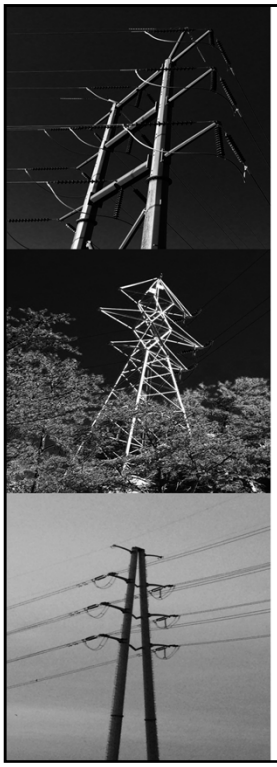

FERC v. Electric Power Supply Association: Defining the Federal-State Divide

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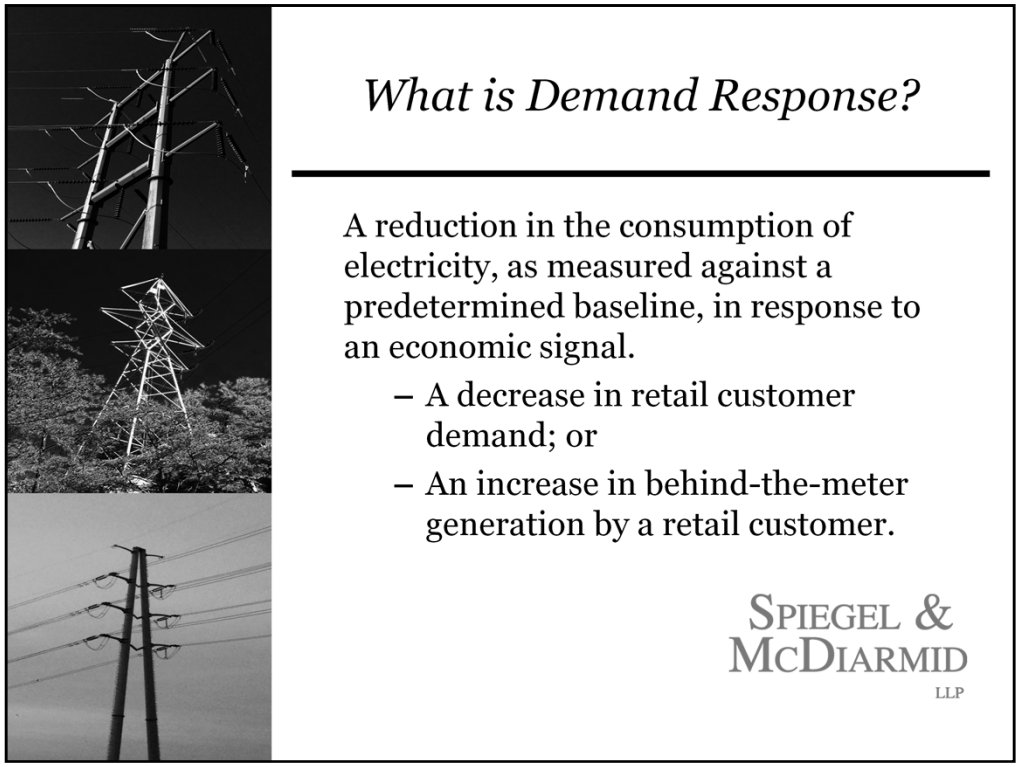
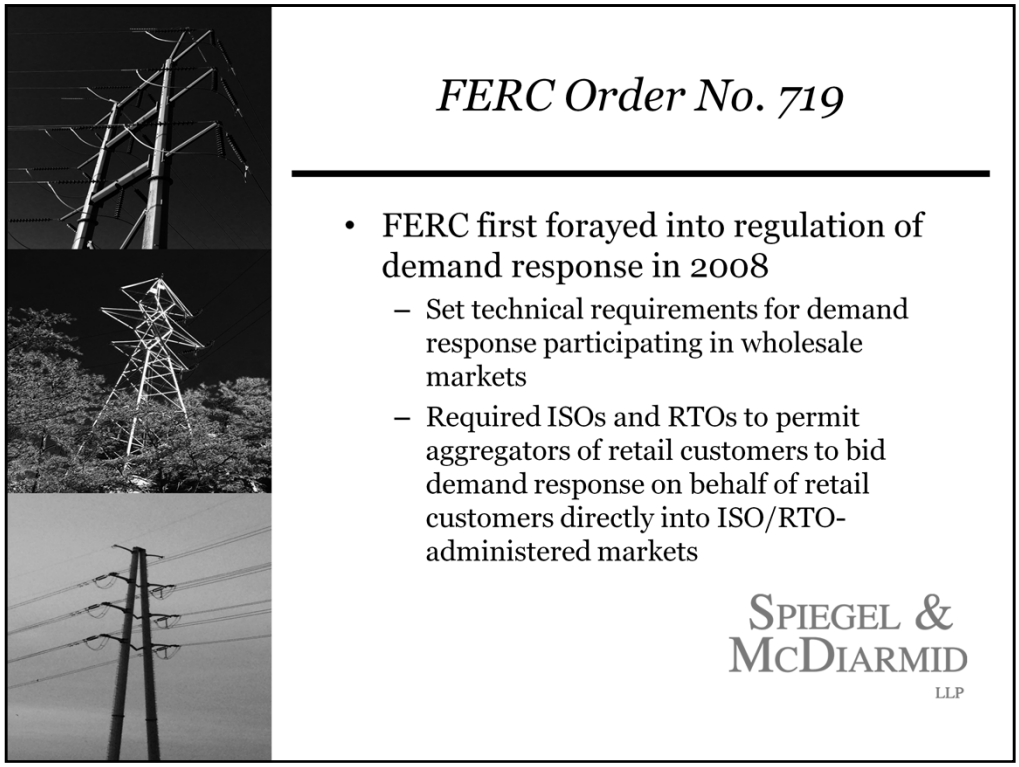


As many of you know, wholesale electric prices fluctuate on a daily, hourly and sometimes a more frequent basis. Retail electric customers, however, see a fixed, per kilowatt hour price in their electric bills, and as a result, have little incentive to change their consumption behavior when wholesale prices are peaking. Demand response attempts to address this disconnect by incentivizing consumers to reduce consumption at hours when prices are highest.

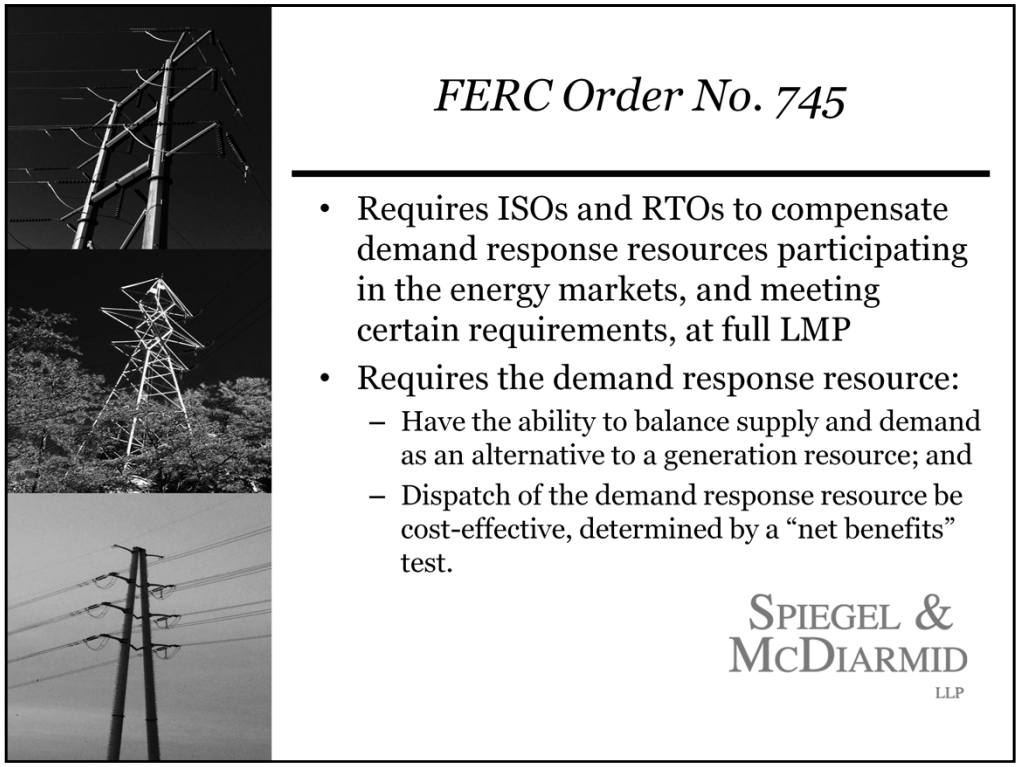
Two important clarifications—DR is not energy efficiency. While energy efficiency uses a lesser amount of power to perform the same task, DR requires forgoing an energy dependent task in response to an economic signal. DR is also not a reduction in consumption purely in response to higher prices—this is simply price responsive demand.

Order 745 and the ensuing litigation involve "wholesale demand response"—that is, demand response acting as a resource in organized wholesale energy markets, meaning it responds to price signals, and is dispatchable and verifiable.

Grid operators have been using demand response to balance supply and demand on the grid for over a decade, but until Order 719 and its progeny, did so "at will."



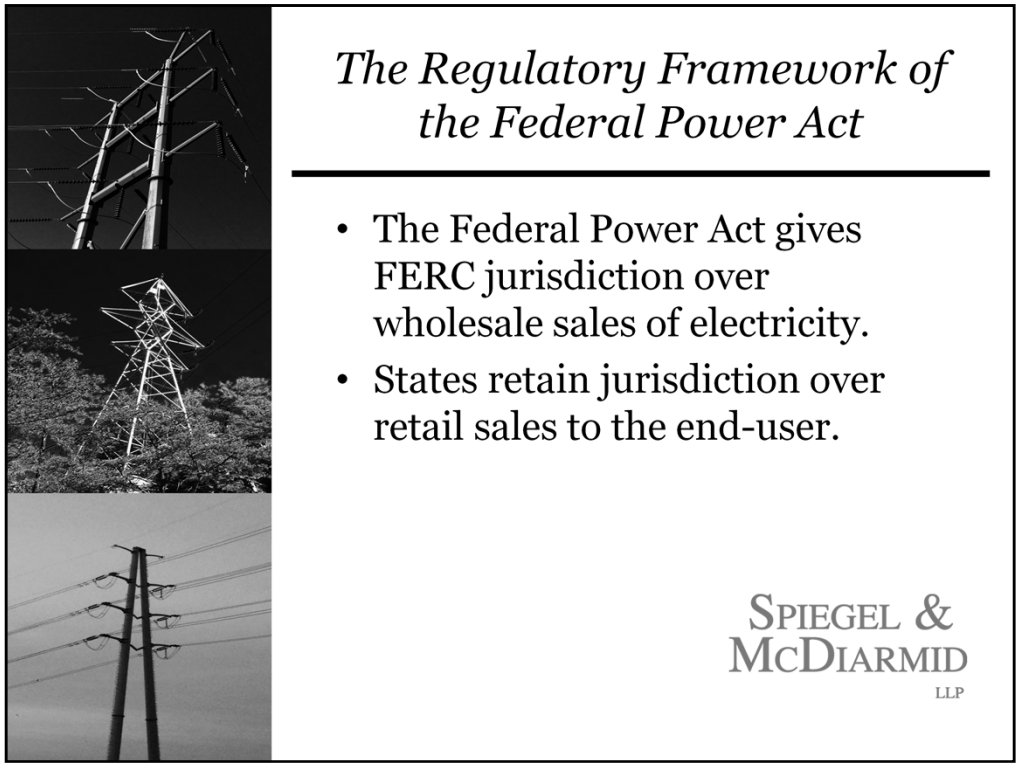
Finding that demand response participating in wholesale markets would increase competition, reduce wholesale power prices and improve market efficiency, FERC issued Order 719 in 2008 as a way to remove barriers to demand response participation in the organized electric markets. Among other things, Order 719 set technical requirements for demand response participating in those markets and required grid operators administering wholesale markets to permit aggregators of retail customers to bid demand response into the markets.



In 2010, FERC determined that this was not enough, and obstacles to demand response's participation in the wholesale markets continued to exist. To further breakdown these barriers, FERC issued Order 745, requiring ISOs and RTOs to compensate demand response resources clearing in wholesale markets at full LMP—the market clearing price paid to generation. Order 745 requires that cost effective demand response bids capable of displacing the need for additional generation and clearing in the market be paid the same price as generating resources.

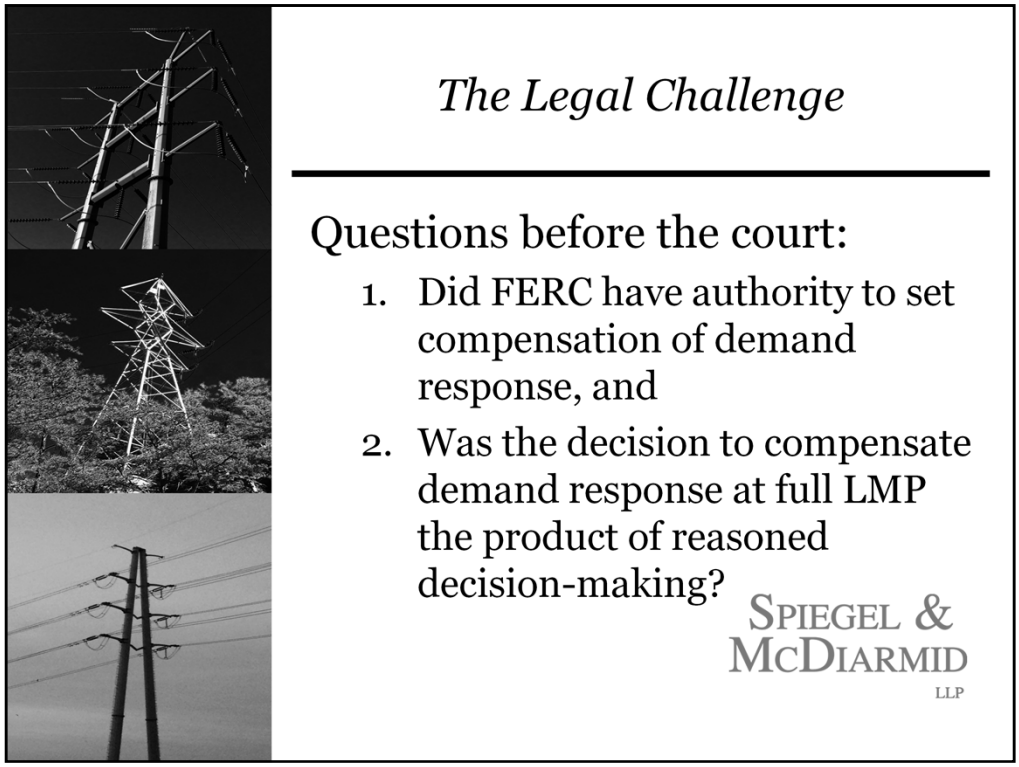
In setting compensation at full LMP, FERC rejected a proposal that demand response be paid LMP minus G—the market clearing price minus any savings a demand response provider would receive from forgoing the purchase of electricity.

Notably, Order 745 does not require demand response to participate in the wholesale markets. Rather, the rule permits states to prevent retail customers from participating in the wholesale markets.



So, what's the problem? As those of you familiar with the Federal Power Act know, jurisdiction over the sale and distribution of electricity is split between federal and state authority based on the type of service. On the federal level, FERC has authority to regulate the transmission of electric energy in interstate commerce and wholesale sales of electric energy, as well as the rates, terms and conditions of such a sale. States retain jurisdiction over the facilities that generate electricity and the retail sales to the end-user.

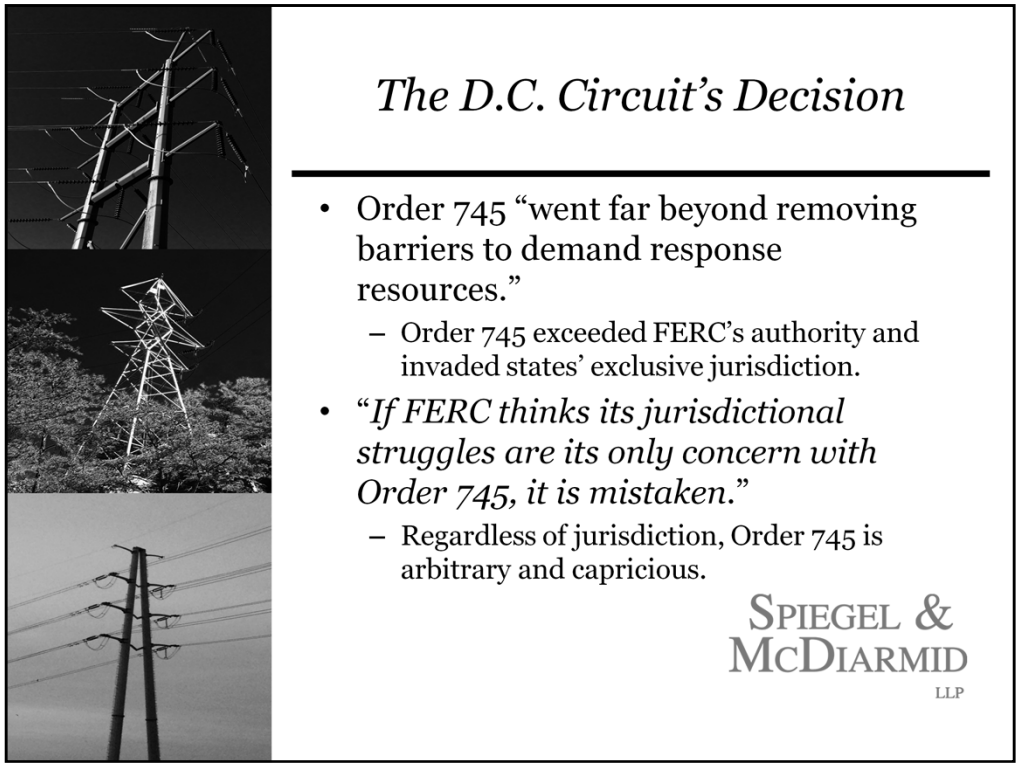
Because Order 745 brings the behavior of retail consumers into the wholesale electric markets, it sits on a jurisdictional knife's edge.



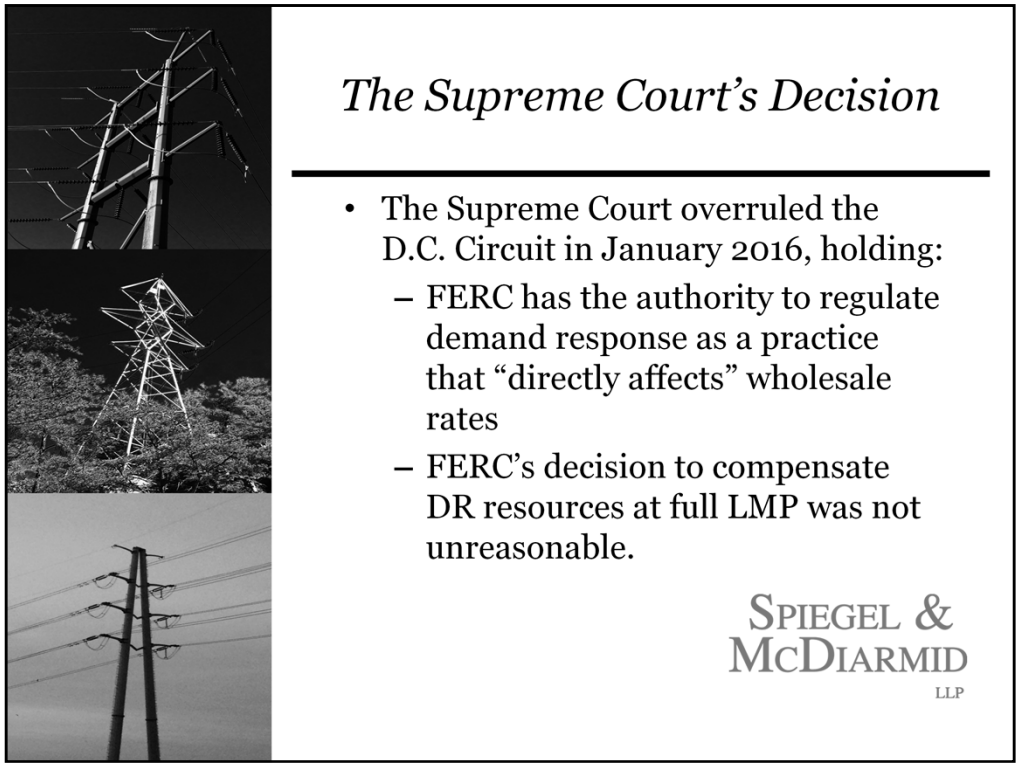
The Electric Power Supply Association, or "EPSA", joined by other industry trade groups and a number of generators challenged the rule before the D.C. Court of Appeals, arguing that by dictating compensation for demand response, FERC effectively regulates the retail price of electricity and thus "usurp[s] states' [exclusive] jurisdiction" over the retail electric market. Specifically, *EPSA* and others argued that Order 745 changed the "effective" retail rate—rather than paying $5 for electricity, the consumer now pays $5 plus the payment the customer forgoes by continuing to purchase at peak times.

They also argued that FERC's decision to compensate demand response at full LMP overcompensates demand response and was unjust and unreasonable and thus unlawful under the Federal Power Act.

FERC and its proponents argued that the rule was a proper exercise of FERC's jurisdiction over all rules, regulations, practices, or contracts "affecting" wholesale electric rates and services, and that its decision to compensate demand response at full LMP was well-reasoned.

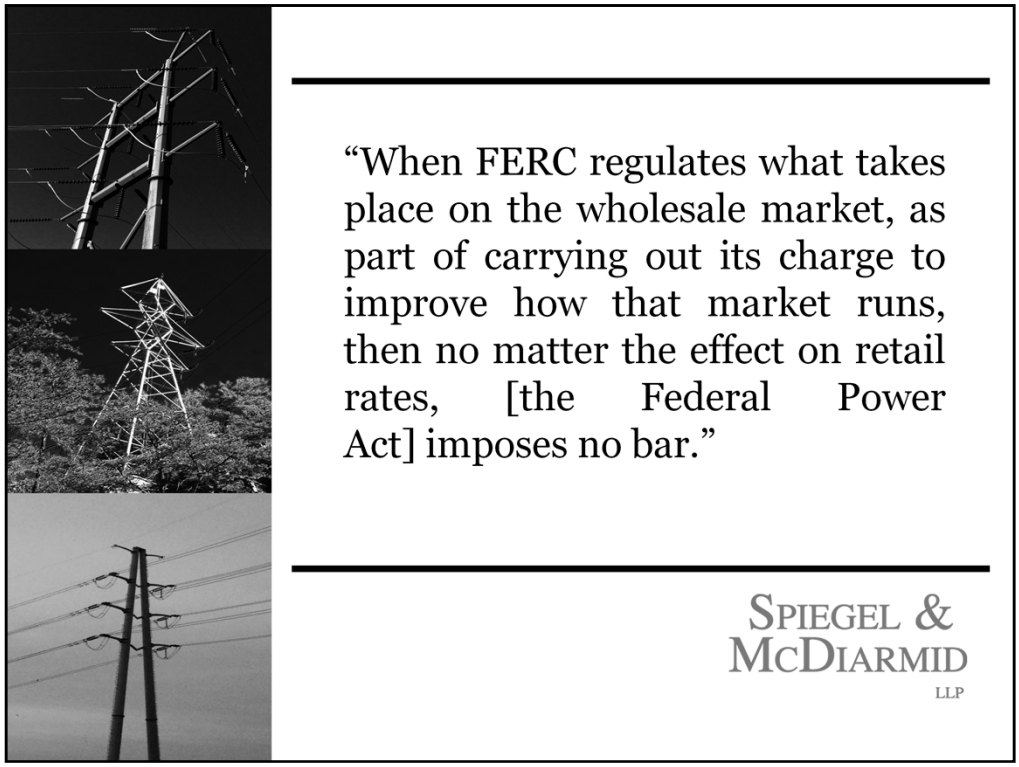


The D.C. Circuit sided with *EPSA*, and a 3-judge panel in 2014 voted 2-1 to vacate the rule, finding that FERC had overstepped its limits into the states' exclusive domain. According to the D.C. Circuit, FERC's role was "to assist and advise state and regional programs," not to regulate demand response itself. Even if FERC had jurisdiction to regulate demand response in this way, the court found that the decision to compensate demand response at full LMP was arbitrary and capricious.

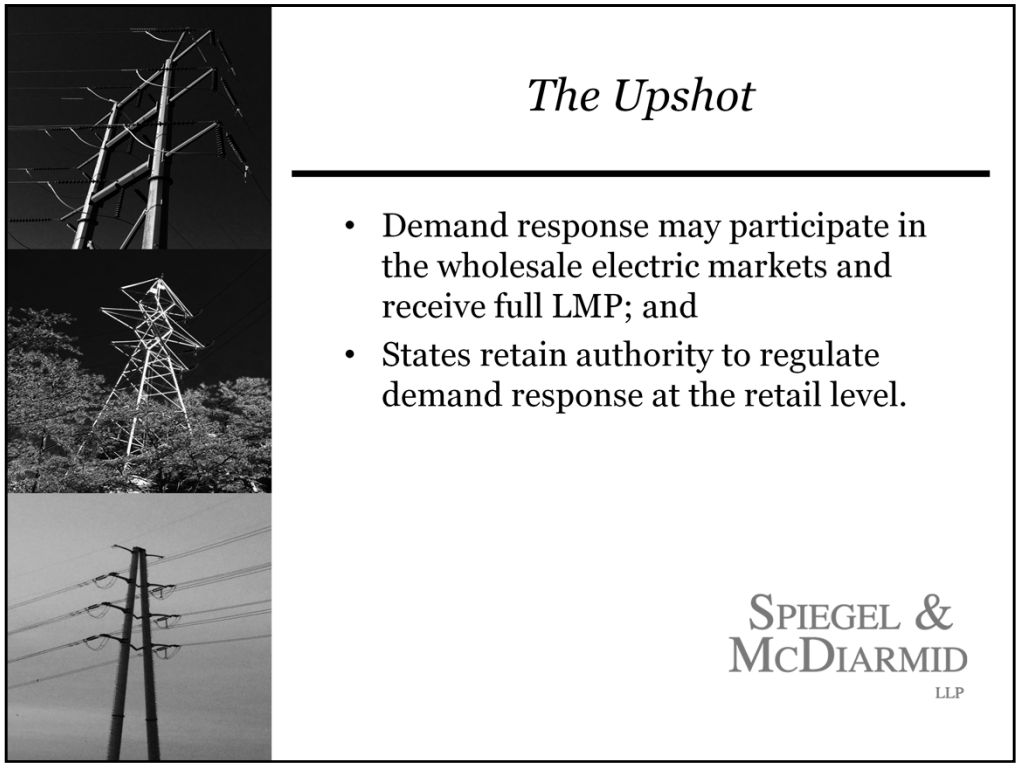


Unhappy with this determination, FERC petitioned the Supreme Court to review the D.C. Circuit's decision.

In January, the Supreme Court breathed new life into Order 745. In a 6-2 decision, with Justice Kagan writing for the majority, the court reversed the D.C. Circuit and held that not only did FERC have the authority to regulate demand response as a practice that "directly affects" wholesale rates, FERC's decision to compensate DR resources at full LMP was not unreasonable.

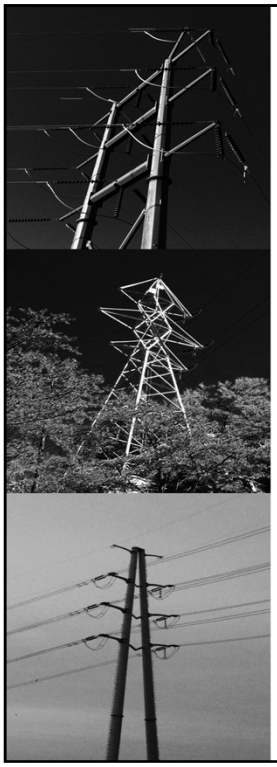


Although the majority recognized that Order 745's compensatory scheme would have an effect on the retail market, Justice Kagan noted that "transactions that occur on the wholesale market have natural consequences at the retail level." The Court further emphasized that Order 745 *regulates directly and is implemented through the wholesale markets*, and did not change "the amount of money a consumer will hand over in exchange for power."



The *EPSA* case assures that FERC may continue to incentivize demand response at the wholesale level. It also continues the steady march away from the "passive consumer" system to one that permits customers to be both producers *and* consumers.

One thing the decision does not do, is limit states' authority to regulate demand response



Questions?

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