Electricity Regulation and the High Court: Parsing the State-Federal Jurisdictional Borders

**Action Item:** Businesses and ratepayers should continue to enjoy the benefits of competitive electricity generation markets despite the Supreme Court’s recent decision in *Oneok v. Learjet*, which should not translate into the resurrection of state subsidy programs aimed at incentivizing the construction of new home-built natural gas electricity generation that raise prices and were previously struck down by two federal circuit courts covering New Jersey and Maryland.

The jurisdictional boundaries between the Federal Energy Regulatory Commission (“FERC”) and the states in the context of electricity markets and natural gas ought to be easy to identify. The Federal Power Act (“FPA”) bestows plenary power on FERC to regulate wholesale sales of electricity, while states retain power to regulate retail sales. The Natural Gas Act (“NGA”) establishes an identical framework for the wholesale and retail sales of natural gas. In practice, however, it’s not that easy. The wholesale/retail bright-line scheme functions poorly because there is a direct relationship between consumption and the volume of sales made to retail customers on one hand, and the volume of energy purchased in the wholesale markets for resale, on the other. As a result, state and federal initiatives and regulations often affect both wholesale and retail sales. In these so-called “mixed” cases, the bright-line jurisdictional test is not easily applied, and courts have struggled to determine whether the government action at issue involves wholesale regulation (within FERC’s jurisdiction), or retail sales (within state jurisdiction).

The Supreme Court recently grappled with this issue in *Oneok v. Learjet, Inc.*, No. 13-271 (Slip Op. Apr. 21, 2015), a decision which will likely add to the confusion. Here, we address what potential impacts, if any, the *Oneok* case may have on three other electricity market cases before the High Court.

The plaintiffs in *Oneok* brought claims pursuant to state anti-trust laws, alleging that natural gas traders were engaged in anti-competitive behavior. The district court dismissed the claims, finding that the NGA preempted all state attempts to regulate such activity, and that FERC alone has the power to regulate practices that directly affect wholesale prices. Easy, right? Nope.

The Ninth Circuit reversed, and the Supreme Court affirmed the reversal. The Supreme Court established a so-called “target” test under which courts must consider “the target at which the state law aims in determining whether [the] law is pre-empted.” Thus, whereas a state law that is aimed directly at wholesale markets...
will fail, a law aimed at general business conduct will stand even if it incidentally impacts wholesale markets, provided that the law does not otherwise conflict with FERC’s regulations. Applying that test, Justice Breyer, writing for the 7-2 majority, found that the state anti-trust laws were broadly applicable to businesses generally and were not specifically targeting the wholesale market. Justice Breyer explained that the laws were directed at practices affecting retail rates, which are “firmly on the States’ side” of the jurisdictional issue. The court, in essence, found that any impacts to the wholesale markets resulting from anti-trust laws were merely incidental to the main purpose of the law, which was directed at retail rates. Thus, the state laws were not preempted by the NGA. Justice Scalia dissented, noting that the majority holding “smudges” the “firm line between national and local authority” and establishes a “make-it-up-as-you-go approach” that will “prove unworkable in practice.”

This ruling is very relevant to cases involving the FPA because it is well established that NGA and FPA are read in pari materia.

There are three key electricity market cases that are now either before the Supreme Court or being petitioned for certiorari. The question is to what extent can those cases be handicapped based on the Oneok decision?

The first case arises out of the D.C. Circuit and involves FERC’s ability to regulate demand response. See Elec. Power Supply Ass’n v. FERC, 753 F.3d 216 (D.C. Cir. 2014) (“EPSA”). Just last week, the court granted FERC’s petition for certiorari. The other two, from the Third and Fourth Circuits, are awaiting a ruling on certiorari and they involve state efforts in New Jersey and Maryland to incentivize the construction of new home-built natural gas electricity generation in those states. See PPL Energyplus, LLC v. Solomon, 766 F.3d 241 (3d Cir. 2014) and PPL Energyplus, LLC v. Nazarian, 753 F.3d 467 (4th Cir. 2014).

In EPSA, the D.C. Circuit overturned FERC Order No. 745, which established compensation rates for qualifying “Demand Response” resources. Demand Response is the practice of compensating consumers for reducing consumption. In a nutshell, the theory of Demand Response is that under certain circumstances, it can be more cost-effective to balance electricity supply and demand by paying users to consume less rather than paying generators to generate more. FERC Order No. 745 sets the Demand Response compensation rate at the market price for energy, referred to as the locational marginal price (“LMP”).

In 2014, the D.C. Circuit, in a 2-1 decision, invalidated Order No. 745 holding, in part, that by ordering compensation for Demand Response from retail customers, FERC was regulating retail electricity markets, a power reserved to the states. Specifically, the court held that because Order No. 745 encroached upon the states’ exclusive jurisdiction to regulate retail energy markets, FERC had no jurisdiction to regulate Demand Response resources participating in wholesale energy markets. As mentioned, the Supreme Court has already granted certiorari.

Solomon and Nazarian involve efforts by New Jersey and Maryland, respectively, to incentivize the construction of new power plants, after those states concluded that PJM’s markets (which serve both Maryland and New Jersey) were providing insufficient incentives for such construction. The two schemes, which are essentially identical, involve state taxpayer subsidies for developers to construct new capacity. Once a developer is selected, the regulated distribution companies are required to sign contracts with the developer that guarantees certain revenues.

In 2014, the Third and Fourth Circuits separately held that the state subsidy programs were preempted by the FPA because they either “set” or “affected” rates in the wholesale market, which falls exclusively under FERC’s jurisdiction. Thus, the subsidies, even though dressed up by their proponents as a state program aimed at building generation in the state, were invalid because they affected the wholesale markets.

So, to summarize, in EPSA, the D.C. Circuit invalidated a FERC Order because it “encroached” upon states’ exclusive jurisdiction to regulate retail energy markets. In Solomon and Nazarian, the Third and Fourth Circuits invalidated state initiatives because they “affected” the wholesale markets under FERC’s exclusive jurisdiction. The common thread among these cases is the respective courts’ attempts to address the dividing line between state and federal authority.
Despite the court’s narrow holding in Oneok that state anti-trust claims are not preempted by the NGA even though they affect wholesale natural gas prices, the decision signaled that the Supreme Court could grant certiorari and revisit the D.C. Circuit’s opinion in EPSA and stretch the bounds of Oneok’s applicability in the context of FERC’s authority under the FPA to regulate Demand Response. Indeed, just last week, the court granted the government’s petition for certiorari in EPSA, which argued that Demand Response providers are integral participants in wholesale electricity markets, thus putting them squarely within FERC’s jurisdiction under the FPA.

Time will tell whether the Supreme Court will grant review of the Solomon and Nazarian decisions. But there is good reason to believe that both circuit court decisions are on solid ground and thus should be affirmed by the court, if reviewed. Put simply, Oneok is apples while Solomon/Nazarian are oranges.

First, unlike the anti-trust laws at issue in Oneok, which are generally applicable to businesses across all sectors of the economy, the New Jersey and Maryland subsidy programs in Solomon and Nazarian were specifically aimed at natural gas generation builds. Second, the state handouts in Solomon and Nazarian directly affected the wholesale market rates in more than just an incidental way. For example, both of the state schemes guarantee payments to or from the selected generators to make up the difference between the market-clearing price and the amount specified in the state-mandated contracts, thereby tying the subsidy directly to wholesale rates. Accordingly, if the court were to grant certiorari, the circuit court decisions ought to be easily affirmed because the subsidies directly “target” wholesale rates.

At the end of the day, the decisions invalidating naked state subsidies favoring particular generators like those of New Jersey and Maryland in Solomon and Nazarian should be affirmed because the state action there not only “affects” wholesale markets, but also directly undermines FERC’s structure of competitive wholesale electricity markets.

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