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Last Friday (May 23), in *Electric Power Supply Association v. FERC*, a D.C. Circuit panel split 2-1 and vacated Order 745, a Federal Energy Regulatory Commission (FERC) rule designed to promote "demand response" (DR). DR is a rapidly growing and valuable means of reducing electricity demand, thereby benefiting consumers and the environment. It is also an important part of the Smart Grid, in which smart meters and devices that communicate with one another and energy service providers can further promote these goals. Indeed, former FERC Chairman Jon Wellinghoff has called DR the Smart Grid's "killer app."

The case tested a question of near first impression about the Smart Grid: which level of government regulates it? For now, the D.C. Circuit has held squarely for the states, concluding that DR regulation is a matter of exclusive state jurisdiction. If the decision stands, it will have many adverse implications for federal regulation to advance the Smart Grid and use the wholesale electricity markets to achieve energy reductions and environmental goals.

What is "Demand Response"?

First, a bit about DR. It is different from using a power plant to generate electricity. DR programs focus on *reducing* consumption at specific times of high electricity demand.

Historically, most DR involved load control programs, which offer customers incentives to reduce consumption or allow a utility to directly control equipment or appliances. A typical program might offer a residential customer $50 per season to allow a utility to turn off an air-conditioning unit briefly at peak demand hours.

Order 745 addressed a different form of DR: its use in the regional wholesale markets where more than half the nation's electricity is traded before being delivered to consumers. For the most part, the entities that operate the grid and run these markets – Independent System Operators (ISOs) and Regional Transmission Organizations (RTOs) – meet increased demand with supply from more power plants, often at higher cost. Yet under certain conditions, reducing demand through DR could alleviate grid stress just as easily as firing up another power plant. A 2009 FERC report estimated that adding more DR could reduce peak demand as much as 4-20%.

FERC found that DR has other benefits for the wholesale power system. It improves grid reliability and cuts marginal electricity costs, because it reduces costly peak demand occurring during a small number of hours each year. Reducing peak demand could also help eliminate the need to build new plants, and lessen power plant emissions. Finally, DR bid into ISO/RTO "ancillary services" markets can help keep the grid in frequency balance, and offset the intermittency of renewable resources added to the grid.

DR bids into the wholesale markets come from firms such as EnerNOC and Comverge that pull together a number of customers, aggregating demand reductions and offering them in blocks into the markets. This enables individual customers to take part in the wholesale markets, and poses an obvious threat to incumbent utilities: lower demand means lower electricity sales. More widespread use of DR could even enable these firms to transform into robust energy services companies that could compete directly with utilities.

FERC's DR Rules (Orders 719 & 745)

Recognizing DR's potential and limited participation in wholesale markets, FERC issued two rules to promote it. 2008's Order 719 required ISOs/RTOs to permit aggregators to bid DR directly into the wholesale energy markets, unless a state law prohibited retail customer participation.

2011's Order 745 went further, aiming to treat DR as comparable to generation in the wholesale markets. It required ISOs/RTOs to accept bids of DR in energy markets from DR providers, and compensate DR at the same rate as electricity delivered into the markets, the "locational marginal price" (LMP). Importantly, DR would only be compensated when cost effective, under a "net benefits test" designed by each ISO/RTO.

This rule was highly controversial, and led to this high-profile challenge to Order 745 by utilities, economists, and trade associations.

FERC's Arguments

Under Federal Power Act (FPA) section 201, FERC may regulate "the sale of electric energy at wholesale in interstate commerce." FERC did not claim that DR involves a "sale of electric energy." By its nature, as the majority noted, "demand response is not a wholesale sale of electricity; in fact, it is not a sale at all."

Instead, FERC justified Order 745 under its broad statutory authority to regulate the wholesale markets. FPA Section 205 states in part, "All rates and charges made, demanded, or received by any public utility for or in connection with the transmission or sale of electric energy subject to the jurisdiction of the Commission, and *all rules and regulations affecting or pertaining to such rates or charges* shall be just and reasonable, ..." (emphasis added)

FERC argued it had jurisdiction over DR because adding it to the wholesale markets "directly affects wholesale rates" by reducing prices and improving overall market functioning. As its two Orders note, "enabling demand-side resources, as well as supply-side resources, improves the economic operation of electric power markets."

FERC also believed there would be limited DR participation in the wholesale markets without its encouragement, and that encouraging DR was well within its role as the markets' regulator.

Majority and Dissenting Opinions

The majority opinion rejected FERC's assertion of jurisdiction, holding that states have exclusive authority over DR. The majority characterized DR as exclusively retail, stating forcefully that, "Demand response—simply put—is part of the retail market. It involves *retail* customers, their decision whether to purchase *at retail*, and the levels of *retail* electricity consumption." It noted that FERC can regulate practices affecting the wholesale market, provided it is not "directly regulating a matter subject to state control, such as the retail market." Proceeding to the obvious conclusion, it stated FERC has done just that, so under *Chevron* step one, the FPA "unambiguously restricts FERC from regulating the retail market."

The court rejected FERC's "affecting" argument as having "no limiting principle. Without boundaries, §§ 205 and 206 could ostensibly authorize FERC to regulate any number of areas, including the steel, fuel, and labor markets." Finally, the court found that even assuming FERC had jurisdiction over DR, it would overturn Order 745 under the familiar arbitrary and capricious standard, because FERC did not adequately consider and explain FERC Commissioner Moeller's dissent to Order 745.

The dissent observed that FPA Section 201's jurisdictional line between "wholesale" sales (subject to FERC jurisdiction) and "retail" sales (subject to state authority) is "neither neat nor tidy." This passage cited *New York v. FERC*, a Supreme Court decision that upheld FERC's Orders restructuring the electricity markets against a

challenge (in part) that FERC had overstepped its jurisdictional bounds. To the dissent, DR presents a thorny conundrum: it looks like decisions by retail electricity customers to use less power, in which case the states regulate it as part of their historical jurisdiction over retail sales of electricity. However, it is also a means for improving reliability of the wholesale markets and achieving other benefits, in which case FERC could regulate it.

This led Judge Edwards to rebuke the majority's finding that DR is a retail matter, stating that, "The task for this court, of course, is not to divine from first principles whether a demand response resource subject to Order 745 is best considered a matter of wholesale or retail electricity regulation. Rather, our task is one of statutory interpretation within the familiar *Chevron* framework."

The dissent observed that, "FERC's explanation of its jurisdiction under the Federal Power Act is straightforward and sensible":

> An ISO's or RTO's market rules governing how a demand response resource may compete in its wholesale market, including the terms by which a demand response resource is to be compensated in the market, are "practices affecting" that wholesale market's rates for electricity. And FERC has determined that an ISO's or RTO's "practice" is unjust and unreasonable to the degree that it inadequately compensates demand response resources capable of supplanting more expensive generation resources.

The dissent thus found DR regulation "squarely within FERC's jurisdiction." It rejected the finding that Order 745 directly regulates the retail market, noting that only DR resources approved by states and bid into wholesale markets are to be paid LMP.

The excerpt above shows the limits of the majority's *Chevron* analysis. The dissent properly saw the central *Chevron* question as a step two analysis: language in the FPA – FERC's authorizing statute – is ambiguous, and a court should defer to FERC's extensively well-reasoned and permissible construction of it. As the Supreme Court's *City of Arlington* decision makes clear, this is true even though FERC is interpreting the limits of its jurisdiction. The dissent observed that FERC cannot overreach and regulate the steel and labor markets, because established D.C.

Circuit precedents restrict FERC to regulating practices that "affect [wholesale] rates and service significantly." DR affects the market as a whole, and satisfies that standard.

The majority opinion also ignored foundational Supreme Court decisions that empower FERC to regulate wholesale rates even if that impacts retail markets. In addition, a recent D.C. Circuit decision empowered FERC to regulate ISO/RTO "capacity" markets even if that impacted determinations of the need for new power plants, normally a state function. The majority distinguished that case on the basis that FERC regulation had an "indirect" impact on the retail market; the dissent properly noted that DR regulation is comparable because it affects both wholesale and retail markets. Finally, the majority made only cursory mention of DR's many benefits, disregarding FERC's conclusions about DR's environmental benefits and the benefits of encouraging the infant DR industry.

Conclusion: The Future of DR and FERC Promotion of Competition in Electricity

FERC may seek a rehearing *en banc* by the full D.C. Circuit. Given the deficiencies of the majority opinion's analysis – particularly with respect to the lack of *Chevron* deference to FERC's construction of the FPA "affecting" language – rehearing should be granted, and the panel opinion should be overturned.

Assuming, however, that the panel's opinion is upheld, DR will be promoted, if at all, by utilities and state public utility commissions. Some states may find it prudent to implement DR programs, but others may put up roadblocks (as Indiana did).

The future of wholesale market DR participation is cloudy. FERC cannot require DR bids into the wholesale markets, or prices at LMP. However, it might still be able to encourage DR indirectly. If a state empowers DR programs, aggregators, utilities, or both could voluntarily offer their resources into wholesale markets, and FERC could approve these efforts.

Looking more broadly, the D.C. Circuit's rejection of FERC's attempt to reshape the wholesale markets may be as significant as *New York v. FERC*. It puts other efforts by FERC to use the wholesale markets to advance goals not directly related to energy sales in immediate jeopardy. One is FERC Order 755, which changed policies for pricing of grid frequency regulation service. FERC's emerging policies on energy storage in Orders 755 and 784 may also come under fire.

Electric Power Supply Association also has enormous implications for the future of competition with incumbent utilities in the electricity sector. Order 745 intended to put upstart aggregators and entrenched electricity generators on a level playing field. Now, responsibility for encouraging new industry entrants will fall primarily to the states. In the case of DR, states may view DR aggregators less favorably than FERC did. This could be a serious setback for this promising means of achieving energy and environmental goals in the electricity markets.