



The Organization of MISO States (“OMS”)<sup>2</sup> submitted Comments to the Commission in support of that filing, in particular in support of the proposed compensation mechanism.<sup>3</sup> The OMS continues to support the compensation formula (LMP – Retail Rate) and the direct assignment of costs of payments made to ARC as is being proposed by the Midwest ISO. The OMS urges the Commission to consider these two issues in tandem, rather than focusing on ARC compensation in isolation.

**B. Payment of the full LMP to ARCs as Proposed by the Commission Would Result in a “Distortionary Subsidy” to ARCs and Participating Retail Customers.**

The economics of demand response from the perspective of wholesale markets are relatively simple. LMPs in organized wholesale market are based on marginal costs whereas retail rates are typically fixed and based on average costs. At certain times, retail rates are lower than LMPs. Depending on each individual customer’s elasticity of demand, some customers would likely curtail certain uses of electricity during these time periods if they faced the higher wholesale LMP rather than the lower retail rate. Therefore, retail customer consumption decisions are “inefficient” during these hours. This is especially a concern during periods when LMPs are relatively high and the differential between LMPs and retail rates is significant.

The policy objective of accommodating ARC participation in wholesale markets is to provide a window to wholesale market LMPs for retail customers. This allows retail customers to make consumption decisions during these hours based on the higher wholesale market LMPs rather than the lower retail rates.

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<sup>2</sup> The OMS is a non-profit, self-governing organization of representatives from each state with regulatory jurisdiction over entities participating in the Midwest ISO. The purpose of the OMS is to coordinate regulatory oversight among the states; to make recommendations to the Midwest ISO, the Midwest ISO Board of Directors, the Commission, other relevant government entities and state commissions as appropriate; and to intervene in proceedings before the Commission to express the positions of the OMS member agencies.

<sup>3</sup> Comments of the Organization of MISO States, Docket ER09-1049-002, November 5, 2009.

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

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

If the Commission were to adopt the proposed rule, state commissions and LSEs could correct this distorted price signal by revising retail tariffs for customers that do business with ARCs in order to charge the retail rate to participating customers for energy which was not consumed or metered as a result of load reductions. However, these tariff revisions could be complex, time consuming and could possibly involve legal issues – namely, billing retail

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<sup>4</sup> See for example, “Fostering Economic Demand Response in the Midwest ISO,” The Brattle Group, December 30, 2008, at page 31; Motion for Leave to Answer and Answer of the Electric Power Supply Association and White Paper by Professor William W. Hogan, Docket No. EL09-68-000, October 30, 2009; Motion to Intervene and Protest of Robert L. Borlick Opposing PJMs Proposed Tariff Changes, Docket No, EL09-68-000, September 16, 2009.

customers for energy which they have not consumed and which was not metered. LSEs would be forced to develop and implement billing mechanisms for participating retail customers in order to accommodate billing information from outside of their normal metering and data acquisition systems from the RTO's Measurement and Verification system. Ironically, state commissions would 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.

The simpler mechanism is the one proposed by the Midwest ISO which uses the RTO's settlement system to combine these two pieces into the compensation formula by subtracting the retail rate from the LMP when it makes payments to ARCs.

The review of a policy issue currently facing the state commissions and LSE may be useful to the Commission to help it understand the practical shortcomings of the proposed rule. Many state commissions and LSEs are presently evaluating the installation of smart meters. One of the objectives of smart meters is the provision of better price signals to retail customers that more accurately reflect wholesale market prices. Let us suppose that a state commission approves the installation of smart meters for its large commercial and industrial customers and establishes a retail rate structure which has hourly variable energy charges equal to the wholesale market LMP. If such a rate structure were to be implemented, the differential between the wholesale market LMP and the retail rate would vanish as would the need for ARCs to bridge this price difference. However, under the proposed rule, an ARC would still find it profitable to sell load reductions from these customers into the wholesale market, even though the retail rate is exactly equal to the LMP and these customers are already receiving the "correct" price signal and are making efficient decisions concerning their consumption of electricity. The efficiency

gains expected of the investment in smart meters based on the ability to provide more complex retail pricing structures that more closely follow wholesale LMPs would be diminished by the resultant subsidy to ARCs and participating customers. An efficient retail price signal made possible by smart metering technology would be replaced with an inefficient price signal in the wholesale market.

The example discussed above shows that the need for ARCs may be temporary, as there will be increasing amounts of customers on real-time rates or rates that more closely follow wholesale prices. Indeed, this year both the Midwest ISO and the PJM Interconnection are developing methods for incorporating Price Responsive Demand (PRD) into their markets. Once LSEs are able to take advantage of these PRD elements in wholesale markets, the opportunities for ARCs are likely to diminish.

**C. Compensation for Demand Response Resources Must be Considered in Conjunction with the Recovery of the Cost of Payments made by RTOs to ARCs.**

Retail rate schedules provide an option to customers to purchase electricity at the retail rate. Depending on the retail rate and the value of the intended use of the electricity, customers choose to exercise this option or not to exercise the option. ARCs provide a payment to the participating customers to give them an incentive not to exercise this option. No energy changes hands and no additional energy is produced.

The RTO is not indifferent to this transaction. This is because the RTO must be revenue neutral in its daily settlements and it must now make a payment to the ARC while the RTO's other costs and revenues remain the same. Therefore, the RTO must have a source for this payment.

There are two potential sources. One is to socialize the cost of the payment across the RTO as an uplift charge to all LSEs. The second is to directly assign the cost to the LSE that provides service to the participating retail customers.

In its proposal to integrate ARCs into its energy markets, the Midwest ISO proposed to directly assign the cost of this payment to the LSE which provides retail service to each participating customer. OMS supports the direct assignment of these costs as proposed by the Midwest ISO. Direct assignment of the cost of this payment is appropriate as the arbitrage opportunities available to ARCs only arise due to differences between an individual LSE's retail rates and wholesale market LMPs. Direct assignment of these costs will create an incentive for individual LSEs to more closely align their retail rates with wholesale market LMPs.

If the cost of this payment is directly assigned, an LSE will face the same costs in the wholesale energy market whether or not its retail customers that participate with an ARC consume MWhs or provide these MWhs as load reductions to the ARC. Either way, the LSE pays for those MWhs. However, if its retail customers provide load reductions to an ARC, the LSE's metered retail energy sales go down, and its retail revenue goes down. The LSE has a reduction in retail revenue but its wholesale market costs remain the same. The LSE is no longer indifferent to the participation of its retail customers with an ARC. Subtracting the retail rate from the LMP effectively restores these lost retail revenues to the LSE and makes the LSE indifferent as to whether its customers consume electricity at the retail rate or provide a load reduction to the ARC.

If the amount of lost retail revenue was guaranteed to be small, LSEs and the State Commissions might be willing to absorb the loss. However, the Commission is definitely advocating a bigger role for ARCs in its orders and in its Strategic Plan. Expectations are that

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

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

**D. Adoption of the Proposed Rule would Encourage State Commissions to Opt Out of RTO Demand Response Programs.**

As the Commission is aware, numerous state commission members of the OMS have issued orders either prohibiting or placing restrictions on the operation of ARCs in their states. The OMS will let these orders speak on their own. However, it should be clear to the Commission that state commissions and LSEs have significant concerns that the potential costs for non-participating customers may exceed the benefits that ARCs can provide to their states and to participating customers. State commissions will have a significant disincentive to support the participation of ARCs in RTO energy markets and in their states if the proposed rule is adopted.

In Order 719-A, the Commission clarified that it was not challenging “the role of states and others to decide the eligibility of retail customers to provide demand response.”<sup>5</sup> The Commission also stated that “we leave it to the appropriate state or local authorities to set and enforce their own requirements.”<sup>6</sup> In the Commission’s order in Docket No. ER09-701-000 / ER09-701-001, which involved proposed tariffs of the PJM Interconnection and (in part) whether state authorities could condition eligibility in an RTO’s demand response programs, the Commission reiterated that “Order No. 719-A thus clarified that relevant retail authorities retain

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<sup>5</sup> Order 719-A, 128 FERC ¶ 61,059, P 49.

<sup>6</sup> Id. P 54

substantial flexibility in establishing requirements for eligibility of retail customers to provide demand response.”<sup>7</sup> As stated earlier in these comments, any requirement by the Commission for RTOs to compensate demand response resources at full LMP is likely to lead state and local regulatory authorities to condition eligibility for demand response participation by ARCs in their states such that ARCs and participating customers do not receive a payment equal to the full LMP. In this sense, then, due to the alignment of wholesale and retail jurisdictions in this matter, whatever payment the Commission requires in an organized wholesale market can be modified by the relevant retail regulatory authorities.

However, there is an easier fix. Compensation mechanisms such as the one proposed by the Midwest ISO resolve the issues associated with lost retail revenues for LSEs, eliminates State Commission legal concerns about the revision of retail rate schedules and billing retail customers for energy which is not metered or consumed, and results in an efficient price signal for ARCs and retail customers that are offering load reductions into RTO energy markets. The Commission should not adopt a rule which would preclude the approval of such a compensation mechanism by RTOs.

OMS understands that some state commissions may wish to provide an additional incentive for ARCs to operate in their states through the payment of the full LMP. OMS is not opposed to such incentives if it is done on a voluntary basis on a state by state basis, and if the costs of the incentive are directly assigned to retail customers within those individual states.

### **III. Conclusion**

In its recently released Strategic Plan, the Commission established a goal of eliminating barriers to participation by demand resources in organized wholesale retail markets. The OMS

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<sup>7</sup> PJM Interconnection, LLC, 128 FERC ¶ 61,238, P 22.

supports this objective. Third-party ARCs will likely play a large role in implementing demand response resources because of their ability to achieve economies of scale, implement new technology and provide demand response services to customers that take retail electric service from multiple LSEs. ARCs can also provide a competitive check on LSEs in the provision of demand response to customers. However, the Commission must remain cognizant that the vast majority of demand response programs have been and will likely continue to be developed and implemented by LSEs under the auspices of the State Commissions.

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

For these reasons, the OMS urges the Commission not to adopt the proposed rule.

The OMS submits these comments because a majority of the members have agreed to generally support them. Individual OMS members reserve the right to file separate comments.

Respectfully Submitted,

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