The Supreme Court Saves Demand Response: Now What?

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The U.S. Supreme Court has upheld FERC's Order 745. See opinion here. That order requires operators of wholesale energy markets to treat demand side bids comparably to generation bids. Comparable treatment requires that demand side bidders (a) be allowed to compete with generators on the "supply side" of the market, and (b) receive the same compensation generation bidders get—the locational marginal price (LMP). This entitlement to LMP compensation is available only to demand resource bids meeting a "cost-effectiveness" test—a test designed to ensure that no wholesale buyer is made worse off by the presence of demand side bids.

The Court's opinion has two main holdings. First, demand side bidding is a "practice …affecting" wholesale rates—a phrase used in the Federal Power Act to define FERC's jurisdiction. Because FERC acted within its wholesale domain, it did not enter the states' FPA-preserved retail domain. Second, the Court held that FERC's justifications for LMP compensation were not "arbitrary and capricious." For more background, see the June 2014 essay, "D.C. Circuit Kills Demand Response Compensation."

With those two questions settled, what can policymakers do next, to ensure that all cost-effective demand response reaches the market and is compensated appropriately?

Market structure and compensation

Market structure: Market structure is about which consumers and aggregators are allowed to sell demand response, the barriers to market entry and exit they face, and to whom they may sell. On this topic the Supreme Court addressed only one facet: FERC may order market operators to allow demand response providers to sell into organized wholesale markets. This legal clarity now gives states options, in at least three areas. First, states can determine whether consumers may sell any demand response to begin with. (A state might have no demand response programs.) Second, states determine what types of companies (e.g., utilities or non-utilities), if any, may solicit and aggregate consumers' demand response offers, for resale into the wholesale market. Third, states determine whether that demand response, once aggregated, should be used solely to reduce the load of the local utility (sometimes called "retail demand response"), or may instead (or also) be sold into organized wholesale markets (sometimes called "wholesale demand response").

Compensation: Seller compensation addresses the price buyers will pay, and how the resulting revenues are allocated among the market participants (e.g., the consumer, the aggregator and the local utility). Sellers of demand resources, like any sellers, seek the highest price. Order 745 addresses only one option: the compensation sellers of wholesale demand

response receive from buyers of wholesale power, in organized wholesale markets. In those markets, the price will depend on how competitive the wholesale market is (and whether, for a market that is not effectively competitive, it is subject to FERC-approved price caps). But this seller of wholesale demand response might prefer to sell retail demand response—foregoing consumption and receiving some compensation, established by the state commission, from the local utility. The price for retail demand response could be higher than for wholesale—if, for example, the state has replaced average pricing with time-of-use rates (which all states should do, so that at any point in time price reflects actual cost). States thus have a key question to answer: May providers of demand response (consumers or their aggregators) sell only to retail utilities (in which case states set the price); or may they sell also (or instead) into wholesale markets (in which case FERC-authorized markets set the price)? Both options are worth pursuing; in fact the most enlightened states will make both options available, allowing consumers to choose. All the options, for market structure and seller compensation, are displayed diagrammatically here.

The market needs clarity, soon. With varying solutions to both market structure and compensation, within and between state and federal fora, there is much room for confusion and litigation. But there is also room for joint solutions. Enlightened regulators will escape from zero-sum, "federal vs. state" mindsets, instead focusing on which regulatory actors are best positioned to make which decisions. Enlightened legislators will work to update the Federal Power Act's awkward, 80-year-old allocation of state and federal powers to accommodate the best solutions. That way, the economic benefits due consumers will not be delayed—or worse, flared off into fees paid to appellate lawyers.

The state veto

Order 745 limits the options available to demand response sellers. It does so by barring wholesale market operators from accepting demand response bids from states that prohibit their customers from participating—even if those bids are cost-effective. The Court cited this state veto as support for its holding that FERC did not invade the states' retail domain. But the Court made clear (in my reading) that Order 745 would have survived without the provision. FERC therefore is free to remove the state veto. Doing so would allow all demand response to play its consumer-protective role of disciplining wholesale prices.

By viewing the state veto as unnecessary to Order 745's survival, the Court put FERC (properly in my view) in an awkward position. FERC justified its Order 745 by reasoning that absent bids from demand resources, wholesale generation prices will not satisfy the Federal Power Act's standard—that wholesale prices be "just and reasonable." Without demand response, FERC found, wholesale prices will be higher than necessary, enriching generation sellers at the expense of consumers. But with demand response, with consumers foregoing consumption, wholesale prices drop. So paying consumers to forego consumption increases economic efficiency, so long as those payments cost less than the total savings from the lower prices. (That's the essence of FERC's "cost-effectiveness" test.)

Allowing states to block entry by cost-effective demand response has the opposite effect: It leads to unnecessarily (and unlawfully) higher prices. Justice Scalia's dissent made that point precisely: "If inducing retail customers to participate in wholesale demand-response transactions is necessary to render wholesale rates 'just and reasonable,' how can FERC, consistent with its statutory mandate, permit States to thwart such participation?"

So FERC has two options. The first option is to eliminate the state veto option, so that wholesale market operators can (and must) accept demand resources from consumers in all states. Consumers would have a federally-granted right to sell demand response; states would be preempted from interfering. As a result, consumers in non-vetoing states would no longer have to pay for wholesale prices made unlawfully high by the vetoing states. FERC's second option is the "nuclear option": Declare that wholesale market prices in regions with state vetoes are no longer lawful—where the effect of those vetoes is to prevent demand response from lowering those prices to "just and reasonable" levels. Wholesale generators in those regions then would have to sell at prices set or limited by FERC, based in some way on some measure of cost.

What FERC cannot do about the state veto is to say nothing. The FPA does not allow FERC to buy favor with some states by harming other states. And as the Supreme Court once declared, the Federal Power Act "makes unlawful all rates which are not just and reasonable, and does not say a little unlawfulness is permitted."[1]

Inadvertent error: The meaning of "interstate commerce"

It is always impressive when a court of general jurisdiction writes clearly and accurately about a technical statute. The Supreme Court's opinion embodied those qualities, with one exception.

The FPA's jurisdictional provision (Section 201(b)(1)) vests FERC with authority over, among other things, "the sale of electric energy at wholesale in interstate commerce." The words "interstate commerce" regularly trip up FPA newcomers; they tripped up the Court here. Presumably referring to those words, the majority opinion, when setting the statutory context, states: "... [T]he Commission may not regulate ... within-state wholesale sales...." The statement is legally wrong. As every FPA practitioner learns, first week on the job, in FPA-land transactions in every state (except Alaska, Hawaii and Texas) are in "interstate commerce" even if their contractual origin and destination lie within a single state. The reason was given by the Supreme Court itself, in a landmark case involving intra-Florida wholesale sales. Upholding the Federal Power Commission (FERC's predecessor), the Court held that because the nation's transmission network is interconnected across state lines, electrons from multiple states commingle, thus placing all transactions within "interstate commerce."[2] More recently, the Court stated that "electricity that enters the grid immediately becomes a part of a vast pool of energy that is constantly moving in interstate commerce."[3]

The Court's error did not affect its reasoning. But it would be destabilizing (in terms of law, policy and commercial contracts) if those seeking to diminish FERC's authority treated this drafting error as a legal holding.

Alfred Kahn

For Professor Kahn, life was a joy. He must be smiling now—from heaven—because (a) the Supreme Court cited his great treatise, The Economics of Regulation: Principles and Institutions; and (b) FERC in Order 745 relied on his comments defending LMP against lesser forms of compensation. He died four months after that submission, his 93-year life ending before he could see the fruit of this last contribution. See my appreciation essay "Alfred Kahn (1917–2010)."   His confidence being as large as his prolificity, he no doubt predicted the outcome.

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[1] *Federal Power Comm. v. Texaco, Inc.*, 417 U.S. 380, 399 (1974).

[2] *See Florida Power Comm. v. Florida Power & Light Co.*, 404 U.S. 453 (1972).

[3] *New York v. FERC*, 535 U.S. 1, 7 (2002). The exceptions are transactions within Hawaii (naturally), Alaska (naturally) and Texas. On the Texas exception, see my Regulating Public Utility Performance: The Law of Market Structure, Pricing and Jurisdiction at p.393 n.117 (2013). For a dissident view of "interstate commerce" under the FPA, see Frank Lindh and Thomas Bone, "State Jurisdiction over Distributed Generators, *Energy Law Journal* (Vol. 34 No. 2 (2013)).