



March 27, 2009

VIA HAND DELIVERY

The Honorable Kimberly D. Bose, Secretary
Federal Energy Regulatory Commission
888 First Street, NE
Washington, D.C. 20426

RE: **Report of ISO New England Inc. and New England Power Pool
Regarding Treatment of Price-Responsive Demand in the New
England Electricity Markets, Docket No. ER08-830-**

Dear Secretary Bose:

ISO New England Inc. (the "ISO") and the New England Power Pool ("NEPOOL"),¹ with the support of the New England Conference of Public Utilities Commissioners ("NECPUC"), hereby jointly file the following report in compliance with Federal Energy Regulatory Commission ("FERC") directives regarding the treatment of price-responsive demand in the New England electricity markets.

I. Introduction

Over the past five months, the region has been involved in the NEPOOL stakeholder process to evaluate and make recommendations on ways to achieve price-responsive demand in the electricity markets. This pleading outlines the history and background of this process and describes at a high-level the stakeholder discussions that have occurred to date on these issues. The ISO and NEPOOL, with the support of NECPUC, are recommending at this time, as described further herein, that a subsequent report be filed with the FERC no later than July 31, 2009. This report would describe

¹ Please note that NEPOOL has joined in this filing based on the recommendation of support from the NEPOOL Markets Committee at its March 25, 2009 meeting, which support was indicated with 3 abstentions, due to the timing required for this compliance filing and the fact that the NEPOOL Participants Committee does not meet until April 3, 2009. In recognition of the fact that under the Participants Agreement, only the NEPOOL Participants Committee can make filings on behalf of NEPOOL Participants before the Commission, NEPOOL will update the record in this proceeding following any formal action taken by the NEPOOL Participants Committee on this filing.

further progress made in the region on these issues, including any areas of consensus, and would request, as appropriate, further guidance and direction from the FERC.

This pleading is being made in compliance with the requirements of Section III.E.1.3 of the ISO Tariff and FERC directives in ISO New England Inc., 123 FERC ¶ 61,266 (June 13, 2008) (“DALRP Order”), which concerned the ISO’s proposed revisions to Market Rule 1 related to the Day-Ahead Load Response Program (“DALRP”). This pleading also includes, as directed by the FERC in the DALRP Order,² a review of the current Customer Baseline methodology. To encourage greater price-responsiveness of demand-side resources in the region, the ISO has previously developed and implemented, in consultation with stakeholders, a Real-Time Price Response Program (“RTPRP”) and the DALRP. Both programs, however, are set to expire on May 31, 2010, coincident with the first Capacity Commitment Period of the Forward Capacity Market (“FCM”). Section III.E.1.3 requires the stakeholder process to consider whether to allow the RTPRP and the DALRP to expire, continue the programs in their current form, or implement modified programs or other market designs.

This report summarizes stakeholder discussions conducted to date on these topics and describes the next steps that the region proposes to take. While there is general agreement that price-responsive demand, i.e., changes in hourly loads due to consumption decisions by customers in response to changes in wholesale power costs, is a critical element of a robustly competitive and economically efficient electricity market, there is often disagreement regarding:

- How to define and measure the economic benefits of price-responsive behavior;
- How to best encourage price-responsive demand;
- The appropriate roles of the ISO, regulators, distribution utilities, load-serving entities, and demand resource providers in implementing policies that promote price-responsiveness in New England;
- How price-responsive behavior ought to be compensated, the appropriate level of such compensation, how to best ensure that compensation is given for actual load response; and
- How to allocate any costs related to price-responsive behavior.

It is not clear at this time whether the region will reach consensus on how to resolve some, if any, of these issues or whether the region will need FERC assistance or direction to resolve these policy issues.

² DALRP Order at ¶ 31.

The ISO has implemented, in consultation with state utility regulators and other stakeholders, a variety of initiatives over the last several years that have been successful in “jump-starting” the price-responsive demand industry in New England. Since the ISO began operations, demand resource capability has grown from 100 MW to over 2,500 MW³ today. The ISO suggests that the key drivers of this growth include:

- Establishing a Demand Resources Department in 2002;
- Opening energy markets that establish day-ahead and real-time Locational Marginal Prices (“LMP”) in 2003, which enabled load-serving entities to purchase energy on a price-sensitive basis;
- Implementing the existing Load Response Program, which is a broad menu of demand response programs addressing system reliability and price-responsiveness, in 2003;
- Issuing a gap Request For Proposals to maintain reliability in Southwestern Connecticut from 2004 through 2008, through which the ISO administered contracts involving 260 MW of demand resources;
- Establishing a winter supplemental demand-response program in reaction to the potential loss of natural gas supplies that may have resulted from the devastation of Hurricanes Katrina and Rita;
- Implementing a Demand Response Reserves Pilot Program in 2006 to determine how small demand response resources (less than 5 MW) can provide a functionally equivalent reserve product;
- Commencing transition payments related to the Forward Capacity Market (“FCM”) in 2006 for which some demand response program participants, energy efficiency, and distributed generation resources were eligible; and
- Executing the first two Forward Capacity Auctions in which demand resources successfully competed with traditional generation resources to provide first 2,500 MW and then 2,900 MW of capacity to the New England region.

While much has been done to expand the region’s demand resource capability, the ISO, NEPOOL and NECPUC believe that more can and should be done. The New England region has little choice but to fully utilize its demand resource potential: (i) it must be considered along with generation and transmission as part of a whole portfolio of resources to ensure reliability criteria are met most efficiently, (ii) the Regional

³ The 2,500 MW total includes energy efficiency and distributed generation as well as demand response resources, which were registered with the ISO as an ICAP Resource as of the beginning of February 2009.

Greenhouse Gas Initiative will limit carbon emissions beginning in 2009, (iii) there are continuing concerns regarding the region's heavy reliance on natural gas for power generation, and (iv) New England's peak demand has historically grown significantly faster than overall energy consumption.

II. Background

a. History of Price-Responsive Demand

The ISO is the private, non-profit entity that serves as the RTO for New England. The ISO operates the New England bulk power system and administers New England's organized wholesale electricity market pursuant to the ISO Tariff, which is regulated by the FERC, and operating agreements with transmission owners. In its capacity as an RTO, the ISO has the responsibility to plan for and operate the New England bulk power system according to reliability standards established by the Northeast Power Coordinating Council ("NPCC") and the North American Electric Reliability Corporation ("NERC").

In its capacity as the regional administrator of the New England bulk power system and the market administrator for the New England wholesale electricity markets, the ISO has developed and implemented programs to promote price-responsive demand in the region. These programs include:

- Real-Time Price Response Program ("RTPRP") in which voluntary load reductions by program participants are eligible for payment when the forecast hourly Real-Time Locational Marginal Price ("LMP") is greater than or equal to \$100/MWh and the ISO has transmitted instructions that the eligibility period is open. Participants are paid the higher of the LMP or \$100/MWh at the time of their interruption.
- Day-Ahead Load Response Program ("DALRP"), which is an optional program that allows a participant in any of the real-time demand response programs to offer interruptions concurrent with the submission of Supply Offers in the Day-Ahead Energy Market. The participant is paid the Day-Ahead LMP for the cleared interruptions, and real-time deviations are charged or credited at the Real-Time LMP.

Both the RTPRP and the DALRP utilize an estimated Customer Baseline to assess the amount of load reduction achieved by program participants.

The RTPRP and DALRP provide program participants with financial incentives to reduce load in response to forecasted LMPs. These programs are currently set to expire on June 1, 2010, at the start of the first Capacity Commitment Period under the FCM. However, the ISO has previously committed (as reflected in the ISO Tariff) to conduct a stakeholder process to review the future of its price-response programs in the context of the FCM. Specifically, Section III.E.1.3 of the ISO Tariff states:

The current Load Response Program will be effective from the Operations Date through May 31, 2010; except as provided in Section III.E.2.1. Consideration of the Load Response Program for energy-based resources beyond May 31, 2010 is subject to further study and consultation with NEPOOL stakeholders and state utility regulatory agencies. The resulting determination will be filed by the ISO in an amended Market Rule filing in adequate time to allow for such program to continue uninterrupted beyond May 31, 2010.

In addition to the ISO Tariff, the FERC also ruled in its order accepting the DALRP market rule revisions that:⁴

We will require ISO-NE to file a report with the Commission by February 16, 2009 detailing its decision to either terminate or continue the Load Response Programs. However, we will also require as part of the February report that ISO-NE include a review of the current Customer Baseline methodology and a timetable for implementing any changes necessary for demand resources to participate in its markets on a comparable basis to generating resources.

To seek stakeholder input on the future of price-response programs, the ISO initiated a stakeholder process on October 22, 2008 to consider whether to allow the programs to expire, continue the programs in their current form or implement modified programs or market designs. As the stakeholder process unfolded, it became clear that additional time was needed for more stakeholder input on these issues. On January 26, 2009, therefore, the ISO requested that the reporting deadline be extended for a short period, until March 27, 2009. The ISO's request for an extension to the reporting deadline was supported by NEPOOL, and NECPUC did not oppose it.⁵ The FERC approved the extension on February 6, 2009.⁶

b. Stakeholder Discussions

Through the NEPOOL Participant Process, the region held multiple meetings at the NEPOOL Markets Committee and the Demand Resources Working Group to discuss the future of price-responsive demand in New England. Initial discussions focused on lessons learned from the existing Load Response Programs, economic frameworks or principles for studying the issues around price-responsive demand, and identification of barriers to price-responsive demand. The region also explored possible approaches for

⁴ DALRP Order at ¶ 31.

⁵ Expedited Motion Of ISO New England Inc. Requesting Extension Of Time To Submit Report, Docket No. ER08-830-000 (filed January 26, 2009).

⁶ Notice Granting Extension of Time (February 5, 2009), ISO New England Inc., Docket No. ER08-830-000.

incorporating price-responsive demand into the energy markets, including programmatic approaches and direct integration approaches, whether through supply-side or demand-side integration. The following is a high-level summary of some of the stakeholder discussions held on such approaches.

i. Programmatic Proposals for Price-Responsive Demand

One approach discussed by the ISO, NEPOOL, and NECPUC for treating price-responsive demand in the energy markets is referred to by the ISO as the “programmatic approach,” which facilitates price-responsive demand through ISO-administered programs. As described by the ISO, programmatic approaches provide incentive payments to program participants for price-responsive behavior, with the resulting price elasticity integrated into the demand side of the wholesale energy market.

The ISO had contended to NEPOOL and NECPUC that a “price-differential” program, which pays a financial incentive based on the difference between hourly wholesale market prices and a customer’s fixed retail rate, appears to meet many of the program design principles articulated by the ISO and some other parties over the course of the stakeholder discussions. There was, however, no consensus on whether to support a price-differential program along the lines that the ISO had described to stakeholders and it was clear in the comments received and discussions among stakeholders on the ISO’s initial proposals that there were policy questions and concerns to be resolved if the region were to support a price-differential program.

Included in those policy questions and concerns were statements from some stakeholders that programmatic approaches should not be viewed as the “end state” and should not provide retail customers with greater benefits than the customer might achieve through dynamic retail rates. Other stakeholders disagreed with those statements and noted their support for programmatic approaches that would allow payments based on the full day-ahead LMP. Some stakeholders objected to any approach that would limit compensation for providers of price-responsive demand solely to savings that would occur under dynamic pricing.

State regulators cautioned against embracing a price-differential program without further study because such a program might not sufficiently address some of the market barriers to demand resources. They stated that other mechanisms might be required to achieve sufficient price-responsive demand. There were a number of discussions in the stakeholder process regarding the appropriate levels of compensation to demand resource providers as well as the policy goals that any program design, including any price-differential program, should meet, for example, whether to maximize consumer surplus and/or create greater economic efficiencies in the market. Stakeholders spent a considerable amount of time discussing issues such as:

- Comparability with other supply-side resources;

- Appropriate incentives to induce load reductions coincident with peak usage; and
- Whether demand resource providers and the customers they serve should receive a payment based on the full LMP in addition to possible retail bill savings for the same load reduction.

ii. *Direct Integration of Price-Responsive Demand*

Stakeholders also considered approaches that would treat demand resources as either supply offers or demand bids in the energy markets. The “supply-side” approach would allow demand resources to submit supply offers like that of a generator into the wholesale energy market. One market participant that advocated for this approach stated that this approach is predicated on providing comparable opportunities in terms of markets access, obligations, and revenues as generation resources. That participant stated that demand resource providers should be: (a) allowed to participate directly in the wholesale market (i.e., obtain obligations, deliver obligations); (b) able to receive revenue payments directly through the wholesale market; (c) subject to symmetric performance incentives and obligations similar to generation resources; (d) not required to participate in a separate, adjunct program; and (e) not forced to work through load-serving entities.

Additional stakeholders argued for integration on the supply-side, in part because of concerns that treating price-responsive demand on the demand side of the market was not comparable treatment to generation resources since it would not result in compensation directly through the wholesale energy market like a generating resource. Other stakeholders noted that demand resources participate as supply resources in the FCM and should be treated similarly here. Those stakeholders argued that demand resources having a capacity supply obligation should be allowed and/or required to participate in and receive revenues in the energy markets when dispatched by the ISO on a basis comparable to generators (with comparable deductions for peak energy rents). Other stakeholders stated that further discussion was needed to explore the treatment of price-responsive demand in the capacity and energy markets.

The ISO identified concerns it had with allowing price-responsive demand to be integrated into wholesale energy markets through supply offers. The ISO stated that allowing price-responsive demand to be offered as a supply resource simultaneously affects demand, creating a supply/demand imbalance in the energy markets. In contrast to generation resources, the ISO contended that demand resources typically do not inject energy into the electric system; rather, demand resources reduce the withdrawal of energy from the electric system. Consequently, the ISO believes that treating demand resources like generation resources in the energy market, i.e., as though they inject energy into the electric system, results in a double counting of their demand reduction value, once as a supply-side resource and once again as a reduction in demand when the demand resource reduces load.

According to the ISO, double counting the effect of a demand resource in the wholesale market affects price formation and creates a potential “missing money” problem, i.e., an under-collection in the energy market of revenue needed to pay all of the suppliers (both generation and demand resources) that performed. Some stakeholders argued that the “missing money” problem is simply a cost allocation issue that could be addressed through revised settlement algorithms, although such algorithms have not been fully examined at this time by either the ISO or stakeholders. Further, the ISO stated that allowing demand resource providers to submit load reductions as a supply offer cannot capture the full economic impact of shifting load from high- to low-cost hours, and cannot capture any of the benefit from increasing load only during low-cost hours, e.g., fuel-switching vehicles from gasoline/diesel to electricity.

Other market participants stated that demand-side treatment of demand resources would avoid the “missing money” issues identified by the ISO. The ISO claimed that such approaches work best when demand resource providers coordinate their actions with the load-serving entities that serve the energy needs of the same retail customers. Also, the ISO stated that such approaches require load-serving entities, retail customers, or some other entity (like a utility company) to compensate demand resources for services rendered. Some market participants contended that this approach presents a market barrier for third party demand resource providers, i.e., aggregators of retail customers or “ARCs,” that are not load-serving entities and that prefer to work independently of load-serving entities and other market participants. These market participants state that the majority of demand response participating in the existing demand response programs, and the majority of demand response with capacity supply obligations in the FCM, are provided by these ARCs. Some participants also state that the methodology for compensation under the demand side approach has not been fully vetted and poses barriers to the end-use customers as well as ARCs.

III. Customer Baselines

In the DALRP Order, the FERC noted that:

Integration of Demand Resources into system operations and planning and system infrastructure upgrades is one of ISO-NE’s high-priority projects through 2010. Thus there will be a need for an accurate baseline for measuring performance of demand resources independent of any future price-response program. Accurate representation of the customer’s normal load is necessary to measure and verify that the load reductions indeed occur, so that demand response providers get paid for their service and New England consumers pay only for the service provided. As such, we agree with ISO-NE that evaluation of baseline methodologies is necessarily linked to the integration of demand response into its markets. We will require ISO-NE to file a report with the Commission by February 16, 2009 detailing its decision to either

terminate or continue the Load Response Programs. However, we will also require as part of the February report that ISO-NE include a review of the current Customer Baseline methodology and a timetable for implementing any changes necessary for demand resources to participate in its markets on a comparable basis to generating resources.⁷

The ISO is filing this section to provide the FERC with its review of the current Customer Baseline methodology. Many approaches to achieving price-responsive demand rely on the use of an estimated Customer Baseline, which is an estimate of what a customer would have consumed but for its response to a high wholesale market price.

While the region has generally discussed the use of Customer Baselines as part of its ongoing review of price-responsive demand, it has not yet fully vetted such issues given that the future of price-responsive demand is still largely unknown. Depending on the direction that is ultimately taken in the region on how to treat price-responsive demand in the wholesale energy markets, the ISO had previously asserted that – to the extent a programmatic approach is adopted – consideration must be given to the type of Customer Baseline methodology appropriate for such a program.⁸ However, the ISO believes that before knowing the characteristics of that new program, the adequacy of the current or any alternative Customer Baseline methodology cannot be determined. Any future consideration of any price-responsive demand approaches need also consider appropriate Customer Baseline methods for those approaches. Given that the stakeholders have not yet reached consensus on how to achieve price-responsive demand in the region, there was no discussion of alternative Customer Baseline methods compatible with those approaches. As a result, while ISO has shared its review of the current Customer Baseline methodology with market participants and state regulators, neither NEPOOL nor NECPUC have made any recommendations with respect to this issue.

A Customer Baseline can be an effective tool for measuring load reductions that occur infrequently. Research conducted by the ISO shows that the current Customer Baseline methodology has acceptable accuracy at an event day frequency of up to 102 days per year. Furthermore, the ISO estimates that Real-Time Demand Response Resources participating in the FCM may be called between 12 – 26 days during the 2011/2012 Capacity Commitment Period. The ISO concludes, therefore, that the current Customer Baseline methodology is adequate for Real-Time Demand Response Resources participating in the FCM. Any other programs to which a Customer Baseline, particularly one that uses contemporary meter data, is applied may need to be called only

⁷ DALRP Order at ¶ 31.

⁸ *ISO New England Inc.*, Docket No. ER08-830-000; Heat Rate Revision for Day-Ahead Load Response Program (filed April 15, 2008) (“DALRP Proceeding”). Yoshimura Testimony pp. 19-20.

infrequently, or program calls to individual participating resources would need to be appropriately limited.

In the fall of 2007, the ISO first observed market behavior in the DALRP that may have resulted in inflated Customer Baseline estimates and higher program payments, prompting changes to the program rules. Since Customer Baselines are estimates that are not directly observable, the ISO contends that it is difficult to verify the legitimacy of a claimed Customer Baseline estimate. To the extent that program participants actively modify their energy usage in response to changing LMP levels over many hours of the year, which the ISO asserts should be the goal of any effective price-responsive demand program, the accuracy of Customer Baseline estimates using contemporary meter data as the basis for the estimate becomes increasingly unreliable.

Finally, the ISO contends that the demand reduction value of energy efficiency resources that generally reduce load over many hours of the year cannot be captured using contemporary meter data to establish Customer Baseline estimates. Accordingly, price-responsive demand programs that seek response across many hours should either avoid the use of an estimated Customer Baseline, or incorporate changes in program design and/or in the Customer Baseline methodology to address these issues.

Some stakeholders contend that there are existing Customer Baseline methodologies that are very accurate and reliable and that such methods are fundamental to the delivery of demand response in virtually all markets across the country. These participants contend that Customer Baseline methodologies may not have been adequately explored to determine whether alternatives to the current approach can address these difficulties. Further, they stated that it was premature to consider eliminating the current Customer Baseline methodology applicable to price-responsive demand and did not recommend elimination of such methodology at this time. These stakeholders contend that appropriate rules could be designed to help prevent inflated Customer Baseline estimates and higher program costs. One stakeholder in particular offered recommended changes to the existing Customer Baseline methodology for demand resources that participate frequently in the energy markets, which would allow for a more contemporary, i.e., more accurate, Customer Baseline while remaining independent of the frequency of participation.⁹ Further discussion is necessary, however, among the region to explore these suggestions, as well as any other proposals offered by stakeholders.

IV. Next Steps

Over the past several months, the New England region has identified several important policy issues relating to price-responsive demand on which the region has not reached, and may have difficulty reaching, broad consensus. Those major policy questions are:

⁹ Such changes were also raised in the DALRP Proceeding before the FERC.

- What is the best approach to encouraging price-responsive demand in wholesale energy markets?
- Should demand resources be reflected on the demand- or supply-side of the wholesale energy market?
- Should total incentives (inclusive of retail bill savings and incentive payments) be based on the LMP, or use some other basis?
- If incentive payments are to be made for price-responsive behavior, who should pay for the incentives?

In order to help resolve the questions to the fullest extent possible, and to narrow and refine those issues upon which there is not agreement, the ISO, NEPOOL, and NECPUC have committed to continue the stakeholder process in New England, with emphasis on obtaining further input from New England regulators and on evaluating the policy questions in an attempt to develop any consensus positions.

The ISO, NEPOOL and NECPUC plan to work together to explore specific proposals and to identify additional analysis that should be conducted. Given the policy questions already identified above, it is likely that the region may need to develop competing or conflicting proposals on a parallel track. This process will help the ISO, market participants, and state regulators understand the implications of the proposals and produce information to help assess alternative ways that price-responsive demand can be implemented in the energy markets.

The ISO, with the input of NEPOOL and NECPUC, agrees to file a report with the FERC on or before July 31, 2009 describing the progress made in the region on the issues outlined in this joint pleading. Such filing shall include, but not be limited to: (i) describing any areas of consensus with respect to the major policy questions identified above and with respect to any specific proposals considered by stakeholders, and (ii) reporting relevant details regarding the stakeholder discussions and its views on the future of price-responsive demand in the region. Additionally, stakeholders will have the opportunity to file any written comments on this report with the FERC, to the extent not captured in what is filed on July 31. In addition, the ISO reserves the right as part of that filing to request that the FERC schedule a Technical Conference to aid the FERC in understanding the policy issues that are being considered within the region, and, if necessary, in providing any policy guidance.

Further, given the time and resources needed to design and implement an innovative program, and the additional time needed for discussions among stakeholders, the ISO currently expects to extend the present RTPRP and DALRP for an interim period of at least one year so that some form of price-responsive demand programs will continue uninterrupted until a new or revised approach can be implemented. Changes to the market rules to extend and/or modify the present RTPRP and DALRP would be subject to the normal stakeholder review process, which the ISO expects to complete before the

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end of this year. It is expected that this review process will examine and make recommendations regarding the present RTPRP and DALRP market rules, including but not limited to those rules governing Customer Baselines as well as the issues previously identified regarding participation frequency.

The ISO, NEPOOL and NECPUC look forward to working together over the next several months to help develop the right solutions on these issues for the region.

Please acknowledge receipt of the foregoing by date-stamping and returning to our messenger the enclosed extra copies of this filing.

Respectfully submitted,

ISO NEW ENGLAND INC.

NEW ENGLAND POWER POOL
PARTICIPANTS COMMITTEE

By: James H. Douglass / nws

By: Michelle C. Gardner / nws

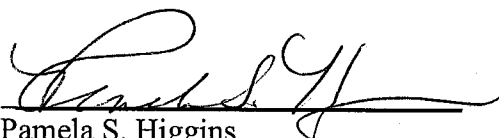
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CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in this proceeding.

Dated at Washington, D.C., this 27th day of March, 2009.

A handwritten signature in black ink, appearing to read 'Pamela S. Higgins', written over a horizontal line.

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