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May Day: FERC's Demand Response Rule Down!

As the month of May draws to a close, it's May Day for FERC's Order 745 rule on demand response, vacated by the D.C. Circuit last week. So fittingly, this May 2014 issue of our newsletter offers an in-depth report on the court's ruling. And there's also a round-up of firm highlights if you're interested in what we've been up to since the last newsletter.

May you enjoy this newsletter and the start of the summer!

Best,

Carolyn Elefant

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D.C. Circuit Responds No to FERC Order 745 on Demand Response

Last Friday, just in time for the Memorial Day line-up of summer movies, the D.C. Circuit released a 2-1 blockbuster ruling in EPSA v. FERC, which voided Order 745, FERC's demand response compensation rule as an unauthorized encroachment on state regulation of retail markets, leaving the industry to ponder what comes next in this cliffhanger of a decision.

Truth be told, the D.C. Circuit's ruling didn't take me entirely by surprise. I've been predicting the demise of Order 745 since 2012, and more recently based on a combination of factors, such as Commissioner Moeller's cogent dissent (dissents heighten the chance of reversal of FERC orders on appeal) and the nine-month stretch since September's oral argument.

Still at most, I assumed that the court would find FERC's controversial locational marginal pricing (LMP) scheme - which compensates demand response resources at the same rates as traditional generation - arbitrary and capricious because it fails to take account that generators pay to produce a unit of power while demand resource providers don't. But I never expected the ultimate plot twist: the court's full-scale and frankly, unprecedented gutting of FERC's rules governing demand response, a practice that's grown entrenched in organized markets (the PJM market experienced a 400% increase in demand response since implementing Order 745) and spawned a growing, billion dollar industry. Let's review the D.C. Circuit's ruling and more importantly, take a look at what may happen in the sequels ahead. WARNING - spoilers ahead!!

Order No. 745 and Its Prequel, Order 719

For those unfamiliar, Order No. 745 was aimed at ensuring comparable treatment for economic demand response resources, *i.e.,* resources that reduce demand for financial benefit rather than for the more traditional purposes such as ensuring reliability or avoiding system emergencies. To this end, Order No. 745 required RTOs and ISOs to pay

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the locational marginal price (LMP), or essentially, the full wholesale price, for demand response resources participating in wholesale markets. As a result (and to oversimplify somewhat), under Order No. 745, generators selling power and customers withholding power are compensated the same way. To guard against potential overpayments for demand response, Order No. 745 includes a net benefits test which allows for LMP pricing only when economic benefits would result.

Still, the problem of overly incentivizing demand response through pricing remains. As Commissioner Moeller discussed in his dissent, by paying the same amount for producing and withholding power, Rule 745 overcompensates demand response providers because generators pay to produce a unit of power while demand response providers don't.

While FERC's Order 745 established a pricing mechanism for demand response, the rule itself didn't authorize participation of demand response in wholesale markets. That authority came in Order 745's lesser-known prequel, Order No. 719, which required RTOs and ISOs to accept bids from demand response providers for certain ancillary services and to permit aggregators of retail customers to bid demand response on behalf of retail customers directly into the organized energy markets. Although Order No. 719 opened the door to wholesale markets for all types of demand response, Order No. 745 LMP pricing applies only to economic demand response (where consumption is reduced in response to financial signals rather than simply for reliability or emergency reasons) provided by customers or aggregated retail customers as a resource in organized markets. Order 745, P. 9. Likewise, Order 745 does not govern compensation for capacity demand response programs administered by RTOs and ISOs for reliability, or for demand response as an ancillary service -- which is compensated under Order 755 (providing for market-based rates for ancillary services, including demand response).

D.C. Circuit Ruling

The Electric Power Suppliers Association (EPSA) sought review of Order 745 at the D.C. Circuit, challenging FERC's payment scheme for demand response provided by retail customers as (1) unauthorized regulation of retail markets which are exclusively within purview of the states and (2) unreasoned decision making that overcompensates demand response providers. FERC defended its

ruling, arguing that "when retail consumers voluntarily participate in the wholesale market, they fall within [FERC's] exclusive jurisdiction" and that its compensation mechanism was a reasonable mechanism to remove barriers to participation of demand response in markets.

Although FERC has authority under Section 201 of the Federal Power Act to regulate wholesale sales, because FERC treats demand resources (like netted station power) as "non-sales," FERC could not rely on Section 201 as a basis for jurisdiction over demand response. Consequently, FERC was forced to justify its authority over demand response under Sections 205 and 206 of the FPA, which require FERC to ensure that all rules and regulations affecting wholesale rates are just and reasonable.

But the court found that "FERC's rationale has no limiting principle" and could be used to expand FERC's authority into any number of areas that might affect rates, "such as steel, fuel and labor markets." The court also rejected FERC's argument that its authority could be "appropriately limited to direct participants" when the "directness of participation" was a product of FERC's rich incentives designed to lure non-jurisdictional, retail resources into wholesale markets to begin with.

What's interesting is that the court did not give FERC a second bite at the apple to elaborate further on limiting principles that might cabin its otherwise unlimited scope of authority. Even when jurisdictional questions are at issue, the court may still remand the case to FERC to further explain the basis for its jurisdiction as it did in the cases leading up to Calpine v. FERC at 8-9. That the court chose to vacate Order 745 rather than remand it reflects its conviction that FERC's rule is beyond repair.

Moreover, the court continued that even absent its "jurisdictional struggles," Order 745 would still fail even if the court had engaged the substantive arguments because the rule was arbitrary and capricious. The court faulted the Commission for "talking around" the argument raised in Commissioner Moeller's dissent as well as its failure to explain how a pricing mechanism that overcompensates for demand response is just and unreasonable.

Judge Edwards dissented. In his view, the court's job was not to decide, in the first instance, whether demand response is appropriately considered a

wholesale or retail resource, but rather, to determine whether the Federal Power Act unambiguously resolves the question. If it does not (i.e, if the statue is ambiguous), the court must defer to FERC's interpretation. Edwards went on to explain that the question of whether demand response "affects wholesale rates and practices" is not a matter clearly resolved by the FPA and that FERC's conclusion. Therefore, FERC's conclusion, based on its industry expertise, that demand response do in fact impact wholesale markets was reasonable and deserved deference, as did FERC's chosen pricing mechanism.

The Aftershock

Presumably expecting reconsideration and/or en banc requests (*i.e.*, request for the entire panel to hear the case), the D.C. Circuit withheld issuance of a mandate - meaning that its decision will not take effect immediately. Federal Rule of Appellate Procedure 35, which governs rehearing and en band petitions expressly states that they are "not favored and ordinarily will not be granted" unless the requesting party can show that en band consideration is either (1) necessary to maintain uniformity of the court's decisions or (2) that the proceeding "involves a question of exceptional importance."

En band is not likely to succeed under the first prong. The D.C. Circuit's ruling, though more definite about FERC's lack of jurisdiction is not inconsistent with precedent. The D.C. Circuit has already established through a series of rulings that FERC cannot invoke its power over practices impacted interstate rates under Section 205 to regulate netted station power transactions which are either non-sales or retail sales. *See* Calpine v. FERC. The D.C. Circuit's decision on Order 745 adopts nearly identical reasoning to *Calpine*.

Petitioners stand a better chance of showing that the proceeding involves "a question of exceptional importance." Although economic demand response (*i.e.*,) customers voluntarily reduce consumption in response to LMP pricing) which is the subject of Order 745 only accounts for two percent of PJM markets (and likely less elsewhere), the court's ruling may call into question FERC's authority over other variants of demand response - RTO/ISO capacity demand response programs (where market participants are paid capacity rates to be available to reduce service to maintain grid reliability), demand response ancillary services, which are eligible for

market-based pricing under FERC Order 755 or demand response facilitated by behind the meter generation addressed in a recent FERC order, Demand Response Supporters v. NYISO. Like the economic demand response programs covered by Order No. 745, capacity and ancillary demand response programs may consist of payments to retail customers to commit to or actually reduce consumption and therefore, would run up against the same "jurisdictional struggles" that sank Order 745. The potentially far reaching scope of the court's decision to all variants of demand response programs could possibly justify *en banc* review.

The Fall Out

For purposes of analysis, let's say that the court's ruling on Order 745 stands. What then? Here are some of the possible sequels to *EPSA v. FERC:*

FERC Demand Response Tariff Provisions

If FERC lacks jurisdiction over economic demand response (or any other variants), an ISO or RTO would be required to amend its respective tariffs to remove those terms and conditions governing demand response programs, or alternatively, the non-jurisdictional demand response provisions would be deemed void. FERC is barred from approving a tariff that offers non-jurisdictional services. See Detroit Edison v. FERC, 334 F.3d (D.C Cir. 2003) (holding that FERC exceeded statutory authority by approving a tariff that offers unbundled retail distribution service which is outside FERC's jurisdiction).

Question of Refunds

I discussed the possibility of refunds in the last issue of the newsletter, as follows:

The California energy crisis spawned years of litigation over refunds, after FERC determined as the result of a Section 206 investigation, that dozens of utilities, generators and munis had manipulated the market and overcharged for power. However, the posture of the Order 745 appeal differs significantly from the California energy crisis cases.

For starters, the petitioners challenging Order 745 did not request refunds as a remedy either before the Commission or the court. Since federal appellate courts are courts of limited jurisdiction, they do not have jurisdiction over issues that were not raised on

rehearing or presented to the court so it is unlikely that the court would require refunds. Likewise, unless a party challenged an ISO demand response compliance filing as unjust or unreasonable or non-jurisdictional, a refund effective date would not have been established for calculating the refunds.

Finally, FERC itself admitted in Order 745 that it lacks jurisdiction over the demand response providers who would have been overpaid or unjustly paid if demand response compensation was set unlawfully or higher than it should have been. Just as the Ninth Circuit held that FERC lacked authority to order municipalities and non-public utilities to refund overpayments resulting from market manipulation, likewise, FERC would not have the power to order demand response providers to issue refunds if Order 745 is overturned (though that doesn't mean that parties won't attempt to seek refunds, nonetheless).

Of course, there may be case-specific instances where parties objected to components of an RTO or ISO compliance filing -- either pricing offered for demand response or cost allocation -- and asked for a refund effective date. In these individual situations, the potential for refunds from the ISO or RTO might be worth evaluating.

Penalties Overboard!

When a court voids an administrative agency's rule for want of statutory authority, it's as if the rule never existed. Thus, if an agency relies on a rule that is subsequently vacated as a basis for enforcement, the resulting penalty can be challenged and overturned even after it's final See The Retroactive Effect of Vacating an Agency Rule , 29 Pace Env. Law Rev. 1 (2012)at 7, *citing Shell Oil Co. v. EPA*, 950 F.2d 741 (D.C. Cir. 1991) (vacating the RCRA "mixture rule" that had been law for almost ten years); *United States v. Goodner Bros. Aircraft, Inc.* 966 F.2d 380, 385 (8th Cir. 1992) (overturning prior convictions that were based in part possibly on the "mixture rule" which was vacated post-conviction).

As noted in my last newsletter, at least one entity currently the subject of a FERC enforcement proceeding for violating demand response rules has argued that FERC lacks jurisdiction to regulate demand response in wholesale markets and therefore, cannot bring an enforcement action for alleged violations of demand response market rules.

Likewise, another civil penalty imposed by FERC for demand response violations settled to the tune of $780,000 and disgorgement of $20,000 in unjust profits, is also potentially vulnerable. Although settled rather than disputed, that shouldn't change the outcome since the settlement resulted from an enforcement action that FERC had no authority to bring to begin with. Entities charged with or subject to investigations of violations of demand response rules should take immediate steps to evaluate the potential for reversal of FERC's enforcement activities.

Changes at FERC Since Order 745's Issuance

The composition of FERC today is somewhat different from back in 2011 when Order 745 was released. Since then, Commissioner Tony Clark has replaced Commissioner Spitzer, and more significantly, Chairman Wellinghoff, chief architect of FERC's demand response program has left the building. Moreover, Clark often sides with Commissioner Moeller, who dissented in Order 745 - meaning that the four Commissioners could split on a future course of action. Moreover, it's not clear whether that tie might break any time soon.

Norman Bay, President Obama's nominee to assume the FERC chairmanship and the head of FERC's Enforcement Division is currently battling to gain confirmation by the Senate due to his widely criticized and far-reaching enforcement policies. If Bay is eventually confirmed - a result that is currently questionable - will he have the appetite for or interest in pursuing appeals of the D.C. Circuit's rulings or exploring alternative approaches to encourage demand response?

Get ready for the Rule 28(j) Filings in the Order 1000 Case on Review

Currently, an appeal of FERC's landmark Order 1000 on transmission planning is pending before the D.C. Circuit. There, opponents have argued, among other things, that FERC exceeded its statutory authority under Sections 205 and 206 of the FPA when it required transmission operators to engage in transmission planning and devise methodologies of allocating the cost of new transmission. Though substantively, Order 745 and Order 1000 have little in common (FERC's authority over wholesale transmission practices under Section 201 is well established, whereas FERC lacks direct jurisdiction

over demand response because it's a non-sale), the Order 1000 petitioners will likely file an Order 28(j) notice of the demand response ruling if only to call the court's attention to a recent example of FERC overstepping its statutory authority.

The need for judicial review of FERC actions, early and often

Back in 2011, I remarked that the dwindling number of FERC appeals - (down to 19 that year from the average of 28 and still declining) was cause for alarm because:

Judicial review eliminates regulatory uncertainty. When FERC orders remain on the books, unchallenged for years, they are still vulnerable to appeal years later. Seeking early review of controversial FERC decisions on issues of first resort can provide finality.

Although EPSA promptly sought judicial review of Order No. 745 following several rounds of rehearing, jurisdictional challenges should have been raised back in 2008 when FERC first authorized participation of demand response in wholesale markets in Order 719. Indeed, in a judicial challenge to Order 719 in Indiana Utility Regulatory Commission (IURC) v. FERC, 668 F.3d 735 (D.C. Cir. 2012), the IURC argued that FERC's authorization of demand response unlawfully encroached on the state's jurisdiction over retail sales. Unfortunately, the D.C. Circuit did not reach the merits of the jurisdictional arguments, finding that they had not been properly preserved on rehearing before FERC.

In most instances, parties forego judicial review of FERC orders, believing that the cost of appeal can't be justified given the low odds of prevailing. But at the same time, there's also a cost to regulatory uncertainty because as *EPSA v. FERC* shows, jurisdictional issues can come back to bite years later. Consequently, parties with concerns about FERC's statutory authority to undertake certain policies should more seriously consider judicial review to make certain of where they stand. And as an aside, appeals needn't be staffed with a brigade of attorneys or run up a 50 or 60 thousand dollar bill. Depending upon the number of issues raised, a smaller firm with appellate and energy expertise (such as mine) can easily tackle an appeal for half the cost.

Other solutions?

For supporters of Order 745, the cleanest, albeit far from simplest solution would be to seek a legislative fix in the form of an express Congressional grant of authority to FERC to regulate demand response resources in wholesale markets. Alternatively, demand response proponents could urge states to beef up demand response initiatives at the retail level, or focus on incentivizing alternatives like energy storage systems and batteries, that can "effectively accomplish what demand response programs do without the regulatory overhead writes Forbes columnist Michael Kanolos.

***If you're interested in learning more about the D.C. Circuit's demand response ruling and its implications, join me for a FREE Teleseminar on June 5, 2014, 3 pm ET - How to Respond to the D.C. Circuit's Recent Ruling on Demand Response. Register** here*

What's Up at the Law Offices of Carolyn Elefant PLLC?

Here's a quick update on some of the firm's recent activities:

The Clean Energy States Alliance published two short reports prepared by firm principal, Carolyn Elefant on constitutional issues and state renewable portfolio standard (RPS) programs:

* Commerce Clause Analysis of People v. Nazarian and Solomon v. Hanna (March 2014)

* Case Note: Minnesota v. North Dakota PUC (April 2014).

On May 1 2014, Carolyn Elefant appeared on behalf of petitioners at the D.C. Circuit in *Minisink Residents for Environmental Preservation and Safety* before a packed courtroom of observers, as reported here in E&E News. A recording of the oral argument is available here.

For the third year running, the firm was listed as a D.C. Energy and Natural Resources Super Lawyer, still one of the only micro-lawyers included on a list of large firms.

Following a blog post on former Virginia gubernatorial candidate Ken Cuccinelli's innovative self-defense gun protection plan, Carolyn Elefant was invited to offer added commentary on the *Daily Show*. The segment can be viewed here.

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