docket No. RM10-17-000 (filed Oct. 13, 2010).

¹⁵⁶ March 17, 2011 Commission Meeting Tr. at 12:9-11.

Finally, rather than eliminating the market imperfections that have hindered efficient pricing at the retail level, the Final Rule will hinder the development of retail dynamic price response programs such as PRD and other State DR reforms.¹⁵⁷ These reforms at the retail level are more narrowly targeted and cost-effective, and they have the potential to eliminate altogether the disconnect between wholesale and retail rates, rendering wholesale DR programs obsolete.¹⁵⁸ The Final Rule will discourage State regulators from pursuing PRD and other initiatives at the retail levels. As the ICC explains:

[A]s the value of the subsidy increases, the state commission's likelihood of implementing time-differentiated retail rates decreases. ***It should be recognized that retail rates reflecting wholesale prices would be the most efficient means of allocating the scarce energy resources.*** ... Specifically, subsidizing demand reductions has the effect of decreasing the potential for retail rate reform.¹⁵⁹

¹⁵⁷ See, e.g., CAISO Comments at 4; Notice of Intervention, Comments and Request for Clarification of the Public Utilities Commission of the State of California Regarding the Proposed Rulemaking on Demand Response Compensation in Organized Wholesale Markets at 9-10, Docket No. RM10-17-000 (filed May 13, 2010) (“CPUC Comments”); Comment of the Delaware Public Service Commission at 2, Docket No. RM10-17-000 (filed May 13, 2010); FTC Comments at 8; ICC Comments at 3; ISO-NE IMM Comments at 5-6; Midwest TDUs Comments at 13; Ohio PUC Comments at 5; OMS Comments at 4; PJM Comments at 5-6; PJM IMM Comments at 5. See also Calpine Comments at 4, Comments of Capital Power Corporation at 6, Docket No. RM10-17-000 (filed May 13, 2010); Comment of the Detroit Edison Company at 4, Docket No. RM10-17-000 (filed May 13, 2010); Comments of Dominion Resources Services, Inc. at 7-8, Docket No. RM10-17-000 (filed May 13, 2010); Comment of Duke Energy at 4, Docket No. RM10-17-000 (filed May 13, 2010); EEI Comments at 22; Exelon Comments 4; Comments of Old Dominion Electric Cooperative at 6, Docket No. RM10-17-000 (filed May 14, 2010); NEPGA Comments at 2; Comments of RRI Energy, Inc. at 2, Docket No. RM10-17-000 (filed May 13, 2010).

¹⁵⁸ See, e.g., Pennsylvania PUC Comments at 4.

¹⁵⁹ ICC Comments at 14 (emphasis added). See also CPUC Comments at 6 (“promulgating a uniform national rule at this time may inadvertently impede the

Moreover, the Commission-mandated subsidy makes DR participation at the wholesale level much more lucrative than solutions at the retail level like PRD, and will likely discourage participation in these programs.¹⁶⁰ According to the NYISO, paying full LMP “may create an incentive for such customers to avoid moving to retail dynamic pricing – the preferable rate structure for recognizing the economic value of load vis a vis generation,”¹⁶¹ while new, innovative technologies “may be kept out of the market by [DR] that would be uneconomic at LMP-G but participates when subsidized at full LMP.”¹⁶² In addition, as a result of the Commission’s action, State regulators would, “[i]ronically ... be faced with the task of revising retail rate structures in order to correct a price distortion created by a wholesale market pricing mechanism which was intended to improve price signals,”¹⁶³ wasting time and resources that they might have otherwise directed towards adopting needed reforms in the retail market. In the Final Rule, the Commission did not even respond to concerns that its own efforts to eliminate barriers to entry by DR would hinder reforms at the retail level.

implementation of the optimal demand response compensation for an individual ISO or RTO which addresses the needs of that particular region.”).

¹⁶⁰ See PJM Comments at 23. See also EEI Comments at 22 (“[t]he Commission should exercise restraint from prescribing uniform standards for wholesale demand response programs that could potentially impede the continued development of demand response at the retail level.”).

¹⁶¹ NYISO Comments at 12.

¹⁶² *Id.* at 15.

¹⁶³ OMS Comments at 3-4.

3. The Final Rule Departs Without Adequate Explanation From Existing Precedent That Subsidies Are Not Necessary To Incent DR Participation.

In the Final Rule, the Commission departed, without adequate explanation, from long-standing Commission precedent for the proposition that permanent subsidies are not necessary to promote DR, and as such its action was arbitrary and capricious.¹⁶⁴ In *PJM ICC*, for example, the Commission rejected a complaint seeking to require PJM to continue to pay subsidies that were set to expire to incentivize DR participation. The Commission properly recognized payment of full LMP as a subsidy and found that payment of LMP minus the retail rate was sufficient incentive for DR participation.¹⁶⁵ The Commission further found that “because these customers are paying the applicable wholesale price, they already have an incentive to curtail load,”¹⁶⁶ and that the complainants had “provided no evidence showing that the subsidy payments were needed to ensure just and reasonable rates.”¹⁶⁷ Similarly, in *PJM Interconnection, L.L.C.*,¹⁶⁸ the Commission accepted PJM’s proposal to pay DR LMP minus the retail rate, and rejected protesters’ arguments that DR should receive full LMP. The Commission explained that “[t]he purpose of a load response program is to try to duplicate what a customer reducing power would receive in an unregulated market where the customer’s price reflects the LMP.”¹⁶⁹

¹⁶⁴ See, e.g., *Fox*, 129 S. Ct. at 1811; *Greater Boston*, 444 F.2d at 852.

¹⁶⁵ *PJM ICC*, 121 FERC ¶ 61,315 at P 26.

¹⁶⁶ *Id.*

¹⁶⁷ *Id.*

¹⁶⁸ 99 FERC ¶ 61,227 (2002).

¹⁶⁹ *Id.* at 61,941.

In such an unregulated market, a customer that reduced consumption would receive a benefit: namely, LMP. To replicate that result, the Commission agreed that “PJM should compensate the customer by paying the difference between the LMP and what the customer would save by not using power (the retail price it didn't have to pay).”¹⁷⁰

4. The Commission’s Determination That The Final Rule Is Necessary To Ensure That ISO/RTO Rates Are Just And Reasonable Is Contrary To Law, Because It Ignores Regulated Sellers’ Statutory And Constitutional Rights To Just And Reasonable Compensation.

The Commission appears to have ended this rulemaking with the same dubious “presumption” that paying DR resources full LMP is the “correct result” with which it “started,”¹⁷¹ concluding that it “is necessary to ensure that rates are just and reasonable in the organized wholesale energy markets,”¹⁷² and that “payment by an RTO or ISO of compensation other than the LMP is unjust and unreasonable.”¹⁷³ In reaching these conclusions, however, the Commission made no attempt to quantify the amount by which jurisdictional rates are excessive or may become excessive in the absence of the Final Rule,¹⁷⁴ the effect of increased DR compensation on lowering jurisdictional rates, or the net effect of the Final Rule jurisdictional sellers’ compensation. Instead, it appears

¹⁷⁰ *Id.*

¹⁷¹ Tech. Conf. Tr. at 7:20-25 (Chairman Wellinghoff).

¹⁷² Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 2.

¹⁷³ *Id.* at P 47.

¹⁷⁴ In fact, the evidence in the record indicates that energy prices fell to record lows in 2009 and have remained at historically low levels since then. See Commission 2009 SOM Report at 7 (“[w]ith lower electricity prices and lower fuel costs, electricity prices fell by half” from 2008 to 2009).

that the Commission has blithely and falsely assumed that more DR, more mitigation, and lower prices are always better. By solely focusing on the potential for DR to lower prices, however, without regard to whether these rates will be compensatory or confiscatory, the Commission has abdicated its duties under the FPA and the U.S. Constitution to ensure that rates for jurisdictional sales are just and reasonable as to jurisdictional public utilities making those sales. Moreover, the Commission has ignored not only its statutory obligations to regulated sellers, but also the statutory language itself, in “somehow equating the concept of a just and reasonable rate with a lower price.”¹⁷⁵ The Commission has thus subordinated the indisputable right of jurisdictional public utilities to just and reasonable compensation for jurisdictional wholesale sales to an alleged right of non-jurisdictional DR providers to higher compensation for non-jurisdictional, retail non-purchases.¹⁷⁶

Federally regulated entities’ right to receive compensatory rates is grounded in the Fifth Amendment of the U.S. Constitution,¹⁷⁷ which prohibits takings of private property for public use without just compensation.¹⁷⁸ The Supreme Court has held that the constitutional right to just compensation is

¹⁷⁵ Moeller Dissent at 7.

¹⁷⁶ Further, as noted above, the fact that the Final Rule is so ill-suited to addressing the actual barriers to DR entry, combined with the Commission’s single-minded focus on lowering prices without regard to whether rates paid to regulated sellers are just and reasonable, begs the question of whether the purpose of the Final rule is simply to subsidize a favored group (*i.e.*, DR providers) at the expense of generators and to lower prices by any means necessary. As such, the Commission’s action “constitutes arbitrary and capricious conduct that cannot stand.” See, *e.g.*, *Woods Petroleum*, 18 F.3d at 860.

¹⁷⁷ U.S. Const. amend V, cl. 3.

¹⁷⁸ See, *e.g.*, *Smyth v. Ames*, 169 U.S. 466, 546 (1898); *Bluefield Waterworks & Imp. Co. v. Pub. Serv. Comm’n of W. Va.*, 262 U.S. 679, 690 (1923) (“*Bluefield*”).

coextensive with the statutory requirement¹⁷⁹ that such rates must, at a minimum, provide a reasonable opportunity for the utility to recover of, and on, its investment.¹⁸⁰ In this regard, the setting of “just and reasonable” rates “involves a balancing of the investor and the consumer interests.”¹⁸¹ Rates must provide “enough revenue not only for operating expenses but also for the capital costs of the business”¹⁸² and be sufficient for the utility to “maintain its credit and attract capital.”¹⁸³ The fixing of just and reasonable rates is thus a two-way street: regulated sellers are prohibited from charging exploitative rates, and in return, they have a right to receive compensatory rates. In the Final Rule, the Commission seemingly made no effort to balance investor and consumer interests, and instead applied a heavy, regulatory thumb on the scale in favor of the latter and to the detriment of the former.

A single-minded focus on lowering jurisdictional rates, like that which appears to underlie the Final Rule, is fundamentally at odds with the Commission’s constitutional and statutory obligations to regulated entities,

¹⁷⁹ *Hope* was decided under Sections 4 and 5 of the NGA, 15 U.S.C. 717c, 717d (2006). As noted, decisions interpreting these provisions may be “cite[d] interchangeably” with decisions interpreting Sections 205 and 206 of the FPA, 16 U.S.C. §§ 824d, 824e (2006). *Arkla*, 453 U.S. at 577 n.7.

¹⁸⁰ *Hope*, 320 U.S. at 607. The Supreme Court reached a similar conclusion regarding just compensation under the Fourteenth Amendment, U.S. Const. amend. XIV, § 1. See *Bluefield*, 262 U.S. at 692-693.

¹⁸¹ *Hope*, 320 U.S. at 603. See also *Grand Council of the Crees v. FERC*, 198 F.3d 950, 956 (D.C. Cir. 2000) (explaining that “‘the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated,’ while there is a ‘consumer interest in being charged non-exploitative rates.’”) (internal citations omitted).

¹⁸² *Hope*, 320 U.S. at 603.

¹⁸³ *Id.*

including the public utility members of the Competitive Supplier Associations. The conflict with the Commission's obligations is all the more glaring in light of the Final Rule's inordinate concern for whether unregulated DR service providers are receiving "just and reasonable" compensation for non-jurisdictional services without sufficient regard for whether the payment of full LMP to DR will produce just and reasonable rates for jurisdictional sellers'.

In the ISO/RTO setting, the Commission has applied *Hope's* directive that rates must be sufficient to cover capital costs and to attract capital to mean that just and reasonable rates must be sufficient to ensure an adequate supply of generation. This is because, in competitive markets, as under the traditional regulatory paradigm, sufficient rates serve both consumers' and investors' interests, as they are necessary to maintain reliability.¹⁸⁴ In fact, the Commission has applied this principle from *Hope* as a cornerstone design element for organized markets by requiring ISOs and RTOs to adopt measures to limit or prevent subsidized, uneconomic entry because such entry can reduce prices to below a just and reasonable level. For example, in unanimously accepting NYISO's proposed buyer market power mitigation rule,¹⁸⁵ the Commission explained that:

¹⁸⁴ See, e.g., *San Diego Gas & Elec. Co.*, 93 FERC ¶ 61,121 at 61,358 (2000) (explaining that in competitive power markets, where "supply is driven by market price instead of regulatory requirements, ratepayer interests may no longer depend solely on whether current prices are deemed too high, but also on whether prices are too low to elicit new supplies over time.").

¹⁸⁵ See, e.g., *New York Indep. Sys. Operator, Inc.*, 122 FERC ¶ 61,211 at P 100 ("*NYISO I*"), *on reh'g & compliance*, 124 FERC ¶ 61,301 (2008), *on reh'g*, 131 FERC ¶ 61,170 (2010) ("*NYISO II*").

While a strategy of investing in uneconomic entry and offering it into the capacity market at a low or zero price may seem to be good for customers in the short-run, it can inhibit new entry, and thereby raise price and harm reliability, in the long-run. Under the FPA, the Commission must ensure that rates are just and reasonable. The courts have long held that establishing just and reasonable rates involves a balancing of consumer and investor interests.¹⁸⁶

Moreover, the Commission has acknowledged that it is “statutorily mandated” to prevent such uneconomic entry¹⁸⁷ because such uneconomic entry “can produce unjust and unreasonable wholesale rates by artificially depressing” clearing prices.¹⁸⁸ The Commission has approved similar buyer-side mitigation rules, for the same reasons, in PJM, NYISO, and ISO-NE.¹⁸⁹ But despite these rules, ISO/RTO rates, particularly with respect to capacity markets, have already fallen well below the minimum level necessary for suppliers to cover their fixed costs and to attract new capital. The Final Rule threatens to reduce ISO/RTO rates still further below compensatory levels.

¹⁸⁶ *NYISO I*, 122 FERC ¶ 61,211 at P 103 (*citing Hope*).

¹⁸⁷ *PJM Interconnection, L.L.C.*, 135 FERC ¶ 61,022 at P 143 (2011) (“*PJM*”).

¹⁸⁸ *Id.* at P 141. See also *NYISO II*, 124 FERC ¶ 61,301 at P 29 (“all uneconomic entry has the effect of depressing prices below the competitive level and ... this is the key element that mitigation of uneconomic entry should address.”).

¹⁸⁹ See *PJM Interconnection, L.L.C.*, 117 FERC ¶ 61,331 at PP 103-104 (2006), *on reh’g and clarification and compliance*, 119 FERC ¶ 61,318 at P 165 (2007); *Devon Power LLC*, 115 FERC ¶ 61,340 at PP 113, 115, *reh’g denied*, 117 FERC ¶ 61,133 (2006).

5. To The Extent The Commission Found That Existing ISO/RTO Mitigation Is Inadequate, Its Determination Is Arbitrary And Capricious, Unsupported By Substantial Evidence, And Contrary To Law.

The Final Rule concludes that payment of full LMP to DR is necessary to ensure that ISO/RTO rates are just and reasonable because, among other things, increased DR participation can lower prices and mitigate supplier market power.¹⁹⁰ The Commission's repeated emphasis on the need for increased DR participation to lower prices and mitigate market power in the NOPR and in the Final Rule strongly suggests that the Commission's decision was based on the unstated, unsupported and erroneous premise that existing ISO/RTO mitigation is inadequate. To the extent that the Commission relied on this unfounded assumption (even implicitly), its decision is not supported by any evidence in the record, much less the substantial evidence necessary to survive judicial review.¹⁹¹ Of course, reliance on such an unstated assumption would also fall well short of satisfying the requirements of reasoned decisionmaking.¹⁹²

It is disturbing that the Commission would so casually cast doubt on the justness and reasonableness of existing ISO/RTO market rules – all of which the

¹⁹⁰ Final Rule, FERC Stats. & Regs. ¶ 31,322 at PP 10, 47. See *also* NOPR, FERC Stats. & Regs. ¶ 32,656 at P 13 (asserting that rates in ISO/RTO markets may have become “unjust and unreasonable,” and that the proposed subsidies to DR are needed “[t]o ensure that wholesale prices in ISOs and RTOs remain just and reasonable.”).

¹⁹¹ See 5 U.S.C. § 706(2)(E) (2006). See *also, e.g., ICC*, 576 F.3d at 477 (explaining that a reviewing court cannot “uphold a regulatory decision that is not supported by substantial evidence on the record as a whole.”).

¹⁹² *MoPSC I*, 234 F.3d 36 at 41 (remanding Commission order because the reviewing court found that “the record does not manifest that [the Commission] originally invoked all of the grounds it now relies on to support its action.”). See *also id.* (“[a] passing reference to relevant factors, however, is not sufficient to carry out ‘reasoned’ and ‘principled’ decisionmaking. We have repeatedly required the Commission ‘to fully articulate the basis for its decision.’”) (*quoting Columbia Gas*, 628 F.3d at 593).

Commission previously approved as just and reasonable – especially given its own repeated and consistent statements to the opposite effect. In Order No. 697-A, for example, the Commission properly adopted, on a generic basis, a “rebuttable presumption that the existing [ISO/RTO] mitigation is sufficient to address any market power concerns.”¹⁹³ Moreover, the Commission has consistently – and correctly – found that the existing mitigation in the various ISOs/RTOs is just and reasonable,¹⁹⁴ without reference to the level of DR compensation or participation, and organized markets have been shown to be competitive year after year by independent regional market monitors¹⁹⁵ and the

¹⁹³ Order No. 697-A, FERC Stats. & Regs. ¶ 31,268 at P 111.

¹⁹⁴ See, e.g., *Maryland Pub. Serv. Comm’n v. PJM Interconnection, L.L.C.*, 123 FERC ¶ 61,169, *order on reh’g*, 125 FERC ¶ 61,340 (2008) (order rejecting complaints regarding PJM’s market power screen, the three-pivotal-supplier test, but finding that mitigated prices were inadequate); *Connecticut ex rel. Blumenthal, et al. v. ISO New England Inc.*, 117 FERC ¶ 61,038 (2006), *reh’g denied*, 118 FERC ¶ 61,205 (2007) (order denying complaint alleging, among other things, that ISO-NE’s mitigation of units subject to the Peaking Unit Safe Harbor bidding rules was inadequate); *California Elec. Oversight Bd. v. California Indep. Sys. Operator Corp.*, 109 FERC ¶ 61,182 (2004) (order denying complaint seeking to require the CAISO to adopt automatic mitigation procedures); *NSTAR Elec. & Gas Corp. v. Sithe Edgar, LLC*, 101 FERC ¶ 61,064 (2002) (order denying complaint that ISO-NE mitigation measures were inadequate to prevent units in an ISO-NE subregion from exercising market power).

¹⁹⁵ See 2010 PJM SOM Report at 3-7; CAISO Department of Market Monitoring, *2009 Annual Report on Market Issues and Performance* at 1 (issued April 2010), *available at*: <http://www.caiso.com/2777/27778a322d0f0.pdf>; ISO New England Internal Market Monitor, *2009 Annual Markets Report* at 2-4 (issued May 18, 2010), *available at*: http://www.iso-ne.com/markets/mkt_anlys_rpts/annl_mkt_rpts/2009/index.html; Potomac Economics, Ltd., *2009 Assessment of the Electricity Markets in New England* at ix-x (issued June 2010), *available at*: http://www.potomaceconomics.com/uploads/isone_reports/ISONE_2009_IMMUN_Report_Final.pdf; Potomac Economics, Ltd., *2009 State of the Market Report for Midwest ISO* at ii-iv (issued Aug. 2010), *available at*: http://www.potomaceconomics.com/uploads/midwest_documents/2009_State_of_the_Market_Report.pdf; Potomac Economics, Ltd., *2009 State of the Market Report: New York ISO* at iv-v (issued Sept. 2010), *available at*: http://www.potomaceconomics.com/uploads/nyiso_reports/NYISO_2009_Full_Text_Final.pdf; Boston Pacific Company, *2009 State of the Market Report: Southwest Power Pool, Inc.* at 7-8 (issued May 26, 2010), *available at*: <http://www.bostonpacific.com/assets/documents/SPP2009SOMReport.pdf>.

Commission itself.¹⁹⁶

The Commission has not even hinted at what previously unrecognized flaw it has identified in existing ISO/RTO mitigation rules has caused it to conclude that those rules are unjust and unreasonable in the absence of the additional mitigation to be provided by increased DR compensation. In this regard, the Final Rule is an abrupt and unexplained departure from the vast body of Commission precedent finding that existing ISO/RTO mitigation is just and reasonable,¹⁹⁷ and a quintessential example of arbitrary and capricious decisionmaking.¹⁹⁸

Moreover, by requiring ISOs/RTOs to amend their tariffs to supplement existing mitigation measures, the Commission's action is contrary to law because the Commission did not find that any existing ISO/RTO mitigation measures are unjust and unreasonable. To require ISOs/RTOs to revise or supplement their existing, Commission-approved mitigation measures (or any other provision of their existing tariffs), the Commission would have had to satisfy the requirements

¹⁹⁶ See, e.g., Federal Energy Regulatory Commission, Office of the Chairman, *Performance Metrics for Independent System Operators and Regional Transmission Operators*, at 8-9 (Apr. 2011).

¹⁹⁷ See, e.g., *Williams*, 475 F.3d at 322 (vacating Commission orders because the Commission "neither explained its action as consistent with precedent nor justified it as a reasoned and permissible shift in policy."); *Nuclear Energy Inst., Inc. v. EPA*, 373 F.3d 1251, 1296 (D.C. Cir. 2004) ("[i]f an agency decides to change course, however, we require it to supply a 'reasoned analysis indicating that prior policies and standards are being deliberately changed, not casually ignored.'" (internal citations omitted)). See also, e.g., *Fox*, 129 S. Ct. at 1811; *Greater Boston*, 444 F.2d at 852.

¹⁹⁸ See, e.g., *PG&E Gas Transmission v. FERC*, 315 F.3d 383, 390 (D.C. Cir. 1989) (vacating Commission order where the Commission had "given no explanation whatsoever for this apparent shift in Commission policy. [The Commission's] failure to come to terms with its own precedent represents the absence of a reasoned decisionmaking process.").

of Section 206 of the FPA,¹⁹⁹ namely, by finding that the existing mitigation provisions are unjust and unreasonable and that its proposed replacement is just and reasonable.²⁰⁰ The Commission has not done so or even acknowledged the requirements of Section 206.

Further, the Commission failed to respond to the arguments raised by the Competitive Supplier Associations and others that payment of LMP to DR would likely result in over-mitigation, which, as the Commission has long recognized, can be just as harmful to competition as under-mitigation and may reduce regulated sellers' rates to unjust and unreasonable levels.²⁰¹ The Commission is required to strike a balance between inadequate mitigation and over-mitigation that "reflect[s] an appropriate trade-off between the interests of buyers and sellers"²⁰² and that allows generators "to charge prices that are high enough for them to recover their fixed costs."²⁰³ In the Final Rule, the Commission failed to do so, or even to give serious consideration to suppliers' legitimate concerns regarding over-mitigation and unjustified price suppression, and is, therefore, arbitrary and capricious.²⁰⁴

In addition, the Final Rule is contrary to law, because it will facilitate, or even mandate, the exercise of buyer market power to artificially suppress prices

¹⁹⁹ 16 U.S.C. § 824e (2006).

²⁰⁰ See, e.g., *Atlantic City*, 295 F.3d at 10; *Sea Robin Pipeline Co. v. FERC*, 795 F.2d 182, 183-184 (D.C. Cir. 1986) (interpreting requirements of the NGA analogue of FPA Section 206).

²⁰¹ See EPSA Comments at 45-46.

²⁰² *Wisconsin Public Power*, 493 F.3d at 262 (citing *Hope*, 320 U.S. at 603).

²⁰³ *Id.* at 263.

²⁰⁴ See, e.g., *Moraine Pipeline*, 906 F.2d at 9.

below just and reasonable levels.²⁰⁵ Moreover, the Final Rule is arbitrary and capricious because it departs, without adequate explanation, from the precedent discussed above where it acknowledged its statutory mandate²⁰⁶ and its constitutional obligation to mitigate buyer market power and because the Commission failed to respond meaningfully to the arguments of the Competitive Supplier Associations and others regarding buyer market power.²⁰⁷ Professor Hogan summarizes these concerns as follows:

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. ***Rather it would be merely 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.²⁰⁸

In fact, the Final Rule would institutionalize the collective exercise of buyer market power to artificially reduce prices below the competitive level through the

²⁰⁵ 16 U.S.C. §§ 824d, 824e (2006).

²⁰⁶ *PJM*, 135 FERC ¶ 61,022 at P 143.

²⁰⁷ See, e.g., EPSA Reply Comments at 55; See also Reply Comments of the New England Power Generators Association, Inc. at 2-3, Docket No. RM10-17-000 (filed May 13, 2010) ("NEPGA Reply Comments"). The Commission also failed to consider whether measures to monitor or mitigate any increased buyer market power should have been included in the Final Rule. 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.

²⁰⁸ Hogan Policy Paper at 14 (emphasis added). See also Comments of Robert L. Borlick Energy Consultant at 11, Docket No. RM10-17-000 (filed May 13, 2010) ("Borlick Comments") ("[f]or a regulator to employ demand response for the explicit purpose of driving down market prices to benefit consumers is tantamount to enforcing the exercise of monopsonistic market power.").

net benefits test. As NEPGA explained, the Commission’s net benefits test assesses whether it is economic (or “cost-effective”) to pay DR LMP based on the “portfolio benefits” to other buyers or positions from the price suppression, rather than on a stand-alone basis.²⁰⁹ In cases such as *Amaranth Advisors, LLC*²¹⁰ and *Energy Transfer Partners, L.P.*,²¹¹ however, the Commission concluded that similar trading strategies that sought to drive down prices – which would be uneconomic when considered on a stand-alone basis, but would generate countervailing profits for other trading positions in the portfolio – constitute market manipulation. Moreover, as recently as one day ago, the Commission recognized the ability and incentive of such “buyers’ cartels” to profitably suppress prices through subsidized, uneconomic entry, and reaffirmed its long-standing policy of prohibiting such conduct.²¹² The Final Rule thus not only completely ignores regulated sellers’ rights to just and reasonable

²⁰⁹ See NEPGA Reply Comments at 2.

²¹⁰ 120 FERC ¶ 61,085 (2007).

²¹¹ 120 FERC ¶ 61,086 (2007).

²¹² Specifically, the Commission stated:

Entities with buyer-side market power can artificially lower the capacity price, sometimes substantially, by subsidizing new investment that is then offered into the market at prices below its full entry costs. ... The cost of the subsidized new resource is higher than the market price, which on first impression would seem to be financially harmful to buyers. But buyers as a whole may benefit from the subsidized resource because the lower market price may reduce the total bill for acquiring existing capacity, and this bill reduction may outweigh the net cost of the new resource.

ISO New England Inc. & New England Power Pool Participants Comm., 135 FERC ¶ 61,029 at P 158 (2011),

compensation and the Commission's "statutor[y] mandate[]"²¹³ to prevent the exercise of buyer market power to artificially suppress prices, but it appears to embrace conduct that would be considered market manipulation if undertaken by market participants. "Buyers' cartels" will now have free rein to exercise market power to suppress prices below competitive, or even compensatory, levels, and thereby transfer revenues from jurisdictional sellers to non-jurisdictional DR providers and other buyers.

6. The Perceived Need For A Net Benefits Test Highlights The Fact That The Final Rule Is Not The Product Of Reasoned Decisionmaking.

The addition of a cost-effectiveness condition – the "net benefits" test – exacerbates the inefficiencies caused by paying DR LMP, and creates additional (and perhaps insurmountable) implementation problems. For these and other reasons, all of the ISOs/RTOs uniformly opposed the Commission's proposal to adopt a net benefits test,²¹⁴ along with a clear majority of commenters from across the spectrum.²¹⁵ As the Midwest ISO explained, "[s]uch a test is both unnecessary in a competitive wholesale market and the *very antithesis* of one,"

²¹³ *PJM*, 135 FERC ¶ 61,022 at P 143.

²¹⁴ As Commissioner Moeller noted at the March 17, 2011 meeting, all of the ISOs/RTOs said "please, please, please don't give us a net benefits test, because we don't know how to do it. Yet that's what the rule did." March 17, 2011 Commission Meeting Tr. at 13:10-12. See also Comments of the California Independent System Operator Corporation at 4-5, Docket No. RM10-17-000 (filed Oct. 13, 2010); Comments of ISO New England Inc. at 4-6, Docket No. RM10-17-000 (filed Oct. 13, 2010); Midwest ISO Post-Conference Comments at 9-10; Comments of the New York Independent System Operator, Inc. at 3-4, Docket No. RM10-17-000 (filed Oct. 13, 2010); Comments of Southwest Power Pool, Inc. at 3-4, Docket No. RM10-17-000 (filed Oct. 13, 2010); Statement of Andrew L. Ott at 2-4, Docket No. RM10-17-000 (dated Sept. 13, 2010).

²¹⁵ Moeller Dissent at 6. See also Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 40 (noting that "[o]pposition to use of a net benefits tests comes from several directions.").

and would “distort the decision of when to procure DR.”²¹⁶ Moreover, the net benefits test further distorts market prices over and above the inefficiencies due to overcompensating DR,²¹⁷ and it may discourage market participants from hedging.²¹⁸ Further, the test presents potentially insoluble computational and implementation issues.²¹⁹

(a) The Net Benefits Test Facilitates The Exercise Of Buyer Market Power.

The net benefits test facilitates, or even mandates, the exercise of buyer market power to transfer wealth from sellers to buyers,²²⁰ and, as noted above, essentially has the Commission acting to enforce a “buyers’ cartel” by ensuring that DR is paid full LMP only when it will serve the collective interests of buyers as a class. As NEPGA explained, the net benefits test would require an ISO or RTO to pay DR LMP based on its determination as to whether dispatching the DR resource is cost-effective by taking into account the “portfolio benefits” for other buyers, rather than whether it would be cost-effective on a stand-alone

²¹⁶ Midwest ISO Post-Conference Comments at 9 (emphasis added).

²¹⁷ See, e.g., FTC Comments at 5 (“[a] plan to inflate the formula for demand response payments to offset insufficient LMPs is very likely to miss the efficient result and instead produce a hodgepodge of over- and under-compensation for demand response.”).

²¹⁸ See, e.g., Ott Statement at 8 (explaining that the net benefits test would “create perverse incentives” because customers who have hedged may still be allocated costs, which may encourage them to discontinue hedging practices.).

²¹⁹ See *id.* at 2 (asserting that it would be nearly impossible to identify specific beneficiaries in practice because (1) “it is not practical to rerun market results with and without” DR “to accurately identify specific beneficiaries for specific hours;” and (2) customers “may not directly benefit from reduced prices because they may already be hedged”).

²²⁰ See Hogan Policy Paper at 14; Borlick Comments at 10-11.

basis.²²¹ In this regard, the Commission appears to be following a troubling approach adopted by several States in recent years in the form of “Demand Reduction-Induced Price Effect,” or “DRIPE.” DRIPE specifically excludes savings from the avoided costs of foregone retail purchases, and refers only to the reductions in energy and capacity prices through the exercise of buyer-side market power, *e.g.*, by subsidizing DR.²²² “DRIPE programs are based on the premise that subsidies for demand response can pay for themselves – **and more** – by depressing energy and capacity prices for all market purchases.”²²³

In the Final Rule, the Commission barely responded to legitimate concerns that the Commission was pursuing a similar strategy, brushing them aside with the bald assertion that “[i]mposing a cost-effectiveness condition does

²²¹ See NEPGA Reply Comments at 2. These concerns were echoed by Roy J. Shanker, Ph.D., who commented on the troubling way in which the NOPR contemplated the “consideration of portfolio effects caused by the reduced demand on all load payments, versus the economic decision-making of individual market participants pursuing their own legitimate business purposes.” Tech Conf. Tr. at 61:17-21.

²²² Post-Conference Comments of the New England Power Generators Association, Inc. at 5, Docket No. RM10-17-000 (filed Oct. 13, 2010) (internal citations omitted) (“NEPGA Post-Conference Comments”). In fact, as NEPGA’s representative, Mr. Joel Newton of NextEra Energy testified at the Technical Conference, DRIPE and similar programs are “the mirror image of a generator withholding.” Tech. Conf. Tr. at 28:16-17.

²²³ NEPGA Post-Conference Comments at 1 (emphasis in original). NEPGA set forth the disturbing parallels between the Commission’s approach and DRIPE as follows:

Both seek to determine whether demand response resources ought to be created for the capacity markets or dispatched in the energy markets. Both go beyond competitive considerations of whether a particular marginal unit of demand response would be the most economic source of capacity or power. Both look to the price effect of using demand response and attempt to justify its use on a portfolio basis, even if any individual unit might not be economic. Both are open and flagrant invitations to the use of buyer market power. Both should be rejected as unlawful and contrary to the Commission’s commitment to competitive markets.

Id. at 5-6.

not convert this unit commitment process by the RTO or ISO into collusion among bidders.”²²⁴ A simple denial, without providing a reasoned analysis demonstrating why commenters concerns are unfounded, does not even begin to satisfy the Commission’s obligation to engage in reasoned decisionmaking.²²⁵

Moreover, the Commission’s decision to adopt the “net benefits” test was not supported by reasoned decisionmaking, because the Commission explicitly acknowledged that its “net benefits” approach cannot achieve the purpose for which it was adopted (*i.e.*, identifying hours in which it is cost-effective to pay DR the full LMP and in which the cost savings from reduced LMPs will offset the “billing unit effect”).²²⁶ According to the Commission:

the threshold price approach we adopt here may result in instances both when demand response is not paid the LMP but would be cost-effective and when demand response is paid the LMP but is not cost-effective.²²⁷

The Commission went on to acknowledge that there will inevitably be differences among the tests that ISOs/RTOs ultimately adopt, and that these differences will cause DR to receive differing levels of compensation in each ISO/RTO.²²⁸ The

²²⁴ Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 65. See also *id.* (stating that the Commission “disagrees that market rules establishing circumstances in which particular resources can participate and receive the LMP represents cooperative price setting”).

²²⁵ See, e.g., *PPL Wallingford*, 419 F.3d at 1198.

²²⁶ See *MoPSC II*, 337 F.3d at 1075 (“[r]eliance on facts that an agency knows are false at the time it relies on them is the essence of arbitrary and capricious decisionmaking.”).

²²⁷ Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 80.

²²⁸ See *id.* at P 78 n.160 (“[t]here will be inherent differences in the supply curves determined by each RTO and ISO under the net benefits test required herein due to decisions the RTOs and ISOs must make based on supply data for their regions, the mathematical methods each RTO and ISO chooses to use for smoothing the supply

Commission offered no explanation as to why it will permit variations among ISOs/RTOs in DR compensation stemming from the methodology chosen for the net benefits test, but not for other reasons.

(b) Costs Of DR Compensation Should Be Allocated Based On Net Purchases, And Should Not Be Allocated To Self Supply.

The Final Rule requires that the costs of the DR subsidy, *i.e.*, the costs of paying full LMP to DR resources, be allocated “to all entities that purchase from the relevant energy market in the area(s) where the demand response reduces the market price for energy at the time when the demand response resource is committed or dispatched.”²²⁹ The Competitive Supplier Associations interpret the Final Rule as meaning that costs associated with DR compensation should be allocated to net purchasers (*i.e.*, market participants whose net cleared demand exceeds their net cleared supply) on the basis of net purchases in the ISO/RTO energy markets, and respectfully request clarification to that effect. In the alternative, if the Final Rule would allow costs to be allocated to market participants to the extent they are self supplying energy (*i.e.*, the extent to which their cleared supply offsets their cleared demand), the Competitive Supplier Associations respectfully request rehearing.

The stated purpose of allocating DR compensation costs on the basis prescribed by the Final Rule is to “allocate the costs of demand response to those who benefit from the lower prices produced by dispatching demand

curves, the certainty of changes in supply due to outages in each region, local generation heat rates, and the choice of relevant fuel price indices.”).

²²⁹ *Id.* at P 102.

response.”²³⁰ Leaving aside for the moment questions of whether customers truly benefit in the long term from price suppression of the sort contemplated by the Final Rule (and they do not),²³¹ it should be indisputable that market participants do not benefit, even in the short run, from lower LMPs resulting from dispatching DR with respect to their self supplied energy needs.²³² Allocating costs associated with DR dispatch to self supplied energy would be inconsistent – and, indeed, fundamentally at odds – with the stated intent of the cost allocation methodology prescribed in the Final Rule. As a result, such an approach would clearly be arbitrary and capricious.²³³ Moreover, it would be contrary to the law, inasmuch as it would conflict with the very decisions cited in the Final Rule for the proposition that the Commission’s allocation rule was “consistent with long-standing judicially-endorsed cost allocation principles,”²³⁴ and other decisions holding that “all approved rates [must] reflect to some degree the costs actually caused by the customer who must pay them.”²³⁵

²³⁰ *Id.* at P 100.

²³¹ *See supra* Section III.B.2.

²³² In general, in any hour of the day ahead or real time energy market, a market participant’s cleared supply offers are credited at the respective LMP and its cleared demand bids (or, in real time, its load) are charged at the respective LMP with the market participant receiving only the net credits after meeting own energy obligations. Because DR-induced LMP reductions would decrease both the charges and credits for energy, no benefit would be received for the amount by which the market participant’s credits offset its charges in that hour.

²³³ *See, e.g., State Farm*, 463 U.S. at 43.

²³⁴ *See* Final Rule, FERC Stats. & Regs. ¶ 31,322 at n.195 (*citing Midwest ISO Transmission Owners v. FERC*, 373 F.3d 1361, 1368, 1370-71 (D.C. Cir. 2004)); *ICC*, 576 F.3d at 476.

²³⁵ *KN Energy*, 968 F.2d at 1300. *See also Pacific Gas & Elec. Co. v. FERC*, 373 F.3d 1315, 1320-21 (D.C. Cir. 2004); *Transmission Access Policy Study Group v. FERC*, 225 F.3d 667, 708 (D.C. Cir. 2000).

Allocating the costs of DR compensation to self supply would not only unfairly and unjustifiably impact market participants electing to self supply (including generators self supplying station power requirements), but would also undermine the operation of the net benefits test. The stated purpose of the net benefits test is to ensure that DR is “cost-effective,” in the sense that it is being dispatched when “the nature of the supply curve is such that small decreases in generation being called to serve load will result in price decreases sufficient to offset the billing unit effect.”²³⁶ Understating the billing unit effect by allocating costs to self supply – which does not benefit from the price decreases – will cause the net benefits test to produce “false positives” and thus payment of full LMP to DR when, even by the terms of the Final Rule, there are no net benefits from dispatching DR. In this respect, the allocation of costs of DR compensation to self supply would be arbitrary and capricious.²³⁷

7. The Commission’s Determination To Adopt The Final Rule In The Absence Of Measurement And Verification Standards Capable Of Preventing Manipulation Is Arbitrary And Capricious.

The Commission agreed with commenters that “measurement and verification are critical to the integrity and success of demand response programs,” because in the absence of such standards, ISOs/RTOs “cannot determine whether that provider has in fact reduced its energy usage when paid to do so.”²³⁸ Yet the Final Rule creates significant, and perhaps insurmountable,

²³⁶ Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 80.

²³⁷ See, e.g., *State Farm*, 463 U.S. at 43.

²³⁸ Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 93. See also ISO-NE Comments at 4; Comments of Joint Consumer Advocates at 12, Docket No. RM10-17-000 (filed

difficulties for ISOs/RTOs in measuring customers' demand reductions and verifying that they have reduced consumption *in response to price signals*, rather than for other reasons such as day-to-day variations in temperature or demand.²³⁹

Like the net benefits test, however, current measurement and verification standards are simply not capable of performing the functions they are intended to serve, in particular, preventing manipulation. ISOs/RTOs and other commenters, including the Competitive Supplier Associations, pointed out that the current standards – the “Phase I” standards of the North American Energy Standards Board (“NAESB”) – are not sufficient for ISOs/RTOs to adequately verify the amount by which DR providers have reduced consumption.²⁴⁰ The Commission itself has acknowledged that the Phase I NAESB standards are only a “starting

May 13, 2010). The Commission directed ISOs/RTOs to review their current standards, and, in their compliance filing to make any changes to those standards necessary “to ensure that their baselines remain accurate and that they can verify that demand response resources have performed.” Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 94.

²³⁹ The Commission’s approach of paying full LMP may render it impossible, even in theory, to accurately estimate customer baselines and demand reductions in response to price signals. See, e.g., ISO-NE Comments at 4 (“[t]here 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.”). The Commission could have avoided these potentially intractable baseline estimation problems if it had adopted an alternative compensation method such as LMP-G, or the “buy the baseline” approach advocated by ISO-NE.

²⁴⁰ See generally *Standards for Business Practices and Communication Protocols for Public Utilities*, Order No. 676-F, 131 FERC ¶ 61,022 (2010) (“Order No. 676-F”). These measures, while helpful, only serve as a framework and lack necessary detail and specificity, which is intended to be developed in NAESB’s “Phase II” measurement and verification standards development process, which is now underway and expected to be completed in late 2011. Similarly, the North American Electric Reliability Council (“NERC”) is in the early stages of developing measurement and verification standards, but these standards are a long way off, and current indications are that there will be some inconsistencies between the NERC and NAESB standards that will take additional time to work out. See EPSA Comments at 30-31.

place”²⁴¹ and that additional standards will be necessary for transparent and consistent measurement and verification of DR products and services.²⁴²

Payment of full LMP in the absence of effective measurement and verification standards, however, invites manipulative strategies to fraudulently collect DR payments without actually reducing consumption, e.g., by inflating baseline estimates to receive payments for normal consumption or day-to-day load variations,²⁴³ or through “load shifting” strategies.²⁴⁴

Concerns about gaming and manipulation are not just theoretical, as the Commission appears to acknowledge in the Final Rule.²⁴⁵ In fact, an official of the Electricity Consumers Resource Council has admitted that “compensation for

²⁴¹ Order No. 676-F, 131 FERC ¶ 61,022 at P 35.

²⁴² *Id.* at P 32. The Commission went on to add that the “measurement and verification standards needed to accomplish this goal should be a focus of NAESB’s Phase II M&V Standards development efforts.” *Id.*

²⁴³ ISO-NE Comments at 32-33. *See also id.* at 31 (explaining that baseline estimation methods available under existing standards “invite sophisticated market participants to strategically schedule load reduction events so as to manipulate the baseline calculation.”).

²⁴⁴ According to the American Council for an Energy-Efficient Economy:
DR has virtually always been implemented during times (i.e., business weekdays) when customers would be engaged in “normal” business operations, greatly enhancing the likelihood that claimed load drops/shifts are “real”, and not free-ridership or gaming of production scheduling. If a customer or DR aggregator is free to bid on DR resources literally at any time, it is almost an open invitation to “game” the system and take advantage of internal scheduling opportunities to claim compensation for load shifts/reduction which would have occurred during an off-peak period anyway. It will be extremely difficult to verify a valid 24/7/365 “baseline” for large industrial customers, and particularly for an aggregated group of customers.

Comments of the American Council for an Energy-Efficient Economy Comments at 4, Docket No. RM10-17-000 (filed May 13, 2010).

²⁴⁵ See Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 95 (clarifying that “demand reductions that are not genuine may be violations of the Commission’s anti-manipulation rules.”).

curbing demand has to be significant for [manufacturers] to shift their production to another time,²⁴⁶ *i.e.*, to engage in load-shifting strategies that do not actually decrease total consumption. The official also acknowledged that “the environmental benefits of DR have been ‘grossly oversold,’ because it basically shifts production timing.”²⁴⁷ The Commission has taken enforcement action against at least one DR provider for violations of the Commission’s regulations prohibiting market manipulation²⁴⁸ and PJM’s tariff.²⁴⁹ The Commission has also issued public notices that Commission OE Staff has preliminarily determined that participants in ISO-NE’s Day-Ahead Load Response Program (“DALRP”) violated the Commission’s anti-manipulation rule by artificially inflating their baseline loads and misrepresenting their load profiles to fraudulently collect DALRP payments.²⁵⁰

While it is heartening that the Commission appears to take seriously the threat of manipulation by DR providers, the Commission’s decision to adopt the Final Rule, before meaningful measurement and verification standards have been developed, was arbitrary and capricious. The evidence in the record

²⁴⁶ Energy Washington, “Power Marketers May Sue FERC Over Rule Encouraging Efficiencies” (posted Mar. 21, 2011).

²⁴⁷ *Id.*

²⁴⁸ 18 C.F.R. § 1c.2 (2010).

²⁴⁹ See *North Am. Power Partners*, 133 FERC ¶ 61,089 (2010) (order approving stipulation and consent agreement between the Commission’s Office of Enforcement (“OE”) Staff and North America Power Partners to resolve violations of the Commission’s anti-manipulation rule and PJM’s tariff provisions, including a civil penalty of \$500,000 and disgorgement of more than \$2.25 million, plus interest, in unjust profits).

²⁵⁰ See Staff Notice of Alleged Violations (Jan. 25, 2011) (notice of violations by Lincoln Paper and Tissue, LLC); Staff Notice of Alleged Violations (Jan. 25, 2011) (notice of violations by Competitive Energy Services, LLC); Staff Notice of Alleged Violations (Jan. 25, 2011) (notice of violations by Rumford Paper Company).

unequivocally indicates that current NAESB standards and ISO/RTO rules cannot prevent fraud and abuse. As noted above, the Commission itself has acknowledged that the current NAESB Phase I measurement and verification standards are only a “starting place,”²⁵¹ while ISOs/RTOs and others have submitted uncontroverted evidence that, under the Commission’s approach, it may not be possible, even in theory, to accurately estimate customer baselines or to identify and measure the amount of demand reductions made in response to price signals. The Commission, however, summarily dismissed these concerns, and blithely assumed that current ISO/RTO rules, as modified on compliance, will be sufficient to address any concerns.²⁵² The Commission’s determination that ISOs/RTOs will be able to solve the problems created by the Final Rule regarding measurement and verification – where these same ISOs/RTOs have informed the Commission that they do not know how to do so and that these problems may in fact be intractable under the Commission’s approach – “is the essence of arbitrary and capricious decisionmaking.”²⁵³

²⁵¹ Order No. 676-F, 131 FERC ¶ 61,022 at P 35.

²⁵² See Final Rule, FERC Stats. & Regs. ¶ 31,322 at PP 93-94. The Commission’s response to these commenters – that the adoption of the net benefits test means that LMP will not be paid to DR resources in all hours and that, consequently, the “implementation of the Final Rule would not appear to prevent the adoption of appropriate baselines,” *id.* at P 94 – does not address, or rebut, their concerns. The adoption of the net benefits test does not reduce or eliminate the practical difficulty of estimating the baseline and measuring the reduction in consumption for any particular hour. Moreover, it is ironic that the Commission would rely on the net benefits test – which was uniformly opposed by all ISOs and RTOs and the clear majority of speakers at the September 13, 2010 Technical Conference who argued that the test would be impractical or impossible to implement and/or could not serve its intended purpose – to “solve,” at least in part, the measurement and verification problems caused by its adoption of the Final Rule.

²⁵³ See *MoPSC II*, 337 F.3d at 1076.

C. The Commission’s Conclusion That A Uniform, National Rule For DR Compensation Is Necessary To Ensure That ISO/RTO Rates Are Just And Reasonable Is Arbitrary And Capricious, And Unsupported By Substantial Evidence.

1. The Commission Improperly Shifted The Burden Of Proof.

In defense of its decision to impose a uniform, national rule for DR compensation, the Commission unlawfully shifted to commenters its own burden of proof, essentially requiring commenters to demonstrate that existing, Commission-approved ISO/RTO compensation rules remain just and reasonable.²⁵⁴ As noted above, the Commission’s action in this regard is unlawful, because it has not even attempted to satisfy the requirements of Section 206 of the FPA. But even assuming *arguendo* that it had, the Commission’s action would still be unlawful insofar as it asserts that commenters bear the burden of demonstrating that existing, Commission-approved tariff provisions should be retained, rather than acknowledging that it is the Commission that bears the burden of proof for changing existing tariff provisions under Section 206 of the FPA.²⁵⁵

²⁵⁴ See Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 67 (“the commenters have not shown why such [regional] differences warrant a different compensation level among the ISOs and RTOs.”).

²⁵⁵ See 16 U.S.C. § 824e(a) (2006); *Alabama Power*, 993 F.2d at 1571 (“the proponent of a rate change under § 206, here [the Commission], has the burden of proving that the existing rate is unlawful . . .”).

2. The Commission's Determination Departs Without Adequate Explanation From Long-Standing Policy Permitting Regional Variations In Market Rules.

In the Final Rule, the Commission departed, without adequate explanation, from its long-standing policy beginning with Order No. 2000²⁵⁶ of not only permitting, but encouraging, regional variations and experimentation in ISO/RTO rate and market design.²⁵⁷ The Commission utterly failed to justify why it chose DR compensation as the one element of market design to be singled out for standardization. Nor did it explain why such selective and preferential uniformity is needed to make ISO/RTO rates just and reasonable or why existing market rules, previously accepted as just and reasonable, would become unjust and unreasonable in the absence of the changes required by the Final Rule.²⁵⁸ As such, its action is arbitrary and capricious.²⁵⁹

In Order No. 2000, the Commission emphasized that it was not proposing a "cookie cutter" format for RTOs, and that it would instead adopt an "open

²⁵⁶ *Regional Transmission Organizations*, Order No. 2000, FERC Stats. & Regs. ¶ 31,089 (1999) ("Order No. 2000"), *order on reh'g*, Order No. 2000-A, FERC Stats. & Regs. ¶ 31,092 (2000), *aff'd sub nom. Pub. Util. Dist. No. 1 of Snohomish County, Washington v. FERC*, 272 F.3d 607 (D.C. Cir. 2001).

²⁵⁷ The Commission has not explained why it is important to require standardization solely for ISO/RTO markets, but not for other markets. As far as the Competitive Supplier Associations are aware, the Commission has not given any indication that it will require such standardization for non-ISO/RTO markets. This notable omission begs the question of whether the Commission has accepted that DR standardization outside the ISO/RTO context raises retail jurisdictional concerns, but somehow believes that a different rule obtains in the ISO/RTO markets. In any case, this aspect of the Final Rule is likewise unduly discriminatory.

²⁵⁸ See, e.g., Moeller Dissent at 2 (noting that the Commission has not found "the existing region-by-region approach to compensation is unjust and unreasonable.").

²⁵⁹ See, e.g., *Wisconsin Valley*, 236 F.3d at 748 (stating that "an agency acts arbitrarily and capriciously when it abruptly departs from a position it previously held without satisfactorily explaining its reason for doing so.").

architecture” to give each RTO and its members the flexibility to adapt their market rules as necessary to meet market needs.²⁶⁰ More recently, in Order No. 719, the Commission reaffirmed its policy of permitting regional variations,²⁶¹ and directed each ISO and RTO to develop its own mechanism for DR price formation and compensation.²⁶² The Commission explicitly rejected the need to adopt a uniform, national rule to standardize DR products²⁶³ and technical requirements across ISOs/RTOs.²⁶⁴ In addition, the Commission declined to address the “double payment” issue for DR resources ancillary services markets, noting that the issue would be “more appropriately addressed by each region,” working with stakeholders, “including state and local regulatory authorities.”²⁶⁵ Similarly, the Commission has affirmed regional variations for various aspects of market design in generic rulemaking proceedings and proceedings involving

²⁶⁰ Order No. 2000, FERC Stats. & Regs. ¶ 31,089 at 31,061.

²⁶¹ Order No. 719, FERC Stats. & Regs. ¶ 31,281 at P 10 (“Absent a single national power market, the development of regional markets is the best method of facilitating competition within the power industry.”).

²⁶² See *id.* at P 50.

²⁶³ See *id.* (concluding that, because “[e]ach RTO and ISO is unique, ... the Commission hesitates to impose a uniform definition.”).

²⁶⁴ In Order No. 719, the Commission concluded that:

It is not appropriate in this rulemaking to develop a standardized set of technical requirements for demand response resources participating in ancillary services markets. Instead, the Commission will allow each RTO and ISO, in conjunction with its stakeholders to develop its own minimum requirements.

Id. at P 59.

²⁶⁵ *Id.* at P 159.

individual ISO/RTO market rules, e.g., rules governing capacity markets, scarcity pricing, and long-term firm transmission rights.²⁶⁶

3. The Commission's Determination To Impose A "One Size Fits All" Rule Is Arbitrary And Capricious.

The Commission failed to establish that permitting regional differences in compensation constitutes a barrier to entry, or to explain how variations among the various ISO/RTO DR compensation rules render them unjust and unreasonable, restrict competition, or facilitate the exercise of market power.²⁶⁷

As noted above, ISOs/RTOs and their market monitors were uniformly opposed to the adoption of a uniform, national rule. For example, Potomac Economics, the external or independent market monitor for ISO-NE, the Midwest ISO and the NYISO opposed standardization, because:

[R]ecognition of differing retail rate structures may require flexibility by the Commission, rather than a one-size-fits-all approach to structuring DR settlement rules in each ISO market. Hence, we would encourage the Commission to establish guidelines for the ISOs that would be premised on maximizing economic efficiency, rather than requiring a specific DR payment scheme.²⁶⁸

Numerous State regulators voiced similar concerns. As the CPUC explained:

²⁶⁶ See, e.g., *Midwest Indep. Transmission Sys. Operator, Inc.*, 116 FERC ¶ 61,292, at P 53 (2006); *Long-Term Firm Transmission Rights in Organized Electricity Markets*, Order No. 681, FERC Stats. & Regs. ¶ 31,226, at P 100 (2006); *Southwest Power Pool, Inc.*, 110 FERC ¶ 61,031 at P 22-23 (2005); *Midwest Indep. Transmission Sys. Operator, Inc.*, 102 FERC ¶ 61,196 at P 43 (2003).

²⁶⁷ In this regard, there are numerous differences in the ISO/RTO rules governing compensation for generators. The Final Rule failed to note this fact, or to offer an explanation as to why it will permit such regional differences for generators, but must eliminate them for DR.

²⁶⁸ Potomac Economics Comments at 9-10.

[I]t is unclear whether the NOPR provides an adequate record from which to conclude that the proposed payment method is the only just and reasonable compensation structure across all ISOs, RTO's states, regions, and local regulatory authority zones.... [P]romulgating a uniform national rule at this time may inadvertently impede the implementation of the optimal demand response compensation for an individual ISO or RTO which addresses the needs of that particular region.²⁶⁹

Commenters from other industry segments likewise opposed standardization.

For example, APPA and NRECA advocated:

allowing local and regional differences to be reflected in pricing rules in RTO-run markets. 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.²⁷⁰

Trade associations representing LSEs and generators, such as EEI and EPSA, also opposed standardization for largely the same reasons.²⁷¹

²⁶⁹ CPUC Comments at 5-6. See also Comments of the ISO/RTO Council in Response to the Federal Energy Regulatory Commission's Notice of Proposed Rulemaking on Demand Response in Organized Wholesale Markets at 2, Docket No. RM10-17-000 (filed May 13, 2010) ("urging the Commission to adopt an approach that allows "each ISO/RTO ... to select an approach that best fits with retail regimes in its footprint."); NYISO Comments at 16 (the Commission "should leave the details of compensation to individual ISOs/RTOs").

²⁷⁰ APPA/NRECA Comments at 11-12.

²⁷¹ See EPSA Comments at 62-70; EEI Comments at 2 ("EEI therefore takes the position that the individual ISOs/RTOs should have the option to structure demand response compensation as their stakeholders choose to do so").

Each ISO/RTO has a set of unique DR products for energy, capacity, and/or ancillary services. Paying the same price for different products hardly achieves the uniformity that the Commission so obviously desires. For example, according to the *National Action Plan on Demand Response* prepared by Commission Staff, PJM, the Midwest ISO, and the NYISO each offer seven total DR products (three of which are for energy), while ISO-NE offers nine separate DR products (four of which are for energy).²⁷² Requiring uniform compensation for these disparate products will inevitably distort market participants' incentives to purchase or sell these DR products.

The Commission erred by failing to respond to the serious objections raised by the Competitive Supplier Associations, ISOs/RTOs, State commissions and others that opposed standardization and supported the retention of the Commission's long-standing policy of permitting regional variation.²⁷³ In addition, the Commission failed to draw a "rational connection"²⁷⁴ between the problem the rule purports to solve (*i.e.*, inadequate DR participation and barriers to entry by DR) and the solution it chose (*i.e.*, a uniform, national rule on DR compensation), or to explain how increased DR compensation will solve that problem.

²⁷² Federal Energy Regulatory Commission Staff, *National Action Plan on Demand Response*, App. B at B-12 to B-14, Docket No. AD09-10-000 (June 17, 2010).

²⁷³ See, *e.g.*, *CAPP*, 254 F.3d at 299.

²⁷⁴ *State Farm*, 463 U.S. 29, 43.

D. The Commission’s Rejection Of The LMP – G Alternative Is Arbitrary And Capricious And Not Supported By Substantial Evidence.

Commenters from across the spectrum,²⁷⁵ including *all* of the ISOs/RTOs with economic DR programs,²⁷⁶ supported the payment of LMP with an offset for avoided retail costs. Notably, even the CAISO, which pays full LMP in its markets, urged the Commission to give ISOs/RTOs the flexibility to account for retail rates in their DR compensation programs.²⁷⁷ These commenters supported payment of LMP-G, because it is the efficient level of compensation, and would also avoid the need for a net benefits test or a cost allocation mechanism.

According to the NYISO:

[P]aying demand response LMP minus a proxy cost for their retail rate (LMP-G) provides the correct economic signals within a wholesale market framework, avoids the need for complicated and contentious net benefits tests and cost allocation rules, and comports much more closely to the outcomes derived from dynamic retail pricing.²⁷⁸

²⁷⁵ See EPISA Reply Comments at 36-40 & n.70 (list of commenters that supported including an offset for avoided retail costs).

²⁷⁶ See CAISO Comments at 3; ISO-NE Comments at 40-44; Midwest ISO Comments at 3; NYISO Comments at 3; PJM Comments at 6.

²⁷⁷ CAISO Comments at 3 (stating that it supports the Commission’s proposal, but emphasized that “other compensatory measures . . . , such as subtraction of the retail rate, or a portion thereof, [are] appropriate for consideration by the ISO or RTO, its stakeholders, and the relevant retail electric regulatory authority, rather than for standardization by the Commission.”).

²⁷⁸ NYISO Comments at 1. See *also* Midwest ISO Comments at 5 (supporting payment of LMP-G because it: (1) makes the LSE financially indifferent, so that it pays the same amount regardless of whether demand reductions occurred; (2) “avoids the creation of cross-subsidies among LSEs and their retail customers;” and (3) “avoids increasing the energy ‘uplift’ charges that reduce market efficiency.”); PJM Comments at 8-9.

This alternative was also supported by State regulators. For example, the Public Utilities Commission of Ohio explained the reasons for its support as follows:

[T]he most appropriate payment for demand response resources in wholesale energy markets is LMP minus the generation portion of the retail rate. This is the economically efficient incentive for demand response resources in these markets. By reducing demand, the responding consumer is already avoiding payment for energy that was not consumed.²⁷⁹

Commenters representing generators appear to have uniformly supported the payment of LMP-G.²⁸⁰

The Commission's rejection of the LMP-G alternative proposed by commenters, and supported by Commission Moeller,²⁸¹ was arbitrary and capricious because it failed to give meaningful consideration to the LMP-G alternative²⁸² and because its rationale for rejecting this alternative is flawed. In the Final Rule, the Commission gave two reasons for rejecting the LMP-G alternative.

First, ... demand response resources participating in the organized wholesale energy markets can be cost-effective, as determined by the net benefits test ... and, in those circumstances, it follows that the demand response resource should also receive

²⁷⁹ PUC Ohio Comments at 3.

²⁸⁰ See, e.g., EPSA Comments at 36-40; NEPGA Comments at 4-5; P3 Comments at 3; IPPNY Comments at 3.

²⁸¹ Specifically, Commissioner Moeller stated that, while he opposed standardization of DR compensation, if he "were to now support any standardization of demand response compensation, it would be the LMP-G approach, which in my opinion, is the only economically efficient outcome for the markets." Moeller Dissent at 11.

²⁸² See, e.g., AGA, 593 F.3d at 14 ("[w]here a dissenting Commissioner raises a reasonable alternative, the majority is required to consider it."); *Laclede Gas*, 873 F.2d at 1498 ("[w]here a party raises facially reasonable alternatives to [the Commission's] decision ... the agency must **either** consider those alternatives **or** give some reason within its broad discretion ... for declining to do so.") (emphasis in original).

compensation at LMP. Second, such comments largely rely on arguments about economic efficiency, analogizing to incentives for individual generators to bid their marginal cost. These arguments fail to acknowledge the market imperfections caused by the existing barriers to demand response²⁸³

The first reason is simply circular: it does not follow from the fact that DR “can be cost-effective” that it should therefore receive full LMP or that it should receive a subsidy equal to its avoided costs. The Commission’s second reason for dismissing arguments that payment of LMP would overcompensate DR is internally inconsistent. As described above, the Final Rule selectively requires “comparable” treatment of DR and generation where the uniform standard is favorable to DR (*i.e.*, requiring payment of full LMP, which gives DR effectively compensates DR at LMP+G),²⁸⁴ but permits disparate treatment when the double standard would work in DR’s favor (*e.g.*, by permitting DR resources to participate in ISO/RTO subject to less stringent performance requirements and penalties than those at apply generators).

The other reasons cited by the Commission are similarly without merit. For example, the Commission’s suggestion that it would not be appropriate to use LMP-G due to concerns about computational difficulties or conflicts with retail rate regulation²⁸⁵ was without merit, as ISOs/RTOs and State commissions indicated that the retail rate can be deducted from LMP without the claimed

²⁸³ Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 61.

²⁸⁴ See Moeller Dissent at 4.

²⁸⁵ Final Rule, FERC Stats. & Regs. ¶ 31,322 at PP 28, 63.

difficulties,²⁸⁶ and the Commission acknowledges that it may be “feasible” to do so.²⁸⁷ In any case, the fact of the matter is that many of the ISOs/RTOs already deduct retail rates from LMP.²⁸⁸

E. The Commission’s Determination Was Contrary To Law And Arbitrary And Capricious Because It Violated The Requirements Of The RFA.

The Final Rule violates the requirements of the RFA,²⁸⁹ which requires the Commission to include in the Final Rule a description and analysis²⁹⁰ of rules that will have a significant economic impact on a substantial number of small entities.²⁹¹ Specifically, the Administrative Procedure Act (“APA”),²⁹² in combination with the RFA, requires the Commission analysis of its “rule’s impact on small businesses be reasonable and reasonably explained,” because “[a]

²⁸⁶ In fact, none of the ISOs/RTOs claimed that there would be any difficulty in subtracting the retail rate from LMP. See CAISO Comments at 5-6; ISO-NE Comments at 17-26; Midwest ISO Comments at 6-11; NYISO Comments at 12-16; PJM Comments at 5-16.

²⁸⁷ Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 63.

²⁸⁸ As noted above, the Midwest ISO and PJM already deduct the retail rate from LMP.

²⁸⁹ 5 U.S.C. §§ 601-612 (2006).

²⁹⁰ The RFA further requires the Commission, when it promulgates a final rule, to issue a description of the compliance requirements for the rule and an analysis that, among other things, estimates the impact of the rule on small businesses and describes the steps that the Commission took to minimize the rule’s impact on small businesses, including an explanation of why any “significant alternatives” to the rule were rejected. 5 U.S.C. § 604(a) (2006). The Commission may avoid these requirements only if it certifies that the final rule “will not, if promulgated, have a significant impact on a substantial number of” small businesses, 5 U.S.C. § 605(b) (2006), which appears to be the course adopted by the Commission in the Final Rule. See Final Rule, FERC Stats. & Regs. ¶ 31,322 at PP 122, 129.

²⁹¹ The Small Business Administration defines a small electric utility as one that, together with its affiliates, did not generate more than four million MWh during the previous twelve months. Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 122.

²⁹² 5 U.S.C. §§ 551, *et seq.* (2006).

regulatory flexibility analysis is, for APA purposes, part of an agency's explanation for its rule."²⁹³ Thus, in assessing the costs and burdens of its proposed rule, and in weighing those costs against any anticipated benefits, the Commission must act rationally.²⁹⁴

In the Final Rule, the Commission failed to satisfy its obligation to engage in reasoned decisionmaking because it simply assumed, without providing any analysis or explanation supporting its conclusion, that the Final Rule would affect only ISOs/RTOs, but not small entities.²⁹⁵ In doing so, the Commission ignored the substantial number of small entities that will be significantly impacted by the Final Rule, in particular, small generators and marketers (including the Competitive Supplier Associations' members), that participate in ISO/RTO-administered markets, not to mention LSEs and DR providers whose power sales are zero or *de minimis*. As discussed in detail above, however, the Final Rule will impose significant costs on these small entities. The Commission's failure to consider the impact of the Final Rule on these entities was therefore arbitrary and capricious.

²⁹³ *Nat'l Tel. Coop. Ass'n v. FCC*, 663 F.3d 536, 540 (D.C. Cir. 2009); see also 5 U.S.C. § 611(b) (in an action for judicial review of a rule, the agency's RFA analysis is part of the record in connection with such review); *Small Refiner Lead Phase-Down Task Force v. EPA*, 705 F.2d 506, 539 (D.C. Cir. 1983).

²⁹⁴ *Thompson*, 741 F.2d at 405.

²⁹⁵ Final Rule, FERC Stats. & Regs. ¶ 31,322 at P 122.

