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BNA Insights

Energy

FERC

Three recent Supreme Court cases addressed the split jurisdiction between state and federal regulation of the electric grid. Joel Eisen, a professor at the University of Richmond School of Law, examines the impact of these cases on the rapidly changing energy sector.

The Supreme Court's New Electricity Federalism

JOEL B. EISEN

In a remarkable burst of activity, the U.S. Supreme Court decided three cases in the past year involving the split of jurisdiction between the Federal Energy Regulatory Commission (FERC) and the states in the energy sector. *FERC v. Electric Power Supply Association* and *Hughes v. Talen Energy Marketing* dealt with the relationship between FERC and the states in governing the electric grid under the Federal Power Act (FPA). *ONEOK v. Learjet* involved regulation of natural gas pipelines under the Natural Gas Act (NGA), which, being nearly identical to the FPA, also serves as precedent for decisions involving the electric grid.

The impacts of these decisions will reverberate for years to come. They mark the end of ''dual federalism'' in electricity law that treated federal and state regulators as operating within separate and distinct spheres of authority, recognizing instead that state and federal initiatives frequently overlap. The Court has provided standards to govern the interaction between FERC and the states going forward, but has also left considerable uncertainty. Thus, these watershed decisions herald a new legal approach to governing the rapid evolution of the modern electric grid, but one in which the precise contours will not be known for some time.

This Insights piece is excerpted from the article, Dual Electricity Federalism Is Dead: But How Dead And What Replaces It?, which is forthcoming in the George Washington Journal of Energy and Environmental Law. The author may be contacted at jeisen@richmond.edu .

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This transformative change in electricity law reflects the tectonic shift occurring today in the electric grid. For over six decades after the FPA's enactment in 1935, the nation's system of making electricity and delivering it to customers was stable and predictable. The nation's major utilities were vertically integrated monopolies, much as the phone system once was. Utilities generated electricity in their power plants, moved it across their transmission wires, and delivered it to their customers. State public utility commissions regulated utilities' rates and services to guard against the ills of monopolization.

In the grid of 1935, federal jurisdiction could be fenced off at a state border. This bright line was typical of the early 20th century's dual federalism, which posited that federal and state regulatory authority could be separated neatly into exclusive spheres. In today's interconnected electricity network, this no longer makes sense. A system of shared responsibility is more appropriate than a jurisdictional bright line, because both the states and FERC are taking actions simultaneously to influence such matters as how many power plants get built and how much renewable energy is added to the grid. In this new environment, many state or federal actions can simultaneously have impacts on both retail electricity rates and wholesale markets.

Rapidly Changing Electric Grid.

Now, there is change everywhere. Solar and wind power are being rapidly added to the grid. This power is generated at the edge of the grid in places like residential rooftops and remote wind farms, rather than in central power stations. It requires new transmission lines, grid connections and advanced management of increasingly diverse sources of power on the grid to protect its reliability. New business models, technologies and upstart competitors, such as solar leasing firms, are challenging traditional utilities. The utilities face a challenging environment in which they may eventually lose customers and perhaps even their long-protected profitability.

Debates in well over two dozen states over charges related to net metering and solar demand highlight these impacts of the industry shift.

Even more dramatic transformations are on the horizon. Potential game changers like battery storage and ''microgrids'' (self-sustaining areas largely disconnected from the traditional grid) abound. If storage becomes more widely available and less expensive than Tesla's ''Power Wall,'' consumers could keep the power they make from solar panels and provide it back to the grid when it would be most advantageous for them to do so. Not far off in the future, electricity may even be traded among ''prosumers'' rather than simply purchased by consumers. Recognizing this, California and New York are experimenting with overhauling the entire system in which electricity is distributed to customers. The watchword is change, and more of it is promised.

The grid's architecture has also changed dramatically. The regional wholesale markets that now trade over two-thirds of the nation's electricity under FERC oversight have been in existence for only fifteen years. And, as a result of the restructuring (partial deregulation) of the 1990s, another major change took place at the retail level. Consumers in sixteen states and the District of Columbia can choose to have their electricity delivered by suppliers other than their utilities. In Maryland, where the events leading to *Hughes* took place, roughly one-fourth of all residential customers are served in this fashion.

Altering the Jurisdictional Boundaries.

The result is a complex and diverse system of electricity generation, transmission and delivery that is evolving rapidly. The FPA's drafters would have considerable difficulty recognizing today's grid. The statute's core provisions, however, are virtually unchanged since 1935, when FDR was a year away from trouncing Alf Landon, the number one movie was Clark Gable's *Mutiny on the Bounty*, and a pound of sugar cost five cents. Under the FPA, FERC regulates the transmission of electricity in interstate commerce and rates, terms and conditions of wholesale sales (any sales that are for resale, that is, not to an eventual consumer). It also has the power to order a remedy if it finds a ''rule, regulation, practice or contract affecting such [wholesale] rate'' to be ''unjust, unreasonable, unduly discriminatory or preferential.'' The states regulate retail sales to end users, siting of power plants and transmission lines, and other matters. This jurisdictional divide between ''wholesale'' and ''retail'' reflected congressional intent to close the ''*Attleboro* gap,'' named for the 1927 Supreme Court decision that proclaimed that the federal government regulated sales of electricity that crossed state lines.

Given this split, the 80-year-old FPA framework still appears to call for FERC and the states to operate independently. In this formalistic reading, it is the last vestige of dual federalism, which is gone from the national scene in other regulated industries. A modern example of the shift is environmental law's ''cooperative federalism,'' where states and the EPA share responsibility for implementing environmental laws. The FPA's bright line is inappropriate as a jurisdictional test in the modern grid, and a system of shared, or concurrent federalism, would be more useful. If designed properly, it would minimize jurisdictional disputes while promoting federal and state initiatives for innovating on the grid, protecting reliability and other attributes.

The Supreme Court, however, cannot act simply because a statute may seem outmoded and ineffective to deal with today's realities. Without congressional action, of course, the Court could not change the FPA's text. Nor could it render an advisory opinion to reinterpret the FPA. Under the Constitution, there must be a case or controversy that the Court can hear. Even that is no guarantee that the case will find its way to the Supreme Court, which controls its docket and takes few of the cases presented to it. Usually, the Court takes cases where two or more federal appellate courts have split on the issues. *Hughes* featured no circuit split, for two lower courts agreed about the FPA's reach. Nor did *FERC v. EPSA*, which originated in the D.C. Circuit Court of Appeals, and *ONEOK*, which involved a Ninth Circuit decision without any corresponding decision of another circuit.

In the absence of a circuit split, the Court often chooses cases it believes are of utmost national importance—for example, the Texas challenge to President Barack Obama's immigration actions currently before the Court. Here, the Court felt compelled to tackle three cases that squarely presented variations on the question introduced above: Which level of government controls the transition underway in the electric grid? Inevitably, given the concurrent actions by both levels of government, conflicts were bound to— and did—arise. The Court's decisions addressed these conflicts and aimed to allocate responsibility for decisions affecting the grid going forward, within the limitations of statutory language written many years ago.

Impacts of FERC Supreme Court Rulings.

The first of the three decisions was 2015's *ONEOK v. Learjet*, in which Justice Stephen Breyer's majority opinion held that the NGA did not preempt actions taken under state antitrust laws to recover damages for manipulation of the natural gas market. Natural gas purchasers claimed that they had been overcharged due to pipelines' manipulation that affected prices in both wholesale and retail markets. The Court was therefore forced to choose whether FERC or state courts held sway. Justice Breyer rejected the argument that FERC had exclusive authority to protect pipeline customers because ''practices'' affecting wholesale rates for natural gas (in this case, the manipulative activities that raised prices) were exclusively within FERC's jurisdiction. Instead, he wrote, preemption of state laws must be determined with reference to ''the target at which the state law aims in determining whether [the] law is pre-empted.'' Because the antitrust laws govern a wide variety of industries, and not just natural gas pipelines, the state lawsuits would stand. If, however, the Court had been presented with a state law that ''aimed directly at the wholesale markets,'' the NGA would have preempted it. There was no further elaboration of what types of state laws ''aim directly'' at the wholesale markets, and more guidance would come later in *Hughes*.

In *FERC v. EPSA*, Justice Elena Kagan, writing for a six-justice majority, upheld a FERC rule requiring that regional grid operators compensate aggregated bids of ''demand response'' (reductions in electricity consumption in response to grid emergencies or price signals) at

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the same wholesale market price paid to generators in the wholesale energy markets. In its rule, FERC recognized that using demand-side measures to reduce peak stress on the grid can help balance supply and demand, improve reliability and decrease peak electricity prices. In the D.C. Circuit, the association representing power producers had argued successfully that FERC did not have authority under the FPA to make this rule, and that demand response was wholly within state jurisdiction because it affected end users.

The Court reversed this decision. It confirmed FERC's authority over ''practices'' affecting wholesale rates for electricity, stated that demand response was such a practice, and upheld FERC's rule. It rejected the argument that demand response was exclusively a state matter, finding that adding it to wholesale markets impacted prices in those markets, and that even if its policies would have impacts on the states and retail electricity rates, FERC was not foreclosed from acting. The Court did mention its ''notable solicitude'' for state demand response programs, and also added that FERC's rule allowed a state government to bar firms within its borders from taking part in wholesale energy markets.

The Court articulated a standard for upholding FERC initiatives such as this rule: FERC can regulate practices if wholesale rates are ''directly'' affected. To the Court, the demand response rule was a prime example of this because injecting demand reductions into wholesale markets immediately impacts wholesale prices. As opaque as this new test may appear, it has solid grounding in over 100 years of doctrine dating to the federal regulation of railroads in the early 20th century. And this decision's grant of authority, coupled with the well-recognized limitation that FERC's initiatives have a ''direct'' impact on wholesale rates that it sets, yields a clearer picture of FERC's role in a system of concurrent jurisdiction.

Indeed, *FERC v. EPSA* has enormous implications going forward, as it gives FERC considerable leeway to regulate matters affecting the wholesale markets. Consider two examples of how boldly FERC could use its ''directly affecting'' authority to craft policies for integrating clean and renewable energy into the electric grid, with environmental benefits such as reducing greenhouse gas emissions. The first involves a program that California's regional grid operator has proposed to integrate distributed energy resources (DERs) into wholesale markets. ''DERs'' are the small-scale resources on the customer side of the electric system, such as rooftop solar, energy storage, plug-in electric vehicles and demand response. At present, a rooftop solar owner could not bid his excess electricity into a wholesale market due to size limits on market participants and other restrictions. Under the California ''micro aggregation'' proposal, this would change. Firms acting as ''distributed energy resource providers'' would aggregate mixtures of resources and sell them into the wholesale markets. This could dramatically expand the amount of DERs in the California wholesale markets and create an entire new class of participants in the grid. A wide variety of firms—electric vehicle charging stations, demand response companies, home automation firms and partnerships between battery storage and solar leasing companies—have expressed interest in the California proposal.

California consumers would participate directly in the wholesale markets through these intermediaries, like the consumers in *FERC v. EPSA* who bid demand reductions into wholesale markets. Suppose that after California gained experience with this program, FERC believed it was successful and issued a rule that expanded it to other regions. Bids of DERs would directly impact wholesale rates: Adding new resources to a regional electricity mix would change prices, much as demand response lowered prices directly at times of peak demand. For that reason, FERC would almost certainly be acting properly under the new ''directly affecting'' standard if it expanded DER aggregation. The potential implications are staggering: In a multi-state region, FERC could allow a consumer with excess solar power to effectively sell it to consumers many miles away in a different state.

FERC could influence an even more dramatic transformation contemplated by California and New York (the latter in its ''Reforming the Energy Vision'' proceeding) that would establish ''distribution system operators'' (DSOs). These entities would fit between grid operators and customers, and coordinate a wide variety of activities, including the interface between DERs and the transmission system, and potentially all dispatch (determining which power generating units operate to serve customers). This function might be handled by existing utilities, as under certain iterations of the New York proposal, or by new, independent entities. Any exchange of electricity between a grid operator and a DSO would be a FERC-jurisdictional wholesale transaction, and FERC would have jurisdiction over other aspects of DSO operations under its ''directly affecting'' authority. In the long run, we might well see FERC adopt an ''open access distribution tariff'' specifying terms and conditions for this interaction, similar to the open access tariffs that govern access to the nation's transmission lines.

One set of issues *FERC v. EPSA* left unaddressed involved how far the states could go in influencing the grid's future direction, when their actions might impact the wholesale markets. This issue arose in *Hughes* in the context of a Maryland law that provided incentives for a new power plant to locate in the state. The state tied its incentive to prices in the ''capacity'' market that the PJM regional transmission organization, the grid operator in the region that includes Maryland, has operated since 2007. Capacity markets came into existence when regional planners recognized that electricity market prices alone would not prompt construction of new power plants. The PJM capacity market, for example, is designed to provide additional payments to generators that commit to sell power into PJM over the next three years.

Maryland officials believed these payments were insufficient to induce construction of new power plants in the state. The resulting state law created a ''contract for differences'' between the winning bidder and load-serving entities (LSEs, the term for utilities and retail suppliers that serve customers). If the contract price exceeded the capacity market price, LSEs would pay the difference to the plant owner. Because PJM already requires LSEs to purchase capacity for the demand they serve, the LSEs could therefore pay a premium above the market price. A group of challengers claimed this interfered with pricing in the wholesale markets, and the 4th U.S. Circuit Court of Appeals agreed. It found that the doctrine of field preemption applied, concluding that FERC's regulation of wholesale markets under

the FPA is so all-encompassing that it leaves no room for a state law.

As *Hughes* reached the Court, many observers believed that it would reject the lower court's field preemption approach. If upheld, FERC would have power to void all state initiatives that might impact the wholesale markets, no matter how substantial the impacts and how legitimate the states' goals might be. That is too imbalanced and blunt an instrument to govern the federal-state relationship. Some believed the Court would adopt a ''conflict preemption'' approach, under which a state law falls only if it conflicts with the intent of the federal statute.

Instead, the Court avoided crafting a broad principle that articulated which state initiatives would and would not conflict with the FPA. It issued a narrow decision that, like *FERC v. EPSA*, hewed closely to the statutory text. The Court overturned the Maryland law because it interfered with the system of setting wholesale rates through the capacity auctions. The Maryland program took the market payment as an input and gave the power plant owner the ability to change it. It allowed the owner to consider the subsidy and therefore bid differently into the market, which, the Court stated, would distort the market design and ''disregards'' the wholesale rate. Notwithstanding the Court's rote enunciation of preemption principles, this decision was grounded solely in an interpretation of the statute. This was evidenced in Justice Sonia Sotomayor's concurring opinion stating that she agreed with the majority decision on that basis.

The Court cautioned that it was only rejecting this particular subsidy program:

> Our holding is limited: We reject Maryland's program only because it disregards an interstate wholesale rate required by FERC. We therefore need not and do not address the permissibility of various other measures States might employ to encourage development of new or clean generation, including tax incentives, land grants, direct subsidies, construction of state-owned generation facilities, or re-regulation of the energy sector. Nothing in this opinion should be read to foreclose Maryland and other States from encouraging production of new or clean generation through measures ''untethered to a generator's wholesale market participation.'' So long as a State does not condition payment of funds on capacity clearing the auction, the State's program would not suffer from the fatal defect that renders Maryland's program unacceptable.

This language, taken together with Justice Sotomayor's concurrence and Justice Kagan's ''notable solicitude'' for the states in *FERC v. EPSA*, demonstrates the Court's reluctance to fashion a sweeping jurisdictional bright line. However, it leaves considerable uncertainty about what state actions are now allowed. Any other state incentive directly conditioned on expected market revenues would be as suspect as the Maryland program *Hughes* rejected, as the Court itself recognized shortly thereafter in refusing to hear an appeal of a 3rd Circuit decision voiding a similar New Jersey law.

What state incentives might survive judicial scrutiny? Consider one recognized by the Court itself — a state's tax incentive. Suppose Maryland gave a power plant owner a complete exemption from local property and other taxes. If it tied the incentive to making up a shortfall in market payments, this would likely be invalid. On the other hand, if it did not do so, the incentive would not be ''tethered'' (linked) to wholesale market participation (property taxes themselves do not ''aim directly'' at the market, in the language of *ONEOK*) and might be permissible. But it might have the same market distorting impact as Maryland's contract for differences mechanism if it provided the same amount of savings. The state could request that FERC approve the initiative, but that may not be likely if it impacts the wholesale markets. This example demonstrates that the laundry list of state initiatives the Court appears to endorse probably raises more questions than it answers.

Several Conclusions From These Cases.

Prior to *ONEOK*, *FERC v. EPSA* and *Hughes*, more than five years had elapsed since the Court had issued *any* decision involving the electric grid, much less three in the span of one year. Taken as a whole, several conclusions may be drawn from these cases. First, FERC has sweeping authority to transform the electric grid under the ''directly affecting'' test, subject to certain limitations. The states can take actions under broad-based statutes, such as antitrust and tax laws, and can pursue their own energy goals as long as their initiatives do not directly target FERC-jurisdictional wholesale rates.

Second, these decisions mark the end of dual federalism in electricity law because it can no longer be said that federal and state actions are disconnected. Instead, the Court has recognized, in all three cases, that the two levels of government are now interconnected for the foreseeable future. *FERC v. EPSA*'s ''directly affecting'' standard and *Hughes*' invalidation of the Maryland contract for differences give FERC authority while preserving latitude for states to act. Thus, both may act simultaneously even if it impacts the other: FERC may act even if it impacts retail rates, and the states can act if they don't ''disregard'' wholesale rates.

Finally, the jurisdictional division of responsibility between FERC and the states is now a matter of experimentation rather than a system governed by hard and fast rules. While the Court has given FERC the green light to act boldly, it is demonstrably uncomfortable with sorting out all of the potential consequences for the states. *Hughes* and *ONEOK* set overarching principles and allow for case-by-case determination of state interference with the federal scheme, rather than aspiring to doctrinal precision. ''Aiming at the wholesale market,'' ''untethered to a generator's wholesale market participation,'' and ''condition on participation in the wholesale market'' are words likely to guide federal courts for years to come.

In the absence of yet another Supreme Court decision clarifying its new positions on electricity federalism, more guidance is not likely to be forthcoming. This language offers little predictability, and states will have to either vet their statutory and regulatory initiatives with FERC or run the risk of litigation. As Professor Emily Hammond of the George Washington University Law School recently observed, ''The difficulty is that *Hughes* doesn't really tell us which state initiatives will survive future Supremacy Clause challenges, and which will fail. We are likely now in the position of awaiting 'Take Four.' '' In states whose utilities do not participate in organized wholesale markets, of course, the principles of

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traditional electricity regulation will continue to apply as before.

One conclusion implicit in all three of these decisions is that there is no need for a new or revamped Federal Power Act. While modern challenges seemed to have stressed this venerable statute near its conceptual breaking point, it has demonstrated its remarkable flexibility to handle today's challenges. Wisely, the Court appears to recognize that the FPA governs a complex, highly technical and rapidly evolving industry, that the Court lacks the expertise of federal and state regulators, and that it might make a serious misstep if it did more to precisely define how the FPA should govern the federal-state relationship going forward. But there has been no suggestion that statutory overhaul is necessary. On the contrary, the Court has relied explicitly on the statutory text to address matters never foreseen in 1935. To the Court, the FPA remains a solid foundation on which to build a robust, modern electric grid.