July 23, 2010

The Honorable Jon Wellinghoff
Chairman
Federal Energy Regulatory Commission
888 First Street, NE
Washington, DC 20426

RE: Notice of Proposed Rulemaking on Demand Response Compensation in Organized Wholesale Markets, Docket No. RM10-17

Dear Chairman Wellinghoff:

The Natural Gas Supply Association ("NGSA") and the Independent Petroleum Association of America ("IPAA") appreciate the Commission's efforts to enhance the efficiency and reliability of our nation's electric grid by encouraging demand response. In the Demand Response Compensation proceeding, the Commission's stated goal is to ensure the competitiveness of wholesale electricity markets by "providing more supply options, encouraging new entry and innovation, and spurring deployment of new technologies." NGSA and IPAA support that goal and view demand response as a strong contributor to effectively managing electricity grid requirements. However, as the Commission considers the level of regulatory influence it should exert to encourage higher levels of demand response, we ask that you carefully weigh the implications of providing a possible market preference to demand response providers.

NGSA and IPAA are concerned that compensating demand response providers an amount equal to the full locational marginal price ("LMP") received by companies that generate electricity and provide ancillary services, may create an unlevel playing field and result in undesirable market ramifications. The Electric Power Supply Association ("EPSA") has voiced concerns regarding whether a mandated level of compensation for all demand response providers at the full LMP provided for generation is warranted and whether it unnecessarily creates an unlevel playing field. We share those concerns.[1] Given that all sources of energy and technologies are needed to meet future energy needs, it should follow that all participants in electric markets, including both demand response providers and generators, should be adequately compensated based on how the market values those services.

[1] Similar concerns were also expressed by Commissioner Moeller in his statement that "it will be difficult for any proposal to place generation and demand response on a precisely level playing field."

While recognizing the benefits of demand response, we are not convinced that demand response should be provided special compensation relative to other means for meeting the nation's energy requirements (i.e., generation). To maintain a level playing field between demand response and generation sources, parties must operate in a competitive market that allows them the ability to pay market value for services required to meet their needs. If regulatory policies interfere with market signals, prices may no longer be cost competitive, thereby unjustly disadvantaging some market players, including gas-fired generation.

Serious consideration must be given to the possible unintended consequences of providing a preference through a uniform compensation mandate at the full LMP price for demand response, regardless of the level of service provided. Unlike competitive market pricing that allows parties to factor in the varying levels of service in terms of duration and reliability, applying the same LMP to all demand response providers will not allow the market to discern between demand response based on its relative reliability and availability over different periods of time. [2] In fact, a non-competitive price for demand response may lead to the use of demand response even at times in which, absent special compensation, other forms of generation may have been available at a lower market price. The full LMP mandate would result in higher overall price for energy to consumers in such instances. These higher energy costs would be in addition to the added consumer costs associated with utilities adding significant capital investments in technologies aimed at better managing demand response.

There are other serious consequences to consider as well. For instance, full LMP compensation mandates may provide an incentive for demand response providers to overestimate their baselines and bid in excess of what they can realistically provide. [3] Over-bidding can easily lead to reliability concerns, particularly when there are significant and sudden changes in the expected demand response that stretch a system's capabilities beyond what it is designed to accommodate.[4] Sudden operational changes could also negatively impact the orderly functioning of the existing natural gas supply and transportation markets and lead to significant increases in imbalance fees for intra-day changes. Moreover, a false sense of dependence on demand response could discourage the building of generation and transmission needed to meet demand requirements. These are all important issues that we ask the Commission to carefully consider prior to making a final decision on demand response compensation.

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[2] In that regard, as Commissioner Moeller has observed, it is very possible that there can be no sustainable rationale to support a finding that the proposed demand response services will be equivalent to the services currently provided by physical capacity generation and priced at LMP.

[3] As EPSA mentions in its comments (EPSA at p. 28), standards are not yet in place that would allow accurate measurement and forecasting of DR supplies and bids. Requiring full LMP for DR providers could incentivize overly ambitious DR bids without any standards by which such bids could be verified.

[4] Natural gas-fired generators are often the flexible providers of intraday electric supply in RTOs across the country and could be called upon at the last minute to ensure reliability and replace any DR that was bid into the market to capture inflated prices but which failed to materialize.

We look forward to working with the Commission as it endeavors to make our energy systems function in a more efficient manner.

Sincerely,

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cc: Hon. Cheryl A. LaFleur, Commissioner, Federal Energy Regulatory Commission
Hon. John R. Norris, Commissioner, Federal Energy Regulatory Commission
Hon. Philip D. Moeller, Commissioner, Federal Energy Regulatory Commission
Hon. Marc Spitzer, Commissioner, Federal Energy Regulatory Commission