19. 16 USC §§ 824d, (Federal Power Act).

20. *Demand Response Compensation in Organized Wholesale Energy Markets*, Notice of Proposed Rulemaking, 130 FERC ¶ 61,213 (2010), ¶ 2.

21. *id*., ¶ 18.

22. William Hogan, *Implications for Consumers of the NOPR's Proposal to Pay the LMP for All Demand Response*, at 16, statement submitted on behalf of the Electric Power Supply Association in FERC Docket No. RM10-17-000, May 12, 2010.

23. Edison Electric Institute, *Request for Rehearing of the Edison Electric Institute*, at 8, FERC Docket No. RM10-17-000, April 14, 2011.

24. For a incisive analysis of the Commission's ''balancing'' argument, see: Steven Stoft, *Concurring opinion on Economic Issues Raised by FERC Order 745, Demand Response Compensation in Organized Wholesale Energy Markets*, Market Surveillance Committee of the California ISO, June 7, 2011.

25. Alfred Kahn's, affidavits are consistent with conventional markets that do not involve ARCs.

26. California Independent System Operator, *Tariff Amendment to Implement Proxy Demand Response Product*, FERC Docket No. ER10-765-000, February 16, 2010; Midwest Independent Transmission System Operator Inc., *Filing re Aggregators of Retail Customers*, FERC Docket No. ER09-049-002, Oct. 2, 2009.

27. ARCs typically retain about 20 percent of the revenues and pay the retail customer the remainder. If the demand response is sold into both the energy and capacity markets, the ARC may cover its costs and profit contribution from the capacity payments alone and may pay the retail customer the full energy price for curtailed load.

28. 134 FERC, *supra* note 1, ¶ 101.

29. Organization of MISO States, *Request for Rehearing of the Organization of MISO States*, Demand Response Compensation in Organized Wholesale Energy Markets, Docket No. RM10-17-000, at 8-9, April 14, 2011.

30. California Public Utilities Commission, *Request For Clarification or, in the Alternative, Request for Rehearing of the Public Utilities Commission of the State of California*, at 9, Demand Response Compensation in Organized Wholesale Energy Markets, Docket No. RM10-17-000, April 14, 2011; California ISO, *Demand Response Compensation in Organized Wholesale Energy Markets, ISO Compliance Filing*, at 13, Docket No. ER11-4100-000, July 22, 2011.

31. Economists will recognize this prescription as the mirror image of a profit-maximizing monopolist's behavior. However, the Commission is confused in thinking that lower LMPs will directly benefit electricity consumers because most retail customers, including virtually all residential and small business customers, are served under tariffs that substantially lag behind changes in LMPs. Thus, the primary beneficiaries to the short-term benefits produced by the NBT may be LSEs – not their retail customers.

32. Hogan, *supra* note 22, at 13.

33. FERC Docket Nos. ER09-68-000 and RM10-17-000.

doi:[10.1016/j.tej.2011.10.012](10.1016/j.tej.2011.10.012)

Response from Jonathan Falk and Michael Rosenzweig: Critique Betrays Misperception of Purpose of Demand Response

Wе believe Jonathan's previous article fully and fairly summarizes our views, and we do not believe Mr. Borlick's response does anything to upset our viewpoint on these matters. But lest there be any misunderstanding, let us try and succinctly point out where we think Mr. Borlick has gone awry.

If a load reduces consumption they save G, the retail cost of power. If a wind generator does not generate, they lose PTC, the production tax credit. PTC has no place in the formula we use to compensate wind generators, nor should it. By Mr. Borlick's logic, we should reduce the compensation to all wind generators by PTC, since the production tax credit might lead to inefficiency as wind generation is built which fails to earn profits

but-for the PTC. Some generators in New York pay a fuel tax, which increases their gas expenses by 7 percent. Others are exempt from this tax. Obviously, by Mr. Borlick's logic, we should reduce the payments to those generators exempt from the tax by 7 percent of the cost of their gas purchases. Otherwise, the gas tax puts an efficiency wedge between those who must pay the tax and those who are exempt.

These are but two examples of actual operating cost inefficiencies in the wholesale market, which we do nothing about for two reasons: *first*, because to do so would thwart important public purposes which we have decided for one reason or another are more important than economic efficiency; and *second*, because we take the LMP calculation process as given and then pay everyone the same thing.

The same should be true for G for demand responders. The ISO has a wholesale problem: balancing supply and demand. If they are willing to pay LMP to bring the supply and demand balance closer to together by 1 MW, then they should pay it to anybody who takes action to make that happen. They don't have to ask whether it is being done efficiently or inefficiently. The efficiency or inefficiency of their decision of how much to pay is embedded in the procedure that generates LMP.

Sometimes, of course, a load brings supply and demand closer into balance without reducing their own consumption through behind-the-meter generation. In this case, they incur their own fuel charges, F. F must be higher than G; otherwise they would use their own generation all the time. *The only possible solution to the efficiency problem Mr. Borlick discusses is to pay such loads LMP*. He recognizes that this is a problem for his position, so he assumes in endnote 10 that whether or not Order 745 applies to behind-the-meter generation is ambiguous. It

---

He wants to classify the Theory of the Second Best as the last refuge of scoundrels.

---

should not be. To separate these two cases of demand response is the same blind alley that led people to consider giving different prices to generation with different cost structures.

Moreover, with this argument, Mr. Borlick continues to misperceive the purpose of demand response. As is clear from the discussion above, DR is a resource that *the independent system operator* (not the LSE) purchases to match supply and demand. A customer who substitutes his own generation for system supply is indeed providing the resource that the ISO values and values at the market price for resources – LMP. This same mistake also causes Mr. Borlick to erroneously characterize the option represented by DR as having a strike price of G when in fact the strike price is different for each customer depending upon the value of consuming the electricity or the cost of backup generation, or their ability to shift consumption, or any number of other considerations which are none of the ISO's business. In fact, his characterizing the strike price as G is a sly way to restate one of his early positions that had fallen by the wayside, which is shared by Prof. Hogan and others, that the DR provider cannot sell something it hasn't purchased. Clearly this is wrong since he agrees that the customer has a saleable option.

Mr. Borlick goes through my laundry list of inefficiencies we blithely tolerate in electric markets and points out, quite rightly, that neither we nor anyone else knows what the ''just price'' is for demand response, or electricity. And of course by ''just price'' we have to include not only economic efficiency principles but all sorts of other policy considerations that put the ''just price'' concept more in line with its original creator, Thomas Aquinas, than to Adam Smith.

But after criticizing us for failure to quantify any of this, neither he nor any other advocate of his position has presented the least shred of evidence to quantify why this potential efficiency loss is worth anyone's effort to quantify. We are only pointing out that should intrepid advocates of his