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COMMENTARY

D.C. Circuit Curbs FERC Authority Over Key Electricity Conservation Programs: Demand Response Deemed Beyond Federal Control

In a significant blow to the authority of the Federal Energy Regulatory Commission ("FERC" or "Commission") over incentive-based electricity conservation measures known as demand response, the United States Court of Appeals for the District of Columbia Circuit vacated a seminal FERC rulemaking order in its entirety as *ultra vires*. Order No. 745, issued in March 2011, required each FERC-approved Regional Transmission Organization ("RTO") and Independent System Operator ("ISO") to modify its energy market tariff to require that a demand response resource be paid the full price established for generators that sell electric energy (known as the locational marginal price) when the demand response resource reduces or limits it electricity consumption.[1] In the D.C. Circuit's May 23, 2014 decision, *Electric Power Supply Ass'n v. FERC ("EPSA")*, the court concluded that Order No. 745 exceeded FERC's authority under the Federal Power Act ("FPA").[2] "Because the Federal Power Act unambiguously restricts FERC from regulating the retail market,"[3] the court held that the FPA foreclosed FERC's claimed regulatory authority over demand response.[4] The court's decision in *EPSA* has long-term implications for FERC's authority to regulate demand response in the energy, capacity, and ancillary services markets, as well as FERC's authority to regulate practices that "affect" jurisdictional rates under FPA Sections 205 and 206, as limited by FPA Section 201.

The *EPSA* Decision

FERC Orders Regulating Demand Response Resources

At issue in *EPSA* is Order No. 745 in which FERC required RTOs and ISOs to implement or amend energy market tariffs to compensate providers of demand response resources based on the marginal value of the resource—the same method ordinarily used to determine payments to generators producing electric energy. Although Order No. 745 regulates compensation in the energy markets, demand response resources also participate in ancillary services markets and capacity markets.

FERC's regulations define "demand response" as "a reduction in the consumption of electric energy by customers from their expected consumption in response to an increase in the price of electric energy or to incentive payments designed to induce lower consumption of electric energy."[5] Order No. 745 divided demand response in the energy market into two categories: (i) "price-responsive demand response,"

which corresponds with higher prices for retail electricity; and (ii) "incentive payments," which are paid to aggregators of demand response resources who agree to reduce or forgo retail electricity purchases at certain times.[6] FERC limited Order No. 745's compensation requirements to "incentive payments" on the basis that these payments constituted "wholesale demand response," whereas "price-responsive demand response" is a "retail-level demand response."[7] Order No. 745 also established a method for allocating the costs of demand response payments "among all customers who benefit from the lower" energy market price that results from demand response participation in the market.[8] These costs were to be allocated proportionally among all energy market participants when demand response resources are participating in the market.[9]

The D.C. Circuit's *EPSA* Decision Holds that FPA Section 201 Unambiguously Limits FERC's Authority Over Practices that "Affect" Wholesale Rates

FERC attempted to persuade the court that Order No. 745's directive for incentive payments for demand response resources is permissible because demand response affects rates in connection with transactions that are squarely within FERC's authority to regulate—wholesale sales of electricity.[10] Notwithstanding the court's recognition in *EPSA* that "demand response is a complex matter that lies at the confluence of state and federal jurisdiction,"[11] the court did not defer to FERC's interpretation of its statutory authority. Rather, the court found FERC's distinction between "retail demand response" and "wholesale demand response" meaningless and "a fiction."[12] In the court's view, if FERC has the authority to regulate so-called "wholesale demand response" under Order No. 745's rationale, FERC necessarily could regulate "retail demand response" in the same way.[13] The EPSA decision rejects FERC's argument that "when retail consumers voluntarily participate in the wholesale market, they fall within the Commission's exclusive jurisdiction to make rules for that market."[14] According to the court, paying demand response resources not to engage in a certain activity (electricity consumption) in the retail market is equivalent to direct regulation of the retail market.[15] "The fact that the Commission is only 'luring' the resource to enter the market instead of requiring entry does not undercut the force of Petitioners' challenge. The lure is change of the retail rate."[16]

While acknowledging that demand response "affects" the wholesale market, which might seem to validate FERC's actions in light of its jurisdiction under FPA Sections 205 and 206 over rules and regulations "affecting" wholesale rates, the court reasoned that FERC's authority would be "almost limitless" if FERC were able to require a change in the retail market simply because that market has an impact on the upstream wholesale market.[17] Under FERC's approach, the Commission "could ostensibly [be authorized] to regulate any number of areas, including the steel, fuel, and labor markets" because those markets too can affect the market for wholesale electricity sales.[18] The EPSA decision resolves FERC's jurisdiction at Chevron's first step, where the "[t]he question is 'whether the statutory text forecloses the agency's assertion of authority.'"[19] The court interpreted FPA Sections 205 and 206 in light of the FPA as a whole, focusing on FPA Section 201's express limitation on FERC's authority over state regulatory issues. FPA Section 201 grants FERC jurisdiction "only to those matters which are not subject to regulation by the States."[20]

EPSA holds that FPA Section 201's limitation can be overcome only where Congress has provided FERC a "clear and specific grant of jurisdiction" over the state regulatory issue.[21] The court concluded that FERC's "broad" interpretation of what "affects rates" under FPA Sections 205 and 206 does not constitute such an express grant.[22] "Otherwise, FERC could engage in direct regulation of the retail market whenever the retail market affects the wholesale market, which would render the retail market prohibition useless."[23]

EPSA also distinguishes *Connecticut Department of Public Utility Control v. FERC,* which upheld FERC's regulation of the installed capacity markets on the basis that the markets affect jurisdictional rates.[24] Although installed capacity market regulations resulted in the construction of new generation facilities, a matter subject to exclusive state control, *EPSA* concluded that the regulations at issue in Connecticut did not directly regulate the construction of new generation.[25] *EPSA* distinguished between rules that incidentally result in increases in non-jurisdictional activities (i.e., the "logical byproduct" of FERC's regulation in *Connecticut* was the construction of additional generation facilities),[26] and rules intending to alter nonjurisdictional activities (i.e., a rule that "reaches directly into the retail market to draw retail consumers into [FERC's] scheme").[27] Rules that incidentally incentivize

nonjurisdictional actions are not ultra vires, whereas rules that intend a change in nonjurisdictional behavior are a form of direct regulation and therefore are beyond the scope of FERC's authority.[28] In *EPSA*, "FERC's metaphysical distinction between price-responsive demand and incentive-based demand [could not] solve its jurisdictional quandary."[29]

EPSA Rejects Jurisdictional Claim Based on a Statement of Policy

As additional support for its jurisdiction, FERC relied on a congressional policy statement accompanying the Energy Policy Act of 2005, which stated that federal facilitation of demand response and removal of unnecessary barriers to demand response were intended by the Act.[30] The court concluded that FERC misinterpreted the congressional policy statement.[31] Even if FERC's interpretation of the policy statement had been correct, *EPSA* holds that FERC "cannot rely on the [policy] section for an independent source of power."[32] Such statements are merely "statements of policy," and "not delegations of regulatory authority."[33] At most, congressional policy statements can be used to assist the court (or FERC) in delineating "the contours of statutory authority."[34]

What Comes Next?

The *EPSA* decision is likely to have a wide-ranging impact on FERC's efforts to regulate the way demand response resources participate in RTO/ISO markets. FERC, the RTOs, and market participants are likely to spend considerable time and effort coming to grips with the repercussions of the court's decision.

Other Demand Response Products Such As Ancillary Services Markets and Capacity Markets

In the wholesale energy markets, energy is supplied to meet the actual demand for electricity, and such demand fluctuates both daily and in real time. In contrast, in the wholesale capacity market, a seller makes a commitment, in advance, that the seller has the capability to meet a specified quantity of customer demand when called upon to do so.[35] The concept of capacity is particularly important to planning in advance for, and meeting, the year's anticipated peak demand for electricity. Ancillary services are distinct from energy and capacity. As relevant here, ancillary services rely on resources other than physical transmission facilities to support the transmission of electric energy from seller to purchaser and to assist transmitting utilities in maintaining reliable operation of the transmission system.

The *EPSA* decision directly applies to Order No. 745, which imposed specific requirements on the way demand response resources participate in the RTO-operated energy markets. However, demand response resources currently participate in both the ancillary services market and the capacity market. *EPSA*'s broad holding, premised on demand response being a retail market activity subject to state regulation, may well prompt challenges to the way FERC regulates these other markets. In both the ancillary services markets and capacity markets, demand response resources are paid to reduce consumption in the retail energy market in response to particular criteria.[36] But the RTO tariffs governing demand response resource participation in each of these markets have been developed in part through voluntary actions resulting from the RTO stakeholder process and in part in response to specific FERC requirements. Unraveling specific aspects of the energy market tariffs, or the tariffs governing other markets, will have repercussions for aspects of the markets over which FERC clearly has jurisdiction.

The process of reevaluating the way FERC regulates these markets already has begun. For example, one FPA Section 206 complaint based on *EPSA* already has been filed, on May 23, 2014, challenging those aspects of PJM's FERC-approved tariff that apply to demand response resource participation in the capacity markets.[37] The complaint relies on EPSA's holding that the FPA "unambiguously restricts FERC from regulating the retail market."[38] This complaint is likely to be the first of many actions by market participants, RTOs, and FERC itself to determine the permissible contours of policies governing demand response resources in the nation's wholesale markets.

Other Cases Where FERC Has Justified Its Proposals Using Its Regulatory Authority Over Practices That "Affect" Rates

The *EPSA* decision's approach to statutory interpretation may have ripple effects in other contexts. *EPSA* concludes that FERC cannot broadly interpret FPA Sections 205 and 206 to sidestep FPA Section 201's specific limitation.[39] In reaching this conclusion, *EPSA* relies on a bedrock rule of statutory

interpretation that "the specific governs the general."[40] This is particularly true "when the two are interrelated and closely positioned, both in fact being parts of" the same statutory scheme.[41] The *EPSA* decision applies this canon of statutory interpretation in restricting FERC's authority under FPA Sections 205 and 206, delineating FPA Section 201's limitation as a *specific* provision, whereas the grant of authority under FPA Sections 205 and 206 is a *general* provision.[42] This reasoning may affect ongoing and future challenges to FERC regulations and actions.

For example, in a pending appeal, FERC is defending its actions under Order No. 1000, a landmark rulemaking order governing electric transmission planning, including the selection of the entity to build new transmission facilities, on the ground that Order No. 1000 governs a practice that "affects" FERC-jurisdictional rates.[43] But, like retail energy markets, transmission construction (including siting and permitting) is subject exclusively to state regulation.[44] Parties to that appeal have filed letters with the D.C. Circuit arguing that *EPSA*'s interpretation of FPA Section 205 and 206 limits FERC's authority over regional transmission planning.[45] Order No. 1000 provides one example of how *EPSA* may be used by stakeholders to oppose future assertions of authority by FERC over practices "affecting" jurisdictional rates.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or the lawyer listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Ken Driver
Washington
+1.202.879.7629
kbdriver@jonesday.com

Matthew R. McGuire
Washington
+1.202.879.3767
mmcguire@jonesday.com

James C. Beh
Washington
+1.202.879.3430
jcbeh@jonesday.com

Kevin J. McIntyre
Washington
+1.202.879.3917
kjmcintyre@jonesday.com

Mosby G. Perrow
Houston
+1.832.239.3895
mgperrow@jonesday.com

Endnotes

1 *Demand Response Compensation in Organized Wholesale Energy Markets*, Order No. 745, FERC Stats. & Regs. ¶ 31,322 at P 2 (2011), *on reh'g and clarification*, Order No. 745-A, 137 FERC ¶ 61,215 (2011), reh'g denied, Order No. 745-B, 138 FERC ¶ 61,148 (2012).

2 *Elec. Power Supply Ass'n v. FERC*, No. 11-1486, slip op. at 14 (D.C. Cir. May 23, 2014). On June 11, 2014, FERC issued a press release stating that it will ask the full D.C. Circuit to rehear *en banc* the *EPSA* decision.

3 *Id*. slip op. at 14.

4 *Id*. slip op. at 6.

5 18 C.F.R. § 35.28(b)(4) (2013).

6 *See* EPSA slip op. at 6-7, 10.

7 *Id*.

8 Order No. 745 at P 5.

9 *EPSA* slip op. at 5.

10 *Id*. slip op. at 7-8.

11 *Id*. slip op. at 3 (quoting Order No. 745).

12 *Id*. slip op. at 6-7.

13 Id. slip op. at 10.

14 Id. slip op. at 6.

15 Id. slip op. at 11.

16 Id.

17 Id. slip op. at 10.

18 Id. slip op. at 8.

19 Id. slip op. at 5-6 (quoting City of Arlington, Tex. v. FCC, 133 S. Ct. 1863, 1871 (2013))

20 Id. slip op. at 8; see also 16 U.S.C. § 824(a) (2012).

21 EPSA slip op. at 9 (quoting New York v. FERC, 535 U.S. 1, 22 (2002)).

22 Id. slip op. at 9.

23 Id.

24 Connecticut Dept. of Pub. Utility Control v. FERC, 569 F.3d 477 (D.C. Cir. 2009).

25 EPSA slip op. at 10 & n.2.

26 *Id*. slip op. at 10 n.2.

27 *Id*.

28 *Id*.

29 *Id*. slip op. at 11.

30 *Id*. slip op. at 12; *see also* Pub. L. No. 109-58, § 1252(f), 119 Stat. 594, 966 (2005).

31 *Id*. slip op. at 11-12.

32 *Id*. slip op. at 12.

33 *Id*. slip op. at 12 (quoting *Comcast Corp. v. FCC*, 600 F.3d 642, 654 (D.C. Cir. 2010)).

34 *Id*. slip op. at 12 (quoting Comcast, 600 F.3d at 654).

35 *See*, e.g., *Connecticut Dept. of Pub. Util. v. FERC*, 569 F. 3d 477, 479 (D.C. Cir. 2009).

36 *See EPSA* slip op. at 11.

37 Complaint of FirstEnergy Service Company, Docket No. EL14-55-000 (filed May 23, 2014).

38 *Id*. slip op. at 14.

39 *Id*. slip op. at 8-9.

40 *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065, 2071 (2012) (citation omitted); *see also EPSA* slip op. at 9 (citing *RadLAX*, 132 S. Ct. at 2071).

41 *RadLAX*, 132 S. Ct. at 2071 (quoting *HCSC-Laundry v. United States*, 450 U.S. 1, 6 (1981) (per curiam)).

42 *See EPSA* slip op. at 8-9.

43 Brief of Respondent FERC, *South Carolina Pub. Serv. v. FERC*, No. 12-1232, at 34 (D.C. Cir. May 25, 2012); *see also Transmission Planning and Cost Allocation by Transmission Owning and Operating Public Utilities,* Order No. 1000-A, 139 FERC ¶ 61,132 at P 151 ("[T]he Commission's authority arises from the fact that planning is a practice that affects rates . . . ."), *order on reh'g*, Order No. 1000-B, 41 FERC ¶ 61,044 (2012).

44 *See*, e.g., *Piedmont Environmental Council v. FERC*, 558 F.3d 304, 314-15 (4th Cir. 2009) (discussing the limits on FERC's backstop authority under FPA Section 216).

45 *See* Fed. R. App. P. 28(j) letters filed in No. 12-1232 (D.C. Cir.) by PSEG Companies (June 6, 2014), ECF No. 238; South Carolina Public Service Authority, (May 30, 2014), ECF No. 237; and Alabama Public Service Commission, (May 30, 2014), ECF No. 236.