

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE
STATE OF CALIFORNIA**

Order Instituting Rulemaking Regarding
Policies and Protocols for Demand Response,
Load Impact Estimates, Cost-Effectiveness
Methodologies, Megawatt Goals and
Alignment with California Independent System
Operator Market Design Protocols

Rulemaking 07-01-041
(January 25, 2007)

**COMMENTS OF THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR
CORPORATION ON THE WORKSHOP REPORTS FOR JANUARY 19-21
REGARDING REMAINING DIRECT PARTICIPATION ISSUES
(PHASE IV, PART 2)**

The California Independent System Operator Corporation (ISO) submits these comments on the January 19-21 workshops and accompanying reports on demand response direct participation issues. The ISO provides responses to issues raised in the workshops and workshop reports. As previously stated in our initial response dated December 8, 2010 and in our second response dated December 13, 2010, the ISO encourages the Commission to steadfastly resolve the remaining direct participation issues and to implement policies and procedures at the retail level that support the development of a healthy and sustainable competitive third-party demand response delivery paradigm.

I. The proposed decision must first answer the question of whether a retail financial settlement mechanism should be adopted.

The first order decision before the Commission is whether or not a retail financial settlement is just and reasonable in the overall demand response compensation scheme. There are basically two camps on this issue. Those that believe the full locational marginal price is the final and appropriate settlement for demand response services given the market and environmental benefits that demand response resources provide. The other camp believes paying the full locational marginal price is inappropriate as it over-

compensates for demand response services –the rationale being that the demand response provider never paid for the load that it sold in the first instance. Thus, this camp proposes a “locational marginal price minus something” compensation methodology. This is the first and most important decision the Commission must decide, whether a retail financial settlement is just and reasonable for demand response resources that are directly bid into the wholesale markets by a demand response provider.¹

If the Commission determines that retail demand response compensation is just and reasonable, then the second order decisions are what charge is to be assessed and how the charge should be assessed. With respect to what charge should be assessed, there are two camps that appear to favor a subtraction from the ISO locational marginal price of either: (i) the ISO default load aggregation point (Default LAP) price; or (ii) the generation component of the retail rate or contract price. As to how the charge should be assessed, the two camps appear to favor either: (i) an assessment to the retail customer through the retail rate; or (ii) a pro forma compensation agreement between the load-serving entity and the demand response provider.

II. The ISO believes that a retail financial settlement is appropriate and that the charge should be equal to the generation component of the retail rate.

As the ISO has previously conveyed in comments to this proceeding, the ISO believes that a retail compensation mechanism (LMP “minus something”) is the just and reasonable approach to maintain economic parity and ensure market efficiency between supply-side and demand-side resources. Just as generator must procure fuel to produce and sell energy output, the equivalent “fuel source” for a demand resource that curtails load is the forward procurement of energy, which is then sold back as demand response, representing an explicit load reduction relative to the customer’s normal consumption pattern.

¹ A demand response provider that is providing demand response services in the wholesale electricity market could be a third party provider, an individual customer, an IOU or an ESP.

Under CPUC jurisdiction, an electricity customer that sells demand response directly or through a demand response provider would have procured energy to meet its normal consumption at either the retail rate as a bundled service customer or a contract rate for a direct access customer. Thus, upholding the economic principle that one can sell only what one first owned, an electricity customer offering demand response services must pay for the energy it would have normally consumed, but for demand response. In other words, for imputed demand response, an electricity customer's total charges when it provides demand response services is the summation of what it consumed, charged at the full retail rate, plus what it would have consumed, but for demand response, charged at the generation portion of the retail rate. The ISO believes that it is the energy or "generation" component of the retail rate that is the appropriate amount to subtract for bundled service customers. Electric service providers should similarly be compensated for the cost of energy procured but not consumed by the customer. This compensation construct is "LMP minus G" where the "G" represents the energy or generation portion of a utility's retail rate or the equivalent energy component in an electric service provider's contract with its customer.

III. The default load aggregation point does not represent the appropriate price for financial settlement.

The ISO does not believe the Default LAP represents the appropriate retail compensation price to subtract from the locational marginal price earned by a demand response resource participating in the wholesale market.² First, retail customers, which are the makeup of demand response resources, are not charged or credited based on wholesale market prices. Retail customers' that adjust their consumption as part of a retail demand response program or as part of a demand response provider's resource portfolio earn an incentive for their participation, usually in the form of an energy and/or

² The Default LAP is the weighted average price of all of the pricing nodes within the transmission access charge area where bids for demand are submitted and settled (effectively the IOU service territory).

capacity payment. In addition to the incentive payment, customers that curtail load also save the cost of energy at the retail rate that they would have consumed, but for demand response. If these customers did not curtail load, then they would pay the full retail rate for the portion of “flexible” load that they could have curtailed, but chose otherwise. In other words, the retail demand response compensation concern, often referred to as the “missing money” issue is inextricably linked to the underlying retail rate. Aggregated retail customers that make up a demand response resource would not have paid or saved based on the wholesale price for energy; they pay or save based on their retail tariff.

Second, the Default LAP varies hourly, which the ISO believes would make it difficult for a demand response provider to structure deals with their customers without knowing what the total transaction costs are until after every day-ahead market runs. This would present a new barrier to participation. The ISO believes a more stable and transparent value, like the generation component of the retail rate, would be a more suitable value for structuring deals with retail customers.

Third, an unanswered question is what compensation value would be used for demand response resources that participate in the ISO day-ahead market. The Default LAP price is produced after the day-ahead market runs. It is unclear to the ISO what money is left and what business opportunity remains for a demand response provider that would have to gamble between what the locational marginal price will be for their demand response resource relative to what the Default LAP price will be. In other words, in the day ahead market the only financial upside is likely minimal arbitrage between the demand response resource’s locational marginal price and the Default LAP price. This compensation opportunity is not likely to represent a sustainable business model given the risk versus likely return and, therefore, is unlikely to attract demand response participation in the day-ahead market. In the ISO’s opinion, the Default LAP is not a viable compensation price for demand response resources participating in the day-ahead

market. Thus, another compensation mechanism for the day ahead market would have to be considered, which leads back to the simplest and most transparent price solution which is the generation component of the retail rate.

Fourth, the ISO does not view the Default LAP as a sustainable price model. The FERC ordered the ISO to disaggregate its Default LAP pricing to increase the number of LAP zones, to provide more accurate price signals and to assist participants in the hedging of congestion charges.³ The ISO will eventually move to disaggregate the bidding and scheduling of load into more granular LAPs and, therefore, does not consider it prudent to establish demand response compensation on a Default LAP pricing structure that will eventually be modified.

IV. The Commission should adopt an average or simplified generation component of the retail rate as a reasonable proxy for purposes of financial settlement.

During the workshop, participants raised concerns about the challenge of pulling out the “right” components of the retail rate that make up the energy component and that these values can vary by rate and class. The ISO understands there is complexity in teasing out and agreeing to the appropriate “generation component” of the retail rate. Here the Commission can provide guidance as to how this might be done in a more simplified fashion. The ISO believes there is likely some compromise on this issue such that a value can be derived by IOU, customer class, or by rate class to settle on a reasonable retail compensation value that reasonably satisfies the “minus G” in the overall demand response compensation scheme for customers providing demand response services.

³*Cal. Indep. Sys. Operator Corp.*, 116 FERC ¶ 61,274 at P 611 (2006) (*MRTU September 2006 Order*); *order on reh'g*, 119 FERC ¶ 61,076 at PP 323-331 (*April 2007 Rehearing Order*).

V. The Commission should ensure the mechanics of how financial settlements are processed treats demand response providers similarly.

If retail financial settlement is ordered by the Commission, the ISO's only concern with how the compensation is assessed is to assure that no demand response provider, be it a utility or a third-party provider, has a "compensation advantage" over the other. In other words, a utility acting as a demand response provider for its bundled customers should have no undue financial advantage over a third-party demand response provider providing demand response services to those same customers by virtue of the mechanics of this process.

VI. The ISO will work with the Commission to iron out any jurisdictional issues that may flow from consumer protections the Commission may adopt.

The ISO has implemented verification and certification processes for demand response providers participating in the ISO markets. These procedures expressly defer to the Commission with respect to certification by the local regulatory authority.⁴ In other words, a demand response provider must be authorized by the local regulatory authority to participate in the ISO markets. Likewise, if the Commission were later to revoke its certification based on consumer complaints the ISO would be inclined to correspondingly revoke the demand response provider's certification. Understanding there may still be coordination and agreed to communication processes between the ISO and CPUC with respect to how this would work in practice, the ISO commits to work with the Commission to sort through any details with respect to the coordination and communication necessary to implement such a construct.

⁴ ISO Tariff, Appendix B, Pro Forma Proxy Demand Resource Agreement, Section 4.3 (requiring demand response providers to certify that participation is permitted by the local regulatory authority and that it has satisfied all applicable rules and regulations of the local regulatory authority).

CONCLUSION

The ISO appreciates the opportunity to provide these comments on this important phase of this proceeding.

Respectfully submitted,

By: /s/ John C. Anders

Nancy Saracino

General Counsel

Sidney Davies

Assistant General Counsel

John C. Anders

Senior Counsel

California Independent System

Operator Corporation

250 Outcropping Way

Folsom, CA 95630

Tel.: (916) 608-7287

Fax: (916) 608-7222

janders@caiso.com

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Attorneys for the California Independent
System Operator Corporation

CERTIFICATE OF SERVICE

I hereby certify that on February 11, 2011 I served, on the Service List for Proceeding R.07-01-041, by electronic mail and United States mail, a copy of the foregoing Comments of the California Independent System Operator Corporation on the Workshop Reports for January 19-21 Regarding Remaining Direct Participation Issues (Phase IV, Part 2)

Executed on February 11, 2011 at
Folsom, California

Anna Pascuzzo

Anna Pascuzzo,
An employee of the California
Independent System Operator