<u>FINAL</u>

Opinion regarding FERC Order 745, "Demand Response Compensation in Organized Wholesale Energy Markets"

by

James Bushnell, Member
Scott M. Harvey, Member
Benjamin F. Hobbs, Member
Steven Stoft, Member
Market Surveillance Committee of the California ISO

April 29, 2011

The Market Surveillance Committee supports the request by the California Independent System Operator for a rehearing of FERC Order 745. While we have consistently supported the goal of increased participation by demand in wholesale electricity markets, we believe that this order, as written, will not advance that goal and may instead create new barriers to efficient demand response. The market mechanisms that would emerge from literal implementation of the order will be extremely complex to execute, disturbingly vulnerable to market abuse, and likely crafted to achieve inappropriate objectives.

There are several aspects of the order that we find potentially very detrimental to the efficiency and competitiveness of wholesale electricity markets. Specifically, we have the following concerns.

- Without modification, the payment formulas can create strong incentives for the inefficient deployment of demand response, leading to the curtailment of energy consumption and associated economic activity even when that activity produces value in excess of the cost of electricity supply.

- The implementation threshold articulated by the ``net benefits'' test is focused on attempting to influence market prices to favor one group of market participants rather than promoting economic efficiency. The pursuit of reduced payments by customers at the expense of revenues of suppliers as an explicit objective is inconsistent with the general philosophy of nodal markets as approved by the Commission, which rightly emphasize market efficiency and nondiscrimination. Further, to the extent that generation investment will need to earn sufficient return in the long run to cover capital costs, efforts to depress short run prices with demand response will be futile because it will necessarily shift revenues to capacity markets or other forms of forward capacity contracts.

- Restrictions on the ability of ISOs to implement minimum bid standards in excess of the net-benefit test threshold and some other rules designed to ensure that consumers only bear the cost of paying for actual demand reductions are likely to lead to abuses of DR programs that result in payments for "demand response" unaccompanied by true reductions in end-use consumption.

Because of the nature of demand response, payments for reductions in demand will always be somewhat vulnerable to mis-measurement. This provides perverse incentives to inflate baselines, as well as the adverse self-selection by participants. In the absence of retail level time-varying prices, these vulnerabilities may need to be tolerated in order to integrate demand into wholesale electricity markets. However, this order needlessly expands those vulnerabilities and encourages abuses that could threaten the credibility and benefits of any demand response program.

We therefore urge the Commission to reconsider elements of this order and reverse the mandates, such as the net benefits test, for the reasons briefly described. The Market Surveillance Committee of the California ISO plans to issue a more comprehensive opinion for review by all interested parties on demand response compensation addressing these and other issues in greater detail.