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Demand Response in Wholesale Markets

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DELIVERING ENERGY LAW
AND POLICY
IN THE EU AND THE US

A Reader

Edited by
Raphael J. Heffron and Gavin F. M. Little

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CONTENTS

The Contributors	xv
Acknowledgements	xlvi
List of tables and figures	xlix
Preface	li
1 Introduction	1
PART 1: ENERGY POLICY DELIVERY IN GENERAL	
2 Six Maxims for Informed Energy Analysis and Policy <i>Benjamin K. Sovacool</i>	5
3 Ending Subsidies for Fossil Fuel Exploration in a World of Unburnable Carbon <i>Shelagh Whitley</i>	12
4 Were North Sea Oil and Gas 'Field Allowances' Subsidies – and Does it Matter? <i>David Powell</i>	17
5 Renewable Energy Disputes <i>Peter D. Cameron</i>	23
6 Using a Legacy Frame to Deliver Energy and Environment Policies <i>Kaitlin T. Raimi and Michael P. Vandenberg</i>	29
7 The Emergence of EU Energy Law <i>Silke Goldberg</i>	33
8 How to Improve Regulation <i>Thomas P. Triebs</i>	40
9 Delivering Energy Networks Security: Economics, Regulation and Policy <i>Tooraj Jamasb and Rabindra Nepal</i>	45

10	The Role of Marketing in Delivering Energy Law and Policy <i>Paul Haynes</i>	50
PART 2: ENERGY POLICY DELIVERY IN THE UNITED STATES		
11	A Brief History of US Energy Policy <i>Daniel H. Cole and Peter Z. Grossman</i>	57
12	Applying Innovation Policy to the US Energy/Climate Challenge <i>William B. Bonwillian</i>	61
13	National Scientific Laboratories as an Energy Policy Vehicle: the United States' Experience <i>William F. Fox</i>	68
14	Delivering Energy Policy in the US: the Role of Taxes <i>Roberta F. Mann</i>	73
15	Delivering the Wind: Deconstructing Renewable Energy Success in Texas <i>Monty Humble</i>	79
16	Solar Rights in the United States <i>Sara C. Bronin</i>	84
17	The US–China Climate Agreement: a New Direction <i>Edward Flippen</i>	88
18	Going Green: The United States Department of Defense and Energy Security <i>Alexios Antypas</i>	92
19	US Conjunctive Water Management and Sustainable Energy Development <i>Jason B. Aamodt</i>	97
PART 3: ENERGY POLICY DELIVERY IN THE EUROPEAN UNION		
20	Delivering New Polity: Paving the Way for the European Energy Union <i>Elina Brutschin</i>	103
21	Antitrust Enforcement in the EU Energy Sector <i>Kim Talus</i>	107
22	Delivering Energy Policy in the EU: Some Thoughts on the Role of Consumers <i>Emanuela Michetti</i>	111
23	The Growing Impact of Free Movement Provisions in the EU Energy Market <i>Sirja-Leena Penttinen</i>	116

24	Energy, Externalities and the Need to Revisit <i>Deutsche Bahn</i> : a Proposal to Reverse the European Stance on EU State Aid Law and International Aviation <i>Geert van Calster</i>	121
25	RES: Towards a New European Policy <i>Theodore C. Panagos</i>	125
26	<i>Energiewende</i> in Germany: the Dawn of a New Energy Era <i>Lutz Mez</i>	129
27	What is a Sustainable Policy? A Case for the <i>Energiewende</i> <i>Gerardo Zarazua de Rubens</i>	135
28	The Finnish Energy Policy: Fulfilling the EU Energy and Climate Targets with Nuclear and Renewables <i>Sanna M. Syri and Behnam Zakeri</i>	141
29	The EU–Russia Relationship and the EU Energy Union: from Dependence and Vulnerability towards Competition and a Free Flow <i>Marek Martyniszyn</i>	145
 PART 4: ELECTRICITY POLICY DELIVERY		
30	The Role of Uncertainty in Energy Investments and Regulation <i>Luis M. Abadie and Joseph V. Spadaro</i>	153
31	Energy Security in an Unpredictable World: Making the Case Against State Aid Limitations in Electricity Generation <i>Paul Murphy</i>	159
32	Delivering a Low-carbon Electricity System in a Liberalised Market <i>Roger Kemp</i>	163
33	A Proposal for Reforming an Electricity Market for a Low-carbon Economy <i>Raphael J. Heffron</i>	171
34	The Role of the Demand Side in Electricity <i>Malcolm Keay and David Robinson</i>	174
35	Replacing Fossil Fuel Generation with Renewable Electricity: is Market Integration or Market Circumvention the Way Forward? <i>Olivia Woolley</i>	179
36	Susceptibility of Electricity Generation to Climate Variability and Change in Europe: a Review of Literature <i>Muriel C. Bonjean Stanton, Suraje Dessai and Jouni Paavola</i>	184

37	The External Dimension of Cross-border Electricity Transmission Planning in the EU <i>Karolis Gudas</i>	191
38	Integrating Vehicles and the Electricity Grid to Store and Use Renewable Energy <i>David Hodas</i>	197
39	A Stitch in Time: Could Ireland's Forthcoming White Paper Breathe New Life into its Brave but Faltering Renewable Electricity Policy? <i>Eva Barrett</i>	202
40	Recent Developments in the Hungarian Electricity Regulatory Framework <i>Robert Szuchy</i>	208
PART 5: NUCLEAR ENERGY		
41	Delivering the Revival of Nuclear Power <i>Keith Baker</i>	215
42	Energy Policy: the Role of Nuclear Power <i>S. D. Thomas</i>	219
43	Financing New Nuclear Power Stations <i>Simon Taylor</i>	223
44	UK Nuclear New-build Plans in the Light of International Experience <i>Tony Roulstone</i>	228
45	Delivering UK Nuclear Power in the Context of European Energy Policy: the Challenges Ahead <i>Philip Johnstone</i>	236
46	Nuclear Liability: Current Issues and Work in Progress for the Future <i>Cheryl Parkhouse</i>	242
47	The Present Status of Nuclear Third-Party Liability and Nuclear Insurance <i>Stephen F. Ashley, William J. Nuttall and Raphael J. Heffron</i>	251
48	Small Modular Reactors: the Future or the Swansong of the Nuclear Industry? <i>Giorgio Locatelli and Tristano Sainati</i>	256
PART 6: RENEWABLE ENERGY		
49	Coherent Promotion of Renewables under a Carbon Emissions Cap <i>Philippe Thalmann</i>	265

50	Renewable Energy Policies Change Carbon Emissions Even Under Emissions Trading <i>Johannes Jarke and Grischa Perino</i>	268
51	The Renewable Trajectory: Avoiding the Temptation of Cheap Oil <i>Michael LaBelle</i>	273
52	Impact of Renewable Portfolio Standards on In-state Renewable Deployment in the US <i>Gireesh Shrimali</i>	278
53	Renewable Support Policies in Europe: Evaluation of the Push-pull Framework for Wind and PV in the EU <i>Ruben Laleman</i>	283
54	A View from the Global Wind Industry <i>Jim Platts</i>	288
55	The New Concept of Competitive Bidding on Photo- voltaic in the German Renewable Energy Act 2014 <i>Joachim Sanden</i>	292
56	Legal Certainty for Green Energy Projects: Sure, but at What Price? <i>Wouter Vanderpe</i>	298
57	The Future of Hydroelectric Power in the United States: Thinking Small <i>Dan Tarlock</i>	302
58	Hydropower: from Past to Future Uncertainties <i>Ludovic Gaudard and Franco Romerio</i>	307
59	Renewable Energy Production in Marine Areas and Coastal Zone: the Norwegian Model <i>Sigrid Eskeland Schütz</i>	312
60	The Geopolitics of Clean Energy: Re-engaging with Russia Through Renewable Energy Cooperation <i>Anatole Boute</i>	317
PART 7: FOSSIL FUELS		
61	Talking About Shale in Any Language <i>Alison Peck</i>	325
62	The Shale Revolution, Fracking and Regulatory Activity in the US: a Policy Divided <i>James W. Skelton, Jr</i>	329
63	Fractured Systems: A Multiple Policy Proposal for Promoting Safe Shale Gas Delivery in the United States <i>Caroline Cecot</i>	333
64	Preparing Pennsylvania for a Post-Shale Future <i>Ross H. Pifer</i>	338

65	The Decline of Coal and the Economic Toll on the Appalachian Region <i>Patrick R. Baker</i>	344
66	The EU Network Codes and Prospects of Cross-border Natural Gas Pipeline Projects <i>Gokce Mete</i>	349
67	Building the Energy Union: The Problem of Cross-border Gas Pipeline Interconnections in Baltic, Central and South-Eastern Europe <i>Jack D. Sharples</i>	354
68	Eminent Domain Authority for Upstream Gas Infrastructure: an Alternative Approach <i>Tara Righetti</i>	359
69	Petroleum Licensing on the UKCS Fifty Years On: Problems, Solutions and More Problems? <i>John Paterson</i>	365
70	Greenland Offshore Petroleum Regulation Towards 'The Blue Arctic' <i>Irina Kim</i>	370
PART 8: ENERGY JUSTICE		
71	Energy Justice: the Yin and Yang Approach <i>Roman Sidortsov</i>	377
72	Sustainable Development and Energy Justice: Two Agendas Combined <i>Kirsten E. H. Jenkins</i>	381
73	Assessing the Justice Implications of Energy Infrastructural Development in the Arctic <i>Darren McCauley, Robert Rehner and Maria Pavlenko</i>	385
PART 9: ENERGY POVERTY AND HEALTH		
74	Energy Poverty and Affordable Sustainable Energy Technologies (ASET's) <i>Lakshman Guruswamy</i>	391
75	Challenging Energy Poverty Policies: Insights from South-eastern Europe <i>Saska Petrova</i>	395
76	Policy Changes for Future-proofing Housing Stock <i>Charlotte A. Adams</i>	400
77	Challenges for Health Services in Identifying Which Groups are Most Vulnerable to Health Impacts of Cold Homes <i>Anna Cronin de Chavez</i>	405
78	Energy, Life, Metabolism and the Food Chain <i>James J. A. Heffron</i>	412

PART 10: ENERGY EFFICIENCY AND DEMAND

- | | | |
|----|--|-----|
| 79 | Energy Efficiency and Energy Demand
<i>Steve Sorrell</i> | 419 |
| 80 | Energy Demand Reduction Policy
<i>Katy Roelich and John Barrett</i> | 424 |
| 81 | Demand Response in Wholesale Markets
<i>Joel B. Eisen</i> | 429 |
| 82 | Perceived Effectiveness of Different Methods of
Delivering Information on Energy Efficiency
<i>Lucie Stevenson and Danny Campbell</i> | 437 |
| 83 | Developing Behavioural Interventions: Three Lessons
Learned for Delivering Energy Policy
<i>Wändi Bruine de Bruin and Tamar Krishnamurti</i> | 442 |
| 84 | Policy Mixes in Stimulating Energy Transitions:
The Case of UK Energy Efficiency Policy
<i>Florian Kern</i> | 448 |
| 85 | The Journey of Smart Metering in Great Britain: a Revisit
<i>Tao Zhang</i> | 452 |
| 86 | Rethinking Household Energy Consumption Strategies:
the Importance of Demand and Expectations
<i>Louise Reid</i> | 457 |
| 87 | Financial Incentives for Energy-efficient Appliances
<i>Souvik Datta</i> | 460 |

PART 11: ENERGY SECURITY

- | | | |
|----|---|-----|
| 88 | Energy Security and Energy Policy Incoherence
<i>Hugh Dyer</i> | 467 |
| 89 | Designing International Trade in Energy Governance
for EU Energy Security
<i>Rafael Leal-Arcas</i> | 472 |
| 90 | NATO and European Energy Security
<i>Behrooz Abdolvand and Konstantin Winter</i> | 477 |
| 91 | Genealogy of the Current Gas Security Situation in the
EU–Ukraine–Russia Energy Triangle and the Role of
International Law
<i>Maksym Beznosiuk</i> | 482 |

**PART 12: COUNTRY-SPECIFIC AND INTERNATIONAL ENERGY
POLICY DELIVERY**

- | | | |
|----|---|-----|
| 92 | German Energy Law
<i>Katharina Vera Boesche</i> | 489 |
| 93 | Delivering Energy Law and Policy in Malta
<i>Simone Borg</i> | 495 |

94	Delivering Energy Efficiency Policies in Romania <i>Sebastian Radocea</i>	502
95	Energy Law in the Czech Republic: 'Unbundling' ČEZ <i>Michael J. Allen</i>	507
96	Delivering Energy Policy Reform in Ukraine: Legal Issues in the Light of European Integration <i>Yuliya Vashchenko</i>	511
97	A Systemic Approach to Renewable Electricity Technology Deployment: The 'Missing Link' in Optimising Policy Delivery in the UK? <i>Geoffrey Wood</i>	515
98	Delivering Energy Policy: Is there a Need for Key Changes in the Next UK Parliamentary Period? <i>Chris Eaglen</i>	520
99	Energy and the State in the Middle East <i>Jim Krane</i>	527
100	Delivering Energy Policy in Argentina <i>Tomás Lanardonne</i>	533
101	The Arctic: Source of Energy? Source of Conflict? Source of Policy Innovation <i>Joseph F. C. DiMento</i>	537

PART 13: CITIES, COMMUNITY ENERGY AND PUBLIC ENGAGEMENT

102	Delivering Energy (Often) Requires Public Consent <i>Heather E. Hodges, Colin P. Kuehl, Eric R. A. N. Smith and Aaron C. Sparks</i>	545
103	Public Engagement and Low Carbon Energy Transitions: Rationales and Challenges <i>Paul Upham</i>	549
104	Delivering Energy Policy in Ireland: Protest, Dissent and the Rule of Law <i>Áine Ryall</i>	554
105	National Energy Policy, Locally Delivered: the Role of Cities <i>Catherine S. E. Bale</i>	559
106	Community Energy in the UK <i>Sandra Bell</i>	562
107	Distributed Energy Resources: Back to the Future and More <i>James E. Hickey, Jr</i>	566
108	Promoting Cost-effective Distributed Generation: Lessons from the United States <i>Karim L. Anaya</i>	570

PART 14: CLIMATE CHANGE AND THE ENVIRONMENT

- 109 Energy and Climate Policy: Synergies, Conflicts and Co-benefits 581
Hannes R. Stephan
- 110 The Multi-level System of Global Governance: Opportunities for more Ambitious Climate Strategies 587
Martin Jänicke
- 111 The What, How and Where of Climate Law 592
Navraj Singh Ghaleigh
- 112 Environmental Law and Climate Change 596
John McEldowney
- 113 Energy and Environment Studies: the Role of Legal Scholarship 601
Gavin F. M. Little
- 114 Overview of the EU Climate Policy Based on the 2030 Framework 605
Noriko Fujiwara
- 115 Climate Policy Instrumentation in Spain 610
Mikel González-Eguino, Anil Markandya and Luis Rey
- 116 Planning Consent and the Law of Nuisance 619
Francis McManus
- 117 Multi-state Endangered Species Act Listings: the Impact to Energy and New Conservation Approaches in the United States 624
Temple L. Stoellinger
- 118 Delivering Energy to the Drylands: Obligations under the UN Convention to Combat Desertification (UNCCD) to Provide Energy, Water and More 630
Roy Andrew Partain

PART 15: NEW TECHNOLOGIES AND ENERGY INITIATIVES

- 119 Delivering New Energy Technologies: the Military as Consumer and Innovator 639
Samuel R. Schubert
- 120 Delivering Energy Policy for Planet Ocean by Investing in Ocean Thermal Energy Conversion Infrastructure 643
Anastasia Telesetsky
- 121 The Necessity of Government Support for the Successful Deployment of Carbon Capture and Storage 647
Matthew Rooney

122	Too Little and Too Late? An Evaluation of the Regulation of Carbon Capture and Storage as an Integral Element of a Future Low-carbon Energy System <i>Stuart Bell</i>	651
123	Carbon Capture and Storage Readiness Assessment: a Premature Regulatory Requirement? <i>Owen McIntyre</i>	658
124	Value of Energy Storage: the Required Market and Policy Supports <i>Behnam Zakeri and Sanna M. Syri</i>	664
125	Energy Storage Systems: a Risky Investment to Provide the Required Flexibility for Future Smart Grids <i>Diletta Colette Invernizzi and Giorgio Locatelli</i>	669
126	An Energy Partnership between the European Union and Brazil for the Promotion of Second-generation Biofuels <i>Stavros Afionis and Lindsay C. Stringer</i>	674
127	Conclusion	679
	Index	681

DEMAND RESPONSE IN WHOLESALE MARKETS

Joel B. Eisen¹

INTRODUCTION

Demand response participation in wholesale markets is an important building block in a profound transformation of electricity systems in the United States and Europe. Technical and economic innovations, supported by governmental policies, are moving electricity systems toward smart grids² that integrate generation, transmission and distribution in a more networked, environmentally responsible and efficient manner, incorporating distributed energy resources and delivering benefits for utilities and consumers.³ As one component of smart

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² J. B. Eisen, 'An open access distribution tariff: removing barriers to innovation on the smart grid', *UCLA Law Review* 61 (2014), 1712, 1714 (contemplating a 'multimodal grid featuring supply, demand, and network management taking place at multiple nodes on the network').

³ The US Energy Independence and Security Act of 2007 established a national policy for grid modernisation and described the smart grid as a system capable of accomplishing over ten diverse objectives. 42 USC Sec. 17381. See J. B. Eisen, 'Smart regulation and federalism for the smart grid', *Harvard Environmental Law Review* 37 (2013), 1–56.

grids, consumers, utilities and regional grid operators may benefit from more use of demand response programmes that reduce peak power consumption and market price spikes, balance intermittency of renewables and achieve greater grid efficiency and reliability.

DEMAND RESPONSE DEFINED

The US Federal Energy Regulatory Commission (FERC) defines demand response as: 'changes in electric use by demand-side resources from their normal consumption patterns in response to changes in the price of electricity, or to incentive payments designed to induce lower electricity use at times of high wholesale market prices or when system reliability is jeopardized'.⁴

There are three broad categories of demand response programmes. Emergency/standby programmes, the most common, offer customers reduced rates or incentive payments if they agree to reduce their interruptible load. For decades, utilities have contracted with large industrial or commercial customers to allow curtailment when necessary to lower utilities' costs of managing peak demand. Participants typically have little control: once enrolled, they generally must reduce load when 'called'. A residential sector example is a programme in which customers agree to allow their utility to directly control air conditioners to reduce demand at peak hours.

Price response bidding programmes allow customers to bid demand reductions into wholesale markets, often through the use of intermediaries (see below). Unlike emergency programmes, these allow customers to choose when and how much energy use they are willing to curtail. Customers can respond to real-time or day-ahead price signals, depending on the market.

The third category is price-responsive demand. In these programmes, customers have variable retail electricity rates, and can reduce consumption when rates are high, or shift consumption to off-peak hours.

In general, customers may handle curtailments in a variety of ways, including shifting electricity use to non-peak hours. At present, most demand response comes from large commercial and industrial users that can stagger equipment start-up, use electricity stored in batteries or produce power from on-site generators to replace power not purchased. These customers usually can provide demand reductions meeting grid operators' minimum size requirements, and can afford to invest in necessary smart meters and communications systems. However, demand response opportunities in the residential sector are growing substantially with increased deployment of smart meters and related technologies.⁵

⁴ CFR 18, Sec. 35.28(b)(4).

⁵ Bipartisan Policy Center, 'Policies for a modern and reliable U.S. electric grid' (February 2013), available at [http://bipartisanpolicy.org/wp-content/uploads/sites/default/files/Energy_Grid_Report\[1\].pdf](http://bipartisanpolicy.org/wp-content/uploads/sites/default/files/Energy_Grid_Report[1].pdf), 50.

DEMAND RESPONSE PARTICIPATION IN WHOLESALE MARKETS

Demand response participation in organised wholesale markets is substantial in the US,⁶ and emerging in Europe and elsewhere.⁷ In the US, FERC-approved 'regional transmission organisations' (RTOs) administer regional transmission grids and oversee multistate wholesale electricity markets.⁸ More than half the electricity sold in the US trades on these markets, while some regions oppose the RTO model and rely on individual utilities to govern transmission.

RTOs typically administer three types of markets:

1. Energy – in an energy market, utilities and other load-serving entities purchase electricity for delivery within the next hour or a day ahead.
2. Capacity – a capacity market is a forward-looking market, in which participants commit to serve future demand with new generating capacity.⁹
3. Ancillary services – these markets compensate providers of 'regulation' (an industry term of art for keeping grid frequency in balance) and reserve services that enable the reliable transmission of electricity.¹⁰

At first, the wholesale markets involved only electricity generators.¹¹ Today, demand response resources can participate in energy markets to substitute for electricity sold at the market price. In capacity markets, demand response curtailments substitute for new power plants. Ancillary service markets have

⁶ US Federal Energy Regulatory Commission, '2014 assessment of demand response and advanced metering' (December 2014), available at www.ferc.gov/legal/staff-reports/2014/demand-response.pdf, at 11, Table 3-3 (demand response programs in organised wholesale markets had a potential of 6.1 per cent of peak demand in 2014).

⁷ Smart Energy Demand Coalition, 'Mapping demand response in Europe today: tracking compliance with Article 15.8 of the Energy Efficiency Directive' (April 2014), available at http://sedc-coalition.eu/wp-content/uploads/2014/04/SEDC-Mapping_DR_In_Europe-2014-04111.pdf

⁸ US Federal Energy Regulatory Commission, 'Regional transmission organizations (RTO)/independent system operators (ISO)', available at www.ferc.gov/industries/electric/indus-act/rto.asp. (One RTO with substantial demand response is PJM Interconnection, LLC (PJM), which administers a large regional grid that includes thirteen states (mostly in the mid-Atlantic region) and the District of Columbia.

⁹ A principal difference between the US and Europe is that in Europe, 'few countries currently allow DSR providers [aggregators] to participate in their energy market or a capacity mechanism', so demand response does not yet have the same opportunities to participate in markets as in the US. Linklaters, 'Capacity mechanisms: Reigniting Europe's energy markets' (2014), available at www.linklaters.com/pdfs/mkt/london/6883_LIN_Capacity_Markets_Global_Web_Single_Final_1.pdf, at 18 (contrasting the European experience with that of PJM).

¹⁰ J. B. Eisen, 'Distributed energy resources, virtual power plants, and the smart grid', *University of Houston Environmental and Energy Law and Policy Journal* 7 (2012), 191–213, at 198.

¹¹ J. B. Eisen, 'Who regulates the smart grid?: FERC's authority over demand response compensation in wholesale electricity markets', *San Diego Journal of Climate and Energy Law* 4 (2012–2013), 69–103, at 80.

comparatively little demand response participation,¹² but demand response can increasingly help with frequency regulation.¹³

Intermediaries known as ‘curtailment service providers’ (CSPs) or ‘aggregators’ bid demand response into the markets. For example, CSPs in the PJM RTO in the US Mid-Atlantic region offer demand response in energy, capacity, day-ahead scheduling reserve, synchronised reserve and frequency regulation markets.¹⁴ Aggregators can also combine demand reductions from a number of customers, enabling smaller customers to participate in markets when they otherwise could not do so. By grouping customers into a block resource, aggregators give RTOs a more reliable and controllable volume of resources for a longer time period, spreading out the risk of customers not curtailing demand when called.¹⁵ Aggregators have begun to market to the residential sector, although this market is still small.

DEMAND RESPONSE BENEFITS FOR REGIONAL GRIDS, UTILITIES AND CONSUMERS

Demand response resources can achieve a variety of financial and operational benefits in wholesale markets. At present, demand on the grid peaks noticeably at a small number of hours each year. This can make the marginal cost of generating electricity highly variable, with prices spiking at peak hours. Unanticipated outages or unusually high demand exacerbate this problem. At peaks that stress the grid to its limits, grid operators traditionally responded by calling on available generation capacity. Yet reducing grid stress through demand response could cut marginal costs as much or more than generating additional power. A 2009 FERC report estimated potential reductions in peak demand of up to 20 per cent.¹⁶ Demand response programmes may also lead to increased conservation if usage at peak periods is eliminated rather than shifted.

Demand response can help meet future anticipated demand and avoid unnecessary expenses of building new power plants. Demand ‘peakedness’ requires grid operators to have power plants on hand to meet peak demand, which leads to oversupply of generating capacity. Many peaking plants operate fewer than 100 hours per year, and demand response could eliminate the need to build them. Demand response can also lower the need for spinning reserves: power

¹² J. MacDonald, P. Cappers, D. S. Callaway and S. Kiliccote, Lawrence Berkeley National Laboratory, ‘Demand response providing ancillary services: a comparison of opportunities and challenges in the US wholesale markets’ (2012), available at www.gridwiseac.org/pdfs/forum_papers12/macdonald_paper_gi12.pdf (noting that ‘organized electricity and ancillary services markets are just beginning to support DR resources for ancillary services’).

¹³ US demand response providers may take advantage of FERC’s Order 755, which changed the policies for pricing of frequency regulation service. ‘Frequency regulation compensation in the organized wholesale power markets’, *Federal Register* 76 (20 October 2011), 67,260.

¹⁴ PJM Interconnection, LLC, ‘Demand response, markets & operations’, available at www.pjm.com/markets-and-operations/demand-response.aspx

¹⁵ Eisen, ‘Distributed energy resources’, 203–5.

¹⁶ US Federal Energy Regulatory Commission, ‘A national assessment of demand response potential’ (June 2009), available at www.ferc.gov/legal/staff-reports/06-09-demand-response.pdf, x, Figure ES-1.

plants that run offline, burning fossil fuels continuously, to supply power on short notice. RTOs increasingly rely on regional planning processes and capacity mechanisms¹⁷ to decide whether new power plants are needed. Factoring demand response into these models can lead to less new construction.

Also, demand response increases grid reliability when used as a balancing resource for wind and solar power.¹⁸ As more distributed energy resources are integrated to the grid, demand response will be more useful in stabilising the grid. Finally, by providing incentives for CSPs and other third party providers, it encourages market competition.

NEW TECHNOLOGIES AND PROGRAMME DESIGNS ARE NEEDED

Because demand response gives consumers incentives to lower or adjust their consumption at strategic times, they can benefit directly. These benefits depend on availability of smart meters and communications systems¹⁹ needed for measuring and verifying demand reductions. Smart meters are digital versions of traditional analogue meters that measure electricity consumption at short time intervals and generate near real-time data. By 2014, nearly one-third of US consumers had them,²⁰ but less than 1 per cent had devices to work with them and help manage energy usage.²¹ Eventually, 'smart' devices will give consumers more flexibility to monitor and control electricity usage, with assistance from energy service companies.²²

Achieving these benefits requires more use of 'dynamic pricing': real-time pricing or other variable electricity pricing structures that more closely match supply and demand. Currently, most US consumers pay a fixed price that does not conform to the cost of providing electricity. Less than 1 per cent of US consumers have any form of variable pricing, with the most common form being time-of-use pricing.²³ Dynamic pricing gives consumers incentives to cut back on consumption, and is important to the success of demand response programmes.²⁴ A 2012 survey of twenty-four utility pilot programmes in

¹⁷ An example of a capacity market is PJM's 'reliability pricing model'. PJM Interconnection, LLC, 'Capacity market (RPM)', available at www.pjm.com/markets-and-operations/rpm.aspx

¹⁸ Eisen, 'Distributed energy resources', 201–5.

¹⁹ US Department of Energy, 'The smart grid: an introduction' (2009), available at http://energy.gov/sites/prod/files/oeprod/DocumentsandMedia/DOE_SG_Book_Single_Pages%281%29.pdf, 12 (listing remote sensors and monitors, switches and controllers with embedded intelligence, and digital relays).

²⁰ US Federal Energy Regulatory Commission, '2014 assessment of demand response and advanced metering', 3, Table 2-1 (31.5 per cent deployment).

²¹ US Department of Energy, 'Advanced metering infrastructure and customer systems', available at www.smartgrid.gov/recovery_act/deployment_status/ami_and_customer_systems##CustomerDevicesDeployed

²² US Department of Energy, 'The smart grid: an introduction', 11.

²³ US Federal Energy Regulatory Commission, '2014 assessment of demand response and advanced metering', 30.

²⁴ A. Faruqui, R. Hledik and J. Palmer, 'Time-varying and dynamic rate design' (2012), available at www.ksg.harvard.edu/hepg/Papers/2012/RAP_FaruquiHledikPalmer_TimeVaryingDynamicRateDesign_2012_JUL_23.pdf, 39.

North America, Europe and Australia found that dynamic pricing programmes yielded both cost savings and demand reductions.²⁵

Besides taking advantage of smarter technologies, demand response programmes must be designed to respond to customers' needs and wants, to prompt them to take part. Communication tailored appropriately to consumers is essential, as is proper design of the payments and incentives, the level of complexity and amount of customer control over the nature and duration of curtailments. For example, the Maryland-based utility Baltimore Gas & Electric (BGE), which serves 1.2 million electricity customers, has worked with the firm Opower, sending pricing signals to residential customers the night before an 'energy savings day' and asking them to take action. By summer 2015, BGE aims to roll out the programme to all of its residential customers.²⁶

STRONGER AND MORE CONSISTENT GOVERNMENTAL POLICIES ARE NEEDED TO SUPPORT DEMAND RESPONSE

New laws, regulations and market structures must be in place to promote effective demand response participation in wholesale markets in the US and Europe.²⁷

An example of US federal policy is FERC Order 745, which required demand response bid into a wholesale energy market to be compensated at the 'locational marginal price', the price generators receive for selling electricity.²⁸ In 2014, however, a US federal appeals court's decision in *Electric Power Supply Association v. FERC (EPSA)* invalidated Order 745, putting the future of more widespread demand response in the wholesale markets in doubt.²⁹ In the US, states control retail electricity sales and the federal government regulates wholesale transactions. The court held that demand response is exclusively a retail-level matter beyond FERC's jurisdiction.

Given demand response's benefits, its severely reduced role in US wholesale markets after the *EPSA* decision would have widespread negative effects. Immediately after the decision, two petitions were filed with FERC to invalidate regional capacity auctions that included demand response resources. The PJM RTO removed demand response from bidding into its capacity auctions,³⁰

²⁵ *Ibid.*, 27–8.

²⁶ US Federal Energy Regulatory Commission, '2014 assessment of demand response and advanced metering', 24.

²⁷ Policies needed in Europe are discussed in Smart Energy Demand Coalition, 'Mapping demand response in Europe today: tracking compliance with Article 15.8 of the Energy Efficiency Directive'.

²⁸ US Federal Energy Regulatory Commission, 'Demand response compensation in organized wholesale energy markets', *Federal Register* 76 (24 March 2011), 16,658 (to be codified at CFR 18, pt. 35).

²⁹ No. 11-1486 (2014) (DC Circuit Court of Appeals).

³⁰ PJM Interconnection, LLC, 'Revisions to the reliability pricing market ('RPM') and related rules in the PJM open access transmission tariff ('tariff') and reliability assurance agreement among load serving entities ('RAA') (14 January 2015), Docket No. ER15-852-000, available at www.pjm.com/documents/ferc-manuals/ferc-filings.aspx

providing instead that load-serving entities controlling demand response could put their obligation to procure capacity. This is controversial because it leaves out industrial customers and CSPs that bid substantial amounts of demand response into PJM's markets.

Concerned about impacts on wholesale markets, the federal government, demand response providers and others petitioned the US Supreme Court to reverse the *EPSC* decision. In May 2015, the Court granted the petition, which may well lead to a conclusion that 'FERC has authority to regulate wholesale rates and activities that have a direct impact on rates, such as demand response'.³¹ The petitioners' argument to this effect is supported in part by two recent decisions of US appellate courts. These decisions rejected state laws offering subsidies to new power plants above PJM capacity market prices, and affirmed FERC's exclusive authority to regulate capacity markets.³² In a related case (*ONEOK, Inc. v. Learjet, Inc.*), the Supreme Court held in April 2015 that FERC's statutory authority to regulate practices affecting wholesale market rates did not pre-empt state antitrust laws.³³ However, the Court may distinguish this decision on the basis that demand response – like capacity market rules – has a more direct impact on rates than state antitrust laws, which the *ONEOK* court believed aim more broadly at businesses' anti-competitive conduct.³⁴

Efforts by grid operators controlling single-state grids in California³⁵ and New York³⁶ are also underway to design new legal structures to promote distributed energy resources and expand demand response programmes in wholesale markets. In Europe, Article 15.8 of the Energy Efficiency Directive outlined specific requirements to promote demand response programs, although progress lags behind the US.³⁷

³¹ J. B. Eisen, 'Supreme Court to hear major energy law federalism case', CPR Blog, Center For Progressive Reform, available at www.progressivereform.org/CPRBlog.cfm?idBlog=9D7551F2-DE35-1637-D13A016B799BBCC0.

³² *PPL EnergyPlus, LLC v. Nazarian* (2014) 753 F.3d 467 (4th Circuit), petition for cert. filed, No. 14-614, No. 14-623 (25 and 26 November 2014); and *PPL EnergyPlus, LLC v. Solomon* (2014) 766 F.3d 241 (3rd Circuit), petition for cert. filed, No. 14-634, No. 14-694 (26 November 2014 and 10 December 2014).

³³ *ONEOK, Inc. v. Learjet, Inc.* (2015) 575 U.S. __ (2015); decided 21 April 2015.

³⁴ Eisen, 'Supreme Court to hear major energy law federalism case'. For further discussion of this and other energy law issues raised by the *ONEOK* decision, see E. Hammond, 'ONEOK v. Learjet, energy law's jurisdictional boundaries: a call for course correction', George Washington Law Review Docket, available at www.gwlr.org/oneok-v-learjet

³⁵ California Public Utilities Commission decisions promoting demand response are described in Jeff St. John, greentechgrid, 'California's demand response 2.0 creates new competitive markets' (11 March 2015), available at www.greentechmedia.com/articles/read/Californias-Demand-Response-2.0-Creates-New-Competitive-Markets

³⁶ New York's ambitious framework called 'Reforming the energy vision' was adopted by the state's Department of Public Service in 2015. New York Department of Public Service, 'Order adopting regulatory policy framework and implementation plan' (26 February 2015), available at www3.dps.ny.gov/W/PSCWeb.nsf/All/26BE8A93967E604785257CC40066B91A?OpenDocument

³⁷ Smart Energy Demand Coalition, 'Mapping demand response in Europe today: tracking compliance with Article 15.8 of the Energy Efficiency Directive'.

CONCLUSION

Demand response offers considerable energy saving and management capabilities, with further success depending on development and deployment of the right technologies required for participation, continued evolution of regulatory initiatives (particularly rules that promote participation in wholesale markets administered by regional grid operators), and encouragement of CSPs and other market participants. Even with these numerous challenges to full deployment, demand response is likely to be an increasing and important component of electricity wholesale markets.