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Implications for the Power Sector of Recent Rulings by U.S. Supreme Court and FERC

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One of the most important issues currently facing the power industry is the potential conflict between federal and state roles in power supply planning. Two recent developments at the federal level bear directly on this issue.

First, on April 19th, in *Hughes v. Talen Energy Marketing LLC et al.* (***Hughes***)*,* the U.S. Supreme Court struck down on federal pre-emption grounds a Maryland program intended to support construction of a new 725 MW natural gas-fired generating plant in Maryland. The Court held, by an 8-0 vote, that the program invaded "FERC's [exclusive] regulatory turf" over determination of wholesale rates for electricity.[1]

Then, just eight days later, on April 27th, the Federal Energy Regulatory Commission (FERC) blocked implementation of two Purchase Power Agreements (PPAs) approved by the Ohio Public Utilities Commission (Ohio PUC). The PPAs, involving FirstEnergy Corporation (FirstEnergy) and American Electric Power Company Inc. (AEP) were intended to support continued operation of more than 6,000 MW of existing coal and nuclear generation in Ohio.

From a legal perspective, neither ruling came as a surprise. The two rulings, however, highlight the obstacles to state efforts to support continued operation of existing generating units and construction of new plants. Over the next few years, sparring over this issue could intensify. FERC, state regulators, the U.S. Environmental Protection Agency (EPA) and the courts are all likely to be involved.

The stakes in resolving this issue are high. Power producers, lenders to the power sector, equity investors, and end-use customers will need to monitor the legal wrangling carefully.

In the wake of *Hughes* and the FERC Orders, generation owners and state regulators will be required to explore new mechanisms to support continued operation of existing coal and nuclear generating units and to achieve long-term resource planning goals without running afoul of FERC.

The success of these efforts could have a major impact on market value of new and existing generating units, decisions regarding whether to retire marginally economic coal and nuclear plants, the attractiveness of building new generation and the frequency and severity of future price spikes.

[1] *Hughes, Slip. Op.* at 12.

Issues regarding the respective roles of FERC and the states also go to core of implementation of the Obama Administration's Clean Power Plan, which seeks to impose state-by-state limits on power plant emissions of CO2.

Tension between Federal and State Jurisdiction over Electric Generation and Power Supply Planning

The Federal Power Act (FPA) establishes a seemingly bright line with respect to federal and state jurisdiction over electric generation: FERC has exclusive jurisdiction over the rates for wholesale sale of electricity; states are responsible for determining whether to authorize construction of new generation and power plant siting. States also set rates for retail sales of electricity. Currently, competitive wholesale markets exist in seven regions of the country, which account for more than 70 percent of total electricity sales in the U.S.

All seven markets have established competitive energy markets. In addition, four of the seven Regional Transmission Organizations (RTOs) have established separate markets for capacity. While the rules for capacity markets vary considerably from region-to-region, they generally require the grid operator to procure the rights to sufficient generating capacity to meet expected peak electricity demand one to three years ahead of time. In most regions, this procurement occurs through a competitive auction process in which successful bidders are paid the market clearing price for the highest-priced resource that clears the market. In PJM Interconnection (PJM), the RTO that encompasses Maryland and Ohio, capacity is generally procured three years ahead of time for a period of one year (e.g., in 2016, for calendar year 2019).

In recent years, capacity markets increasingly have become the primary driver of the economic viability of existing generating units and proposed new plants.

Dispute in the Maryland Case

The dispute in *Hughes* arose at a time when prices for capacity in PJM had been rising rapidly, with particularly steep increases for electricity purchasers in Maryland, which has only limited interconnections to the rest of the PJM. In response, the state enacted legislation requiring the Maryland Public Service Commission (PSC) to take action to protect end use customers from excessive costs.

The PSC initially responded by requesting a modification of the rules for the PJM capacity auction to allow the capacity payments to extend for ten years for new generation built in the state. The PSC contended that that was the minimum period needed to provide power plant developers sufficient price certainty to finance construction of new generation.

FERC rejected this proposal. In response, the PSC developed an alternative approach, under which power plant developers were given an opportunity to submit bids to build a new natural gas-fired generating unit in the state. Rather than entering into a traditional purchase and sales agreement, however, the successful bidder was asked to:

1. Make a commitment to build new generation in Maryland and sell the energy and capacity into the PJM market; and

2. Enter into a contract for differences with the Electric Distribution Companies (EDCs) in the state, under which payments would be made to or received by the generator based upon the difference between the market clearing price in the PJM auction and the contract price.

Under this arrangement, the generator was assured of receiving a pre-determined price for capacity, giving it price certainty. The capacity charges paid by end users for the 725 MW unit covered by the program was capped at the contract price.

Further, by encouraging the construction of new generation in the state, the program was intended to reduce the market clearing price for capacity in the Maryland capacity zone, potentially achieving large savings for electricity customers in state.

Court's Findings

In a unanimous decision, the Supreme Court upheld an earlier Fourth Circuit ruling that the Maryland program violated the Supremacy Clause. Citing well-established precedent, Justice Ginsberg, in her opinion for the Court, observed that a state law or action is preempted if, under the particular facts and circumstances of the case, it "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[2]

In this instance, the Court ruled, the contract for differences "is indistinguishable from a traditional bilateral contract for the sale of capacity." FERC had "approved the PJM capacity auction as the sole rate-setting mechanism for sales of capacity to PJM, and… deemed the clearing price *per se* to be just and reasonable."[3] By allowing the successful generator to recover a different amount, the contract for differences interfered with FERC's "plenary authority over wholesale rates." *Id.*

In reaching this conclusion, the Court emphasized that its holding was "limited."[4] Justice Ginsberg noted that in "one significant respect" the contract for differences differed from a typical bilateral contract in that it "did not transfer ownership of the capacity from one party to another."[5] Instead, the generator still owned the capacity, but was entitled to be paid the capacity prices provided for under the contract for differences even when the capacity price established in the PJM auction differed. The Court stated that, if the generator had not been required to bid into the auction, "the state's program would not suffer from the fatal defect that renders Maryland's program unacceptable."[6]

Significance of the Court's Ruling

There is no reason not to take at face value the Court's statement that its holding in *Hughes* is "limited." The Court went out of its way to emphasize that "[n]othing in this opinion should be read to foreclose… states from encouraging production of new or clean generation through measures 'untethered to a generator's wholesale market participation.'"[7]

Further, the Court's emphasis on the transfer of ownership suggests that if control over capacity rights had been transferred to the EDCs and the EDCs bid it into the auction at a lower price, the Maryland program might have survived judicial review.

[2] *Crosby v. National Foreign Trade Council*, 530 U.S. 363, 373 (2000).
[3] *Slip Op.* at 12.
[4] *Slip Op.* at 15.
[5] *Slip Op.* at 14.
[6] *Slip Op.* at 15.
[7] *Slip Op.* at 15.

The Court's decision, however, is likely to encourage challenges to any state program that attempts to encourage construction of new generation or support continued operation of existing plants. The resolution of these challenges could often depend on the specific mechanisms used to implement the state's resource planning goals.

Considerable care will be required, therefore, in attempting to structure support mechanisms that can withstand judicial review. In addition, advice from regulatory counsel will be needed to assess the likely outcome of future litigation regarding the respective roles of FERC and the states. The results of this battle could affect the future value not just of plants that are subject to special arrangements, but every power plant whose revenues depend upon market prices for energy and capacity.

FERC Order Striking Down Purchase Power Agreements Approved by the Ohio PUC

While the facts and circumstances in the FirstEnergy and AEP disputes differ slightly, the basic issues are the same. In each instances, the parent company owns both one or more retail distribution companies in Ohio and one or more affiliated generation companies with authority to sell power at market-based rates. The generation owned by the deregulated generation affiliates includes a number of aging, marginally economic coal-fired plants and, for FirstEnergy, the Davis-Besse nuclear plant.

While FirstEnergy and AEP each acted separately, the approach developed by each company was similar. In each instance:

- The retail distribution company (or companies) entered into an agreement to purchase power from its generation affiliate for eight years;
- Power was sold at a cost-based rate; and
- The retail distribution company was obligated to sell the energy and capacity acquired under the PPA into the PJM market.

Further, each company proposed a special Distribution Rider that flowed through to distribution customers the difference between the contract rate specified in the PPAs and market prices in PJM.

Functionally, therefore, the PPAs were similar to the contract for differences in *Hughes*, with three notable differences:

- Each PPA constituted a true bilateral contract;
- The PPAs apply to existing units; and
- The PPAs were linked to numerous other power supply commitments by *FirstEnergy and AEP* that went well beyond the terms and conditions of the PPAs themselves.

Finally, both FirstEnergy and AEP had previously been granted blanket waivers by FERC to enter into power sales agreements between affiliates. At least initially, therefore, the PPAs were subject to review by the Ohio PUC rather than FERC.

Ohio Proceedings and Filing of Complaints before FERC

The Ohio PPAs were filed with the Ohio PUC more than a year and a half ago and engendered an unusually large amount of controversy. A large number of parties, including other competitive wholesale suppliers, intervened. Some of the wholesale suppliers filed competing offers to sell power they contended would save billions of dollars for customers. On January 27th, prior to the PUC taking action, Dynegy, the Electric Power Supply Association (EPSA) and several other competitive suppliers filed complaints against FirstEnergy and AEP before FERC, asking the Commission to invalidate the PPAs.

On March 31st, the Ohio PUC approved both of the PPAs but specifically reserved the right to oversee each company's bidding into the PJM auction.

FERC Action

On April 27th, less than four weeks after the Ohio PUC acted, FERC issued orders granting each of the complaints, blocking implementation of the PPAs and requiring refunds retroactive to the date the complaints were filed.

FERC's rulings, like the Supreme Court's holding in *Hughes*, were narrow in scope. Specifically, the sole issue addressed by the Commission was whether to rescind the blanket waivers for affiliate transactions previously granted to FirstEnergy and AEP.

FERC routinely issues blanket waivers for power sales by merchant generators to retail affiliates in states that allow retail choice. These waivers are based on the Commission's finding in Order No. 697 that:

> … retail customers in retail choice states who choose to buy power from their local utility at cost-based rates are not … captive customers [of the affiliated companies] because, although they may choose not to do so, they have the ability to take service from a different supplier whose rates are set by the marketplace ….[8]

Both FirstEnergy and AEP argued that, since Ohio's retail choice law had not been modified since the original waivers had been granted, the Ohio PPAs were not subject to FERC review.

FERC squarely rejected this argument, finding that, while retail ratepayers still had a right to choose retail suppliers, under the PPA riders approved by the Ohio PUC, they were obligated to pay a surcharge even if they switched suppliers. As such, FERC ruled, they were:

> … involuntarily … in a situation in which [their] rates subsidize or support another entity—i.e., they must pay a non-bypassable generation-related charge, through the PPA Rider, representing a contract for price differences in wholesale ….service …irrespective of their retail provider….[9]

In FERC's view, this was precisely the harm FERC's policy sought to avoid, presenting the potential for "the inappropriate transfer of benefits from captive customers to shareholders."[10] Accordingly, FERC granted the complaints' request and rescinded the blanket waivers for both companies.

[8] *Electric Power Supply Association, et al. v. FirstEnergy Solutions Corporation, et al.*, 155 FERC ¶ 61,101 at P 57 (2016) (order on complaint) (***FirstEnergy***).

[9] *FirstEnergy* at P 60.

[10] *FirstEnergy* at P 64.

Further, FERC contended, its decision to rescind the affiliate waivers "does not frustrate or usurp the Ohio Commission's role in protecting retail customers."[11] Instead, FERC "has an independent role to ensure that wholesale sales … are just and reasonable and protect against affiliate abuse," which only FERC can exercise. *Id.*

Status of the Ohio PPAs

FERC's ruling was technical in nature, requiring FirstEnergy and AEP to revise their market-based rate tariffs. It does not prohibit FirstEnergy or AEP from filing PPAs with FERC and seeking Commission approval.

Under the Commission's rule, however, if the blanket waiver is not applicable, sales by merchant generators to affiliated franchise utilities are generally barred unless the generator can demonstrate that the sale is at or below competitive market rates. Meeting this standard typically requires conducting a fully transparent competitive bidding process administered by a third party.

Neither AEP nor FirstEnergy intends to follow this path. Instead, both companies have abandoned their PPAs. AEP has announced that it intends to seek state legislation allowing it to re-regulate some or all of its merchant generation in Ohio. FirstEnergy, for its part, has adopted a new strategy, asking the Ohio PUC to approve a hedging agreement that replicates the financial terms of its earlier proposal, but without the PPA.

FirstEnergy's revised approach, intended to bypass the need for FERC approval, has already drawn the ire of both environmental groups seeking to shut down the coal units and competitive suppliers. If the PUC grants FirstEnergy's request, its order is nearly certain to be challenged in federal courts and before FERC. FirstEnergy is likely to argue that FERC has no authority to regulate hedging arrangements, which are a mainstay of the power industry.

Opponents are likely to contend that from a functional standpoint, the new arrangement proposed by FirstEnergy is no different than the contract for differences challenged in *Hughes* and should be rejected on the same grounds.

Implications for Energy Markets and Resource Planning

Efforts by states to support construction of new generation and continued operation of existing generating units are not likely to end soon. Neither the Supreme Court's ruling in *Hughes* nor FERC's orders, however, create a clear pathway to accomplish these goals. With respect to new plants, the Supreme Court identified a number of mechanisms that states might consider to support construction of new generation, including "tax incentives, land grants, direct subsidies, construction of state-owned generation facilities, or re-regulation of the energy sector."[12]

The Court made clear, however, that its decision "did not address the permissibility of… [these]… measures." *Id.* Further, while tax incentives and land grants might pass muster, the practical and political obstacles to re-regulation are substantial. It also may be difficult to structure subsidies that avoid the pitfalls of the Maryland program and still benefit end-use customers.

[11] *FirstEnergy* at P 65.

[12] *Slip Op.* at 15.

With respect to existing plants, if anything the potential obstacles may be even more formidable. FERC's position is that any action that subsidizes operation of specific generating units, even on a short-term basis, can potentially distort the market, unfairly discriminating against other generators and deterring new generators from entering the market. It is not clear, therefore, what mechanisms to support existing generation (if any) might satisfy the Commission.

From the states' perspective, this situation presents cause for considerable concern. There is a growing belief among generation owners and regulators that RTO market rules do not provide adequate incentives to construct new generation or continue to operate existing units that have low operating margins currently but may have considerable future value.

In both *Hughes* and the Ohio cases, the states believed that important state interests were at stake. In *Hughes*, for example, the Maryland legislature believed that needlessly high electricity costs could force industrial energy users to leave the state and seriously harm the state's economy. Further, the Ohio PPAs were believed to be necessary to protect jobs in the coal industry (long a bedrock of the Ohio economy) and to ensure fuel diversity, reducing the potential for price spikes if the state became overly dependent upon natural gas.

While these contentions have been debated, the effect of the Supreme Court's decision in *Hughes* and the Ohio decisions is to block the states protecting state interests, on the grounds that they intrude on FERC's jurisdiction, without FERC ever directly assessing the potential justification for the states' actions.

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