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Supreme Court Upholds FERC Rule on Pricing of Demand Response in Organized Electricity Markets

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On January 25, 2016, in a 6-2 decision, the Supreme Court reversed a decision of the Court of Appeals for the District of Columbia Circuit (D.C. Circuit) and in so doing unconditionally upheld the Federal Energy Regulatory Commission's (FERC) Order No. 745, a rule requiring that cost-effective demand response resources participating in organized energy markets be paid the full locational marginal price (LMP). *FERC v. Electric Power Supply Assn.*, 577 U.S.(2016).

FERC Order No. 745: Compensating Demand Response in Wholesale Energy Markets

Order No. 745, issued in March 2011, established a framework for compensating demand response bid into the organized energy markets operated by independent system operators (ISOs) and regional transmission organizations (RTOs). Demand response resources are typically retail electric consumers—often aggregated by third-party companies—that reduce their consumption of grid-provided electricity during specific hours called by the organized market operator. Order No. 745 built upon 2008's Order No. 719, which required organized markets to permit demand response resources to participate in the market but did not direct the level of compensation for those resources. Order No. 745 required RTOs and ISOs to pay the full LMP to cost-effective demand response resources—that is, the same price paid to generation. The organized market operator was required to apply a "net-benefits test" that would establish a price threshold at which the dispatch of a demand response resource would be cost-effective. Only when that test was met would demand response have to be paid the LMP.

D.C. Circuit Vacates Order No. 745

Order No. 745 was appealed to the D.C. Circuit. In a 2-1 decision, the D.C. Circuit held that FERC had exceeded its statutory authority under the Federal Power Act (FPA) in issuing Order No. 745, and that, in any case, the Commission had acted arbitrarily in requiring that demand response be paid LMP (*for more information, see VNF's Alert on the 2014 decision*). The D.C. Circuit majority held that demand response was not a "wholesale sale" of electricity subject to FERC jurisdiction under FPA Section 201, and that the Commission's authority over rules and regulations *affecting* wholesale rates under FPA Section 205 was not sufficient to bring regulation of demand response pricing under the its jurisdiction. The D.C. Circuit concluded that regulation of demand response pricing was reserved exclusively to the states under FPA Section 201. Additionally, the Court of Appeals found that, even if FERC had authority to promulgate rules concerning the pricing of demand response in wholesale markets, the particular decision to require use of LMP was arbitrary and capricious under the Administrative Procedure Act.

In a lengthy dissent, Judge Edwards argued that regulating demand response in wholesale markets fell within a permissible reading of FERC's statutory authority under FPA Section 205 as affecting wholesale prices (satisfying the *Chevron* test for construing ambiguous statutes), and that the Commission had reasonably and adequately explained its decision-making—including the level of compensation for demand response resources.

The Supreme Court Reverses the D.C. Circuit to Uphold Order No. 745

Justice Kagan's majority opinion, on behalf of six justices, reversed both holdings of the D.C. Circuit. The opinion found that FERC had sufficient authority under Section 205 of the FPA to regulate demand response in the organized markets, because such demand response directly affected prices of wholesale sales that clearly fall under FERC jurisdiction. The majority found that such regulation did not intrude on state authority to regulate—*i.e.,* set the price, terms and conditions of—retail sales. Additionally, the

majority further held that FERC had sufficiently justified its decision to require the payment of LMP for cost-effective demand response, rejecting the D.C. Circuit's finding that this determination was arbitrary and capricious. Justice Scalia, joined by Justice Thomas, dissented; Justice Alito did not participate.

On the jurisdictional issue, the Court held that FERC's obligation under Section 205(a) of the FPA to ensure that "all rules and regulations affecting or pertaining to [wholesale] rates" are just and reasonable *unambiguously* includes the ability to set the required level of compensation for any demand response resources participating in the wholesale energy markets. While the Court acknowledged that a capacious reading of "affecting" could unreasonably leave FERC's authority unbounded, FERC's regulation here was in line with the FPA because the regulated action *directly* affected wholesale rates. This "directly affecting" standard allowed the majority to draw a clear distinction between demand response compensation as compared with the more attenuated regulation of labor or materials costs.

The Court also found that Order No. 745 did not run afoul of the FPA's reservation of regulation of retail sales to the states. The majority noted that FERC expressly allowed states to preclude retail customers in their states from participating as a demand response provider in an organized market. The Court held that "[w]hen FERC regulates what takes place on the wholesale market, as part of carrying out its charge to improve how that market runs, then no matter the effect on retail rates, [the FPA] imposes no bar." (Opinion at 19) In other words, because Order No. 745 merely set rules for whether and how the wholesale markets incorporate demand response—and left it to the states to determine whether retail customers might participate—FERC's order did not impermissibly infringe on state authority. The Court also rejected the argument that demand response participation in wholesale markets might fall outside the purview of either Federal or state regulation. The Court reasoned that such an interpretation would leave a substantial regulatory gap, in contravention of the purpose of the FPA.

Finally, the Court reversed the D.C. Circuit's determination that Order No. 745's requirement that demand response resources be paid LMP was arbitrary and capricious. Expressing particular reluctance to overturn the technical and policy judgment of an expert agency in a complex area such as rate design, the majority held that FERC had weighed competing views and provided a sufficiently detailed explanation of its choice to require compensation at LMP when prices exceeded the net-benefits test threshold.

The dissent argued that because demand response transactions were not sales of energy for resale, FERC lacked authority to regulate them under the plain language of the FPA. Additionally, the dissent would have upheld the D.C. Circuit on the grounds that Order No. 745 impermissibly intruded on state jurisdiction by regulating retail customers.

Implications

The *FERC v. EPSA* decision may have several significant implications for demand response resources and future FERC regulations.

First and most notably, *FERC v. EPSA* allows demand response to continue to play a robust role in organized electricity markets. The D.C. Circuit's opinion had created significant uncertainty regarding the ability of organized markets to dispatch and compensate demand response, which is now clearly resolved. While a Supreme Court decision upholding the D.C. Circuit would have created turmoil for demand response providers and markets seeking to use demand response, the *FERC v. EPSA* decision has instead removed regulatory barriers to the expanded deployment of demand response resources in wholesale markets.

Second, the majority decision has now explicitly adopted a generally applicable standard for determining whether particular FERC actions are permissible under the FPA's authority to regulate practices "affecting" rates. Adopting a D.C. Circuit precedent, the Court now requires a demonstration that a practice *directly* affects wholesale rates for that practice to be subject to FERC's authority. Thus, the presence or absence of a "direct" effect upon rates may well become a crucial point for future cases regarding rules promulgated under the FPA or analogous sections of the Natural Gas Act.

Third, the majority explicitly recognizes that FERC's regulation of wholesale markets may affect retail activities regulated by states to some degree without running afoul of the limits of the FPA. The

majority's holding acknowledges that wholesale and retail markets "are not hermetically sealed from each other" (Opinion at 18) and that some amount of overlap is inevitable. Under *FERC v. EPSA*, FERC need not avoid all actions affecting retail markets.

Finally, this decision may affect the remaining Federal Power Act case before the Supreme Court in this term—*Hughes v. PPL EnergyPlus* ("*Hughes*"). *Hughes* presents another opportunity for the Court to further delineate the relationship between state and federal regulation in the electricity industry. In *Hughes,* Maryland directed utilities in the state to enter into long-term contracts with a new generator, using a contract for differences pricing mechanism tied to the revenues received by the generator in the wholesale market. The lower courts found that this program—as well as a similar New Jersey program—impermissibly interfered with Federal authority over wholesale markets by affecting the level of wholesale market compensation for the selected generator. The upcoming decision in *Hughes* may shed further light on the extent to which state retail market regulation may permissibly affect FERC-jurisdictional wholesale markets.

For more information

For assistance or additional information, please contact David Yaffe, Doug Smith, or anyone within the firm's Electricity practice group.

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