FERC Issues Regulations Requiring Standardization of Demand Response Compensation in Wholesale Electricity Markets

On March 15, 2011, the Federal Energy Regulatory Commission (FERC) amended its regulations under the Federal Power Act to establish a uniform, nationwide approach to compensation for demand response resources participating in a market administered by a Regional Transmission Organization (RTO) or Independent System Operator (ISO). Demand response is a reduction in the consumption of electricity by customers in response to electricity prices or other economic signals. FERC’s new regulations establish requirements for compensation to resources that can provide demand response and that (1) have the capability to balance supply and demand as an alternative to a generation resource and (2) are cost-effective as determined by a net benefits test mandated by FERC.1 Pursuant to these regulations, demand response resources that meet these conditions must be paid the market price for energy that is paid to generators in RTO and ISO wholesale energy markets, referred to as the locational marginal price (LMP). FERC concludes that such compensation “reflects the marginal value of the resource to each RTO and ISO.”2 Although FERC has previously approved other demand response compensation structures that have been implemented by various RTOs and ISOs, FERC’s new rule establishes that compensation to demand response resources that meet these conditions other than at the LMP is “unjust and unreasonable.”3

1 Demand Response Compensation in Organized Wholesale Energy Markets, Order No. 745, 134 FERC ¶ 61,187 (2011) (Demand Response Compensation Rule, or Rule). The Order adds Section 35.28(g)(1)(v) to the Commission’s regulations.

2 Order No. 745 at P 47.

3 Id. The FERC Demand Response Compensation Rule does not preclude other approaches to compensation for demand response resources when these conditions are not met.
FERC’s new regulations also establish new requirements for allocating to customers the costs of payments made to demand response resources.

**Compliance Requirements for ISOs and RTOs**

The Demand Response Compensation Rule requires RTOs and ISOs to submit compliance filings to FERC by July 22, 2011, to implement the new compensation structure and to establish a specific net benefits test to be implemented by each RTO and ISO to determine when demand resources are cost-effective. By September 21, 2012, RTOs and ISOs must also undertake a study examining the requirements for and effects of implementing a dynamic approach to determining when demand response resources are cost-effective as part of the software systems used by RTOs and ISOs to dispatch supply and demand in the electric systems they operate, and then file the results of the study with FERC.

**The Net Benefits Test**

FERC states that the net benefits test ensures 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. FERC concludes that a net benefits test is needed because dispatching demand response resources to balance electric system supply and demand may result in an increased cost per unit to customers (i.e., load) associated with the decreased level of overall demand for electricity.

FERC is requiring each RTO and ISO to implement a net benefits test to determine on a monthly basis under which conditions it is cost-effective to customers to pay full LMP to demand response resources. RTOs and ISOs must undertake an analysis on a monthly basis, based on historical data and the RTO’s or ISO’s previous year’s supply curve, to identify a price threshold to estimate where customer net benefits would occur. As part of its July 2011 compliance filing, each RTO and ISO must file the data, analytical methods and the actual supply curves used to determine the monthly threshold prices for the last 12 months to show how the RTO or ISO would calculate the curves.

By September 2012, the ISOs and RTOs must individually or collectively study the feasibility of a dynamic approach to determining the net customer benefits of dispatching demand response. FERC adopted this two-step approach in recognition of the difficulties in modifying dispatch software systems in the near-term.

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4 The FERC Demand Response Compensation Rule allows an RTO or ISO to show in its compliance filings, in whole or in part, that its exiting or proposed practices are “consistent with or superior to” the requirements of the Rule. Order No. 745 at P 4 n.7.

5 Order No. 745 at P 3.
Cost Allocation

The FERC Demand Response Compensation Rule also requires ISOs and RTOs to allocate the costs associated with demand response compensation proportionally to all customers that purchase from the relevant energy market in the area(s) where the demand response resource reduces the market price for energy at the time when the demand response resource is dispatched.6

FERC Jurisdiction

A number of commenters expressed concerns regarding whether standardizing demand response compensation in wholesale electricity markets will affect demand response at the retail level or preclude state regulators from exercising their authority to address retail electricity issues. FERC disagreed with these concerns and stated that its actions in this proceeding “are consistent with Congressional policy requiring federal level facilitation of demand response, because this Final Rule is designed to remove barriers to demand response participation in the organized wholesale energy markets.”7

Looking Ahead

FERC’s standardizing of compensation will benefit demand response providers, many of whom have been pushing for their service to be compensated at the same level as power generation. The Demand Response Compensation Rule may also serve to encourage innovation by those that seek to participate in wholesale electricity markets and spur the development of new technologies.

However, it is possible that the Rule may have unintended consequences. In his dissenting opinion, FERC Commissioner Moeller expresses a number of concerns with the Rule, including a concern highlighted by a number of commenters that demand response resources will be overcompensated if they receive an LMP payment in the wholesale market as well as an additional savings by avoiding a retail payment for generation as a result of its decision not to consume. Without a further adjustment to the wholesale payment, Commissioner Moeller believes the Rule “will negatively impact the long-term competitiveness of the organized wholesale energy markets.”

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6 Order No. 745 at P 100.
7 Order No. 745 at P 113.
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