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Client Alert Commentary

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Federal Appeals Court Decision Could Create Risk for Demand Response Suppliers in Wholesale Markets

D.C. Circuit Court vacates FERC Order No. 745 on demand response compensation, determining that FERC does not have jurisdiction.

On May 23, 2014, the U.S. Court of Appeals for the D.C. Circuit Court issued a decision in *Electric Power Supply Association v. FERC* (*EPSA*) vacating and remanding the Federal Energy Regulatory Commission's (FERC's or Commission's) Order No. 745, which provides compensation for demand response resources that participate in the energy markets administered by Regional Transmission Organizations (RTOs) and Independent System Operators (ISOs). The decision holds that FERC did not have jurisdiction under the Federal Power Act (FPA) to issue Order No. 745 because demand response is part of the retail market, which is exclusively within the states' jurisdiction to regulate. Furthermore, the court holds that even if FERC did have jurisdiction under the FPA to issue Order No. 745, the Order would still fail as arbitrary and capricious because FERC failed to properly consider concerns of the petitioner and other parties that Order No. 745 would result in unjust and unreasonable rates because it would overcompensate demand response resources.

Background

As detailed in a prior Clean Energy Law Report post, Order No. 745 requires demand response resources participating in the organized wholesale energy markets administered by RTOs and ISOs to be paid the full market clearing locational marginal price of energy (LMP) where (1) the demand response resource is capable of replacing a generation resource and (2) dispatch of the resource is deemed to be cost-effective through the application of a "net benefits test." The Energy Power Supply Association appealed Order No. 745 after FERC upheld the Order on rehearing. Both Order No. 745 and FERC's order on rehearing, Order No. 745-A, were issued over the dissent of FERC Commissioner Philip D. Moeller, who argued that paying demand response resources full LMP overcompensates those resources because in addition to any incentive payments received, those resources also receive the benefit of not paying the cost of retail energy consumption that they otherwise would have incurred.

In its orders and on brief before the D.C. Circuit, FERC clarified that its jurisdiction under the FPA over demand response was not direct because FERC does not view demand response as a wholesale sale of electricity, or even a sale of electricity. Instead, FERC asserted that Sections 205 and 206 of the FPA granted it jurisdiction because these provisions require FERC to ensure that all rules and regulations affecting rates in connection with the wholesale sale of electricity are just and reasonable. FERC also asserted that its exercise of jurisdiction through Order No. 745 was supported by the Congressional policy statement in § 1292(f) of the Energy Policy Act of 2005 (EPAct of 2005), which encourages the removal of barriers to demand response participation in organized wholesale energy markets.

EPSA Decision

In *EPSA* the D.C. Circuit squarely rejects FERC's reliance on its "affecting" jurisdiction under Sections 205 and 206 of the FPA as unreasonable because it "has no limiting principle" and "could ostensibly authorize FERC to regulate any number of areas, including the steel, fuel and labor markets." The court instead finds that the limits of FERC's "affecting" jurisdiction are best determined by Section 201 of the FPA, which states that FERC's jurisdiction "extend[s] only to those matters which are not subject to regulation by the States." The court thus finds that the FPA unambiguously restricts FERC from regulating the retail market and Order No. 745 results in impermissible regulation under the FPA because demand response is part of the retail market—"[i]t involves *retail* customers, their decision whether to purchase *at retail*, and the levels of *retail* electricity consumption."

The court also rejects FERC's reliance on EPAct of 2005, finding that FERC cannot rely on a statement of Congressional policy as an independent source of jurisdictional authority. Moreover, the court finds that in Order No. 745 FERC "went far beyond removing barriers to demand response resources" and instead drew these resources into the wholesale market and dictated the compensation they must receive.

As mentioned above, in *EPSA* the D.C. Circuit did not stop at invalidating Order No. 745 on jurisdictional grounds. The court also finds that FERC failed to properly consider and engage "reasonable (and persuasive)" arguments by Commissioner Moeller and various parties that Order No. 745 overcompensates demand response providers. The court finds that FERC did not adequately explain how Order No. 745 results in just and reasonable compensation and therefore holds that the Order is arbitrary and capricious.

Dissent

Judge Edwards issued a strong dissent from the majority's decision in *EPSA*. Judge Edwards begins his dissent observing that the D.C. Circuit and the Supreme Court have recognized that the jurisdictional line between FERC's wholesale jurisdiction and the states' retail jurisdiction "is neither neat nor tidy." He then asserts that Order No. 745 could be viewed as falling on either side of this jurisdictional line as the FPA does not unambiguously speak to the issue. Given this asserted ambiguity, he argues that the court should defer to FERC's interpretation under the *Chevron* doctrine. Judge Edwards emphasizes that Order No. 745 does not intrude on state authority over retail sales or markets because the order only calls for compensation of demand response resources where such resources are permitted under state law to participate in organized wholesale energy markets. He asserts that there is a limiting principle to FERC's jurisdictional authority under Sections 205 and 206 of the FPA: FERC cannot directly regulate retail sales and FERC can only issue regulations that either directly affect or are closely related to wholesale rates. Judge Edwards concludes that Order No. 745 falls comfortably within this limiting principle. Finally, Judge Edwards asserts that FERC did respond to arguments that Order No. 745 overcompensates demand response providers. He argues that the court should defer to FERC regarding the proper compensation scheme because the Commission put forth a reasonable explanation that compensating demand response resources at full LMP would provide the proper incentive for demand response providers to overcome market barriers.

Vacatur and Remand

The D.C. Circuit's decision vacating and remanding Order No. 745 will not go into effect immediately because the court, on its own motion, is withholding the mandate of its decision until seven days after the disposition of any timely petition for rehearing. In order to be timely, a rehearing request must be submitted within 45 days from the court's decision. Beyond rehearing before the D.C. Circuit any subsequent appeal in this case that might be heard would be before the US Supreme Court.

Implications

Order No. 745 is limited to the compensation to be provided to demand response resources in organized wholesale energy markets. However, the scope of the D.C. Circuit's holding in *EPSA* that FERC does not have jurisdiction under the FPA over demand response because demand response is part of the retail market is potentially much broader and could impact other organized wholesale power markets for which FERC has required or approved participation of demand response resources. For example, in 2008 and 2009, FERC required RTOs and ISOs to allow for participation of demand response resources in RTO and ISO ancillary service markets on a comparable basis to other resources in Order Nos. 719 and 719-A (and in this latter order FERC relied on its "affecting" jurisdiction). In addition, prior to these orders, FERC had already approved tariffs for RTOs and ISOs that included provisions regarding participation of demand response resources in their capacity markets (though the jurisdictional issues addressed in those orders did not relate specially to whether FERC has jurisdiction to approve demand response resources participation in the capacity markets). And, in some of the earliest orders approving the participation of demand response resources in organized wholesale markets, such as emergency load response programs, FERC based its jurisdiction on a finding that such participation was considered to be wholesale in nature when it involved the sale for resale of energy that would ordinarily have been consumed by a retail consumer.

The potentially broader impact of the holding in *EPSA* is not just theoretical. On the same day that the D.C. Circuit issued its decision in *EPSA,* a participant in the capacity market administered by PJM Interconnection LLC (PJM) filed an emergency complaint at FERC requesting that FERC order PJM to remove all portions of its tariff allowing or requiring PJM to include demand response as suppliers in its capacity markets, with a refund effective date of May 23, 2014. This complaint further requests that FERC issue an order requiring PJM to delay the results of its most recent capacity auction (which was completed on May 23, 2014, and in which a total of more than 10,000 MW of demand response resources were procured) pending rehearing of *EPSA* because these auction results must be considered void and legally invalid because of the inclusion of demand response resources. Application of the court's holding in *EPSA* to prospectively or retroactively disallow demand response resources to participate in organized wholesale capacity markets could have serious consequences for demand response suppliers because demand response resources derive significantly more revenue from participation in these markets than they do from participation in organized wholesale energy markets. For example, the 2013 State of the Market Report for PJM, that PJM's capacity market was "the primary source of revenue to participants in PJM demand response programs."

Conclusion

The D.C. Circuit's decision in *EPSA* raises the possibility that if demand response provisions in existing ISO and RTO tariffs are determined to be void or legally invalid, demand response providers in certain instances could be forced to issue refunds for the compensation they have received. Market analysts see the decision as creating risk for demand response suppliers participating in wholesale markets. PJM has issued a statement that "PJM hereby advises that it will continue to abide by the terms of its Tariff and Operating Agreement as relates to demand response in its markets."

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