

First Read

US Electric Utilities & IPPs

Putting Demand Response in Doubt

Equities

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Court decision this morning puts Demand Response compensation on its head

A US Court of Appeals released a decision this morning that removes FERC's jurisdiction over Demand Response (DR), deeming it a 'retail' market, effectively relegating it to state jurisdiction. We see the decision as interjecting significant risk in both energy and capacity market risk on participation of Demand Response nationally, as it would appear that it being not FERC jurisdictional would impede in its ability to participate in FERC-jurisdictional markets. The decision appears limited to Order 745 implementation of full LMP (power price) compensation, with the bulk of this compensation doled out through PJM as best we understand.

We suspect this opens wider question how DR can participate?

While we don't mean to appear too alarmist (as this could have significant impacts on power markets), there remains a likely appeal to clarify how Demand Response can participate in Base Residual Auctions (BRA). It appears that IPPs will have to further petition FERC and the ISOs to revise their tariffs given the latest decision to gain clarity on precisely how the regions will each interpret the change to state jurisdiction.

States enter the fray: this could cut both ways on DR compensation

We would expect states to immediately implement their own regulations to soften the blow of any reduction in DR participation, given the very significant and disruptive impact on prices in energy markets, but more importantly on capacity prices with 12.5GW clearing in last year's auction (out of 14.5GW offered, vs. 169GW total cleared). As such, while there exists a clear potential for a near-term blow to the value of DR to the energy markets (more modest), and even capacity compensation (the big risk), we see states taking over DR regulations as cutting both ways. We see the potential for more generous compensation in jurisdictions encouraging participation, while those that have been opposed, implementing tighter rules. Additionally, under state regulation, it would appear that utilities might ultimately be the entities controlling the bidding-in of DR products.

What does this mean? Positive for IPPs, but no immediate auction impact

Going into the afternoon before RPM results, we suspect this could provide some modest support for the PJM generators, particularly seeing continued concerns among the community over the outlook for the results to be posted after the close. We suspect this will add significant uncertainty to DR participants, with much more action to come back at both FERC and before the ISOs on specific tariff reform. The decision today is unlikely to have an effect on the RPM results (and is improbable to have retroactive implications), but could very well have impacts on incremental auction procurements as well as future BRAs, lending some support for future upside to capacity prices (particularly when coupled with other rules FERC failed to act on in time for the latest auction). USCA Case #11-1486

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Statement of Risk

Risks for Utilities and Independent Power Producers (IPPs) primarily relate to volatile commodity prices for power, natural gas, and coal. Risks to IPPs also stem from load variability, and operational risk in running these facilities. Rising coal and, to a certain extent, uranium prices could pressure margins as the fuel hedges roll off Competitive Integrations. Further, IPPs face declining revenues as in the money power and gas hedges roll off. Other non-regulated risks include weather and for some, foreign currency risk, which again must be diligently accounted in the company's risk management operations. Major external factors, which affect our valuation, are environmental risks. Environmental capex. could escalate if stricter emission standards are implemented. We believe a nuclear accident or a change in the Nuclear Regulatory Commission/Environment Protection Agency regulations could have a negative impact on our estimates.

Risks for regulated utilities include the uncertainty around the composition of state regulatory Commissions, adverse regulatory changes, unfavorable weather conditions, variance from normal population growth, and changes in customer mix. Changes in macroeconomic factors will affect customer additions/subtractions and usage patterns

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