

A Divided Court Decides the Future of Demand Response: Oral Argument of FERC v. Electric Power Supply Association

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I. Introduction.....	1
II. Factual Background	2
III. Oral Argument Analysis.....	4
A. Justice Scalia: FERC May Not Regulate Wholesale Rates Through Activity in the Retail Market.....	4
B. Justice Roberts: Order 745 Improperly Affects Retail Prices by Imposing Opportunity Costs on Retail Consumers	6
C. Justice Kennedy: FERC’s Intent Does Not Determine Its Jurisdiction.....	6
D. Justice Breyer: All Wholesale Market Regulation Affects the Retail Market.....	7
E. Justice Kagan: Denying FERC Jurisdiction over Wholesale Demand Response Would Create a Regulatory Gap	8
F. Justice Sotomayor: FERC Acted Reasonably When Choosing LMP as the Demand Response Compensation Rate	8
IV. Conclusion.....	9

I. INTRODUCTION

In May 2014, the D.C. Circuit held, by a vote of 2-1, that the Federal Energy Regulatory Commission’s (“FERC”) Order 745 governing demand response resources in the wholesale energy market exceeded FERC’s authority under the Federal Power Act and was arbitrary and capricious under the Administrative

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Procedure Act.¹ FERC, alongside three aggregators of electricity consumers and two parties representing customers of wholesale market operators, petitioned for certiorari. I attended oral argument on October 14, 2015; having seen the attorneys argue and the Justices react to their arguments, I gained a unique perspective on this case. This Field Report will present a brief background of the relevant facts and law, analyze the arguments presented in court, and predict how the U.S. Supreme Court will decide the case.

II. FACTUAL BACKGROUND

The electricity sector is comprised of two transmission markets: wholesale and retail. Wholesale transmission is “the transmission of electricity sold, or to be sold, at wholesale in interstate commerce,”² whereas retail transmission services provide electricity to end-users within a state.³ Regional Transmission Organizations (“RTOs”) and Independent System Operators (“ISOs”) oversee the wholesale energy market by soliciting bids from suppliers of electricity to meet wholesale buyers’ demand.⁴ These wholesale buyers, in turn, deliver electricity to end-users in the retail market.⁵

RTOs and ISOs accept these bids, from least to most expensive on a megawatt-hour basis, until the wholesale buyers’ demand is met.⁶ Once demand is met for a particular place and time, the market clears, and the clearing price is used to calculate the eventual price paid to all generators in the area whose bids were accepted.⁷ This clearing price is known as the Locational Marginal Price (“LMP”) and reflects the value of energy at a specific time and location.⁸ For example, one electricity supplier could bid \$20 per megawatt-hour, another could bid \$40 per megawatt-hour, and

1. Elec. Power Supply Ass’n v. FERC, 753 F.3d 216, 232 (D.C. Cir. 2014).

2. 16 U.S.C. § 796(24) (2012).

3. *How Is Electricity Sold at Retail?*, ELEC. POWER SUPPLY ASS’N, <https://www.epsa.org/industry/primer/?fa=sold> [<https://perma.cc/HSL2-V6RB>] (last visited Nov. 17, 2015).

4. A wholesale supplier could be an electric power plant. Local electric utilities are often wholesale buyers.

5. *See Market for Electricity*, PJM, <http://learn.pjm.com/electricity-basics/market-for-electricity.aspx> [<http://perma.cc/8GMN-JD6J>] (last visited Nov. 17, 2015).

6. *Id.*

7. *How Wholesale Electricity Prices Are Set*, ELEC. POWER SUPPLY ASS’N, <http://www.epsa.org/industry/primer/%3Ffa=prices> [<http://perma.cc/Y9EM-W27S>] (last visited Nov. 17, 2015).

8. PJM, LOCAL MARGINAL PRICING 1 (2015), <http://www.pjm.com/~media/about-pjm/newsroom/fact-sheets/locational-marginal-pricing-fact-sheet.ashx> [<http://perma.cc/4BT9-FM43>].

a third could bid \$70 per megawatt-hour. If only the first two bids need to be accepted to meet demand, then the clearing price will be \$40 per megawatt-hour, which will be used to calculate the LMP to be paid to both the \$40 and \$20 supplier.⁹

Traditionally, electricity markets operated by increasing the supply of energy to meet demand, as described above. Yet a relatively new type of transaction, known as demand response, decreases demand rather than increases supply. Using demand response, RTOs and ISOs may pay individual electricity consumers and aggregators of electricity consumers¹⁰ for commitments to reduce electricity consumption at times and places in which demand is high.¹¹

Demand response works by linking the wholesale and retail markets: large individual consumers of electricity, who normally operate in the retail market,¹² may bid “*negawatts*” into the wholesale market by committing to a reduction of their electricity consumption during a day’s peak hours. On a large scale, this helps prevent blackouts and brownouts and lowers the overall cost of electricity for end-use customers because the market will clear at a lower price, resulting in a lower LMP.¹³ Demand response also helps RTOs and ISOs clear the market without resorting to environmentally unfriendly coal-fired power plants, which usually bid high.¹⁴

FERC Order 745,¹⁵ the disputed order in this case, requires RTOs and ISOs to compensate a large retail consumer’s commitment to reduce demand when such reduction is capable of balancing supply and demand in the wholesale market, and when compensation is cost-effective under a “net-benefits test.”¹⁶

9. Richard H. Seamon, *Can FERC Regulate How Operators of the Wholesale Electricity Market Pay Electricity Consumers for Commitments to Reduce Their Consumption?*, 43 *PREVIEW* 15, 15 (2015).

10. EnerNoc, one of the appellees in this case, is this type of aggregator.

11. *Demand Response*, OFF. ELEC. DELIVERY & ENERGY RELIABILITY, <http://energy.gov/oe/technology-development/smart-grid/demand-response> [<http://perma.cc/V8ZT-UYUR>] (last visited Nov. 17, 2015).

12. A factory is an example of a large retail electricity consumer.

13. PJM, *MARKETS FAQs*, <http://learn.pjm.com/three-priorities/buying-and-selling-energy/markets-faqs/what-is-demand-response.aspx> [<http://perma.cc/7WBF-2ZTF>] (last visited Nov. 17, 2015).

14. Brief for Conservation Law Foundation, et al. as Amici Curiae Supporting Petitioners at 16, *FERC v. Elec. Power Supply Ass’n*, 135 S.Ct. 2049 (2015) (No. 14-840).

15. *Demand Response Comp. in Organized Wholesale Energy Markets*, 134 FERC ¶ 61187, 2011 WL 890975 (Mar. 15, 2011).

16. *Elec. Power Supply Ass’n v. FERC*, 753 F.3d 216, 219 (D.C. Cir. 2014).

Essentially, RTOs and ISOs pay the LMP for megawatts only when reducing demand is cheaper than increasing supply, and thus would have the effect of actually lowering the market-clearing price for wholesale electricity.¹⁷

III. ORAL ARGUMENT ANALYSIS

The Supreme Court reviewed this case to answer two questions: first, does the Federal Power Act (“FPA”) authorize FERC to regulate how operators of the wholesale electricity market pay electricity consumers and their agents for commitments to reduce electricity consumption?¹⁸ Second, if FERC has this authority, is its determination that LMP is the appropriate compensation rate nonetheless invalid because it is “arbitrary and capricious” within the meaning of the federal Administrative Procedure Act?¹⁹

At oral argument, the Justices heard from Mr. Donald Verrilli, Solicitor General of the United States and counsel for FERC; Mr. Carter Phillips, counsel for private petitioners, including EnerNoc; and Mr. Paul Clement, counsel for Electric Power Supply Association and the other respondents. The Justices’ behavior during the proceedings indicates a likely 4-4 split on the issue of whether FERC has the statutory authority to issue Order 745 and a likely ruling that FERC’s choice of LMP as the compensation rate was arbitrary and capricious.

A. Justice Scalia: FERC May Not Regulate Wholesale Rates Through Activity in the Retail Market

Justice Scalia’s line of questioning focused on the issues surrounding sections 205 and 206 of the Federal Power Act, which provide FERC with jurisdiction only over wholesale electricity

17. Returning to the scenario above, if an RTO were forced to accept a \$70 megawatt bid because of high demand, the clearing price would be \$70, with a corresponding increase in LMP. However, if a consumer entered a \$50 bid of megawatts, and the subsequent reduction in electricity usage were enough that the RTO would not have to accept the \$70 bid, then under Order 745, the RTO could set the market clearing price at \$50. This would result in a lower LMP, which would be paid to those generators whose bids were accepted *as well as* to the consumer who bid the megawatts. Thus, the introduction of demand response into the wholesale market can affect the wholesale market price.

18. Seamon, *supra* note 9.

19. *Id.*

market rates²⁰ and practices directly affecting those rates.²¹ FERC argued that payments for commitments not to purchase electricity constitute a practice directly affecting wholesale electricity because reducing end-use consumer demand lowers the wholesale market clearing price.²²

Justice Scalia showed a strong inclination against FERC's demand response jurisdiction. He repeatedly emphasized that FERC is not merely affecting retail rates through regulation of the wholesale market, but rather FERC is affecting retail rates *in order to* regulate wholesale rates. In essence, he believes that FERC is buying promises not to consume *retail* electricity, effectively regulating retail rates. Mr. Verrilli pushed back, arguing that under Order 745, states retain control of retail rates and may bar retail customers from entering the wholesale market, and thus FERC is not exceeding its jurisdiction.

Clearly unsatisfied, and still trying to find inconsistencies in Mr. Verrilli's argument, Justice Scalia compared demand response to a hypothetical policy under which FERC would pay retail customers to reduce their energy consumption. This, like FERC's current regulatory system would regulate the wholesale market by affecting the retail market. It would also go, indisputably, beyond FERC's jurisdiction. Mr. Verrilli distinguished Justice Scalia's hypothetical, in which FERC's actions would take place in the retail market, from the case at hand, where all of FERC's actions take place in the wholesale market. Ever persistent, Justice Scalia raised the same hypothetical with Mr. Phillips, who responded that FERC's direct control of retail prices would *indirectly* affect wholesale rates, and thus lie beyond FERC's jurisdiction. He posited that since demand response *directly* affects the wholesale market, it is within FERC's jurisdiction under sections 205 and 206 of the FPA, which allow FERC to regulate any direct effects in the wholesale market. While listening with a furrowed brow, Justice Scalia sat back in his chair with his arms folded, expressing clear disapproval of this argument.

20. See 16 U.S.C. § 824d(b) (2012) (FERC has jurisdiction over the "sale of electric energy at wholesale in interstate commerce"); *New York v. FERC*, 535 U.S. 1, 2 (2002) (limiting FERC's sales jurisdiction to the wholesale electricity market).

21. 16 U.S.C. §§ 824d(a), 824e(a) (2012).

22. Brief of Petitioner at 3, *FERC v. Elec. Power Supply Ass'n*, 135 S.Ct. 2049 (2015) (No. 14-840).

B. Justice Roberts: Order 745 Improperly Affects Retail Prices by Imposing Opportunity Costs on Retail Consumers

Even though states retain nominal control of setting retail prices, FERC's opponents argue that FERC's regulation of demand response effectively establishes retail rates by imposing an opportunity cost on consumers that do not sell their demand on the wholesale market.²³ Justice Roberts explained this argument by way of an analogy to hamburgers: if a McDonald's hamburger costs five dollars and FERC pays people three dollars to not buy hamburgers, then the effective price of the hamburger is eight dollars because the customer foregoes the three dollar incentive to not buy a hamburger. Accordingly, the federal government is effectively raising the price of retail energy by incentivizing retail customers to not purchase retail energy. Yet Mr. Verrilli reiterated, as he did with Justice Scalia, that states retain their control over the retail market because they can bar consumers from entering the wholesale market and because they unilaterally set prices in the retail market.

Justice Roberts seemed unconvinced, and later argued that even if states retain control of prices, FERC can merely raise the compensation rate to further lure customers into the wholesale market, thus negating any effect that resulted from the state's price control. Mr. Phillips responded that FERC does not intend to affect the retail rate, but Justice Roberts seemed unpersuaded by this argument, especially in light of Justice Kennedy's rebuttal that intent is irrelevant.

C. Justice Kennedy: FERC's Intent Does Not Determine Its Jurisdiction

Justice Kennedy seemed to agree with Justice Scalia and Justice Roberts. First, he focused his questions on the enigmatic line between wholesale and retail, and whether or not FERC is "luring" customers into wholesale markets. Mr. Verrilli responded that, on the contrary, wholesale demand response was initially motivated by private actors who saw potential for profit. In response to this argument, Justice Kennedy sat silent and inscrutable. Yet soon thereafter, when Mr. Verrilli asserted that the market would correct any imbalance between retail and wholesale demand, Justice

23. *Id.* at 35–36.

Kennedy pointed out the circularity of that argument: if FERC controls the market, how can it depend upon the market to correct itself? As noted earlier, he also expressed hostility to Mr. Phillips's argument that FERC does not intend to affect the retail market, sarcastically rebutting that FERC's position is: "oh, well, we didn't mean this, but we're doing it." Justice Kennedy will likely side with Justices Scalia and Roberts in ruling against FERC.

D. Justice Breyer: All Wholesale Market Regulation Affects the Retail Market

Justice Breyer seemed to support FERC, but had an open-minded view about the respondent's position. In a somewhat condescending professorial tone, Justice Breyer explained that FERC is using a legitimate means to meet consumer demand, and there is no law that prevents it from exercising this option. He characterized demand response as a money-saving mechanism that satisfies wholesale peak demand and exists solely within the wholesale market. While it affects retail prices, "so does everything we do in respect to wholesale prices." Later, however, he backtracked a bit and acknowledged that he understands Mr. Clement's argument, whereas at the beginning of the session he did not. Additionally, when he asked whether or not FERC's regulation is reasonable under *Chevron*,²⁴ he seemed satisfied with Mr. Clement's answer that FERC's lack of jurisdiction over retail rates precludes the *Chevron* analysis.

The *Chevron* issue turns on whether FERC adequately explained its decision to make the compensation rate LMP, as opposed to some other compensation rate such as LMP minus the generation component of the retail price. FERC merely needs to show that it took alternative rates seriously when considering the order and decided against them.²⁵ Justice Breyer claimed that FERC considered all possible compensation rates and settled on LMP. Yet when Mr. Clement asserted that FERC did not fully consider the Federal Trade Commission's report, Justice Breyer backed

24. *Chevron v. NRDC*, 467 U.S. 837 (1984), established a test used in judicial review of an administrative agency's interpretation of statutory ambiguity. Courts start by looking for an express delegation of authority from congress, and in its absence, defer to an agency's reasonable interpretation of an ambiguous authorizing statute. FERC argues that there is no express delegation of demand response, and their interpretation of the FPA's implicit authorization of demand response for matters directly affecting the wholesale market is reasonable.

25. Seamon, *supra* note 9, at 17.

down again and said that he would read the reports in greater detail. At the beginning of the argument, Justice Breyer seemed like FERC's strongest ally, but by the end, his opinion wavered and he had made some important concessions.

E. Justice Kagan: Denying FERC Jurisdiction over Wholesale Demand Response Would Create a Regulatory Gap

Justice Kagan played a limited role in the debate, but she leaned in favor of the petitioners. She asserted that § 1252(f) of the Energy Policy Act of 2005, entitled "Federal Encouragement of Demand Response," implicitly warrants federal regulation of demand response akin to Order 745. Mr. Clement, however, pointed out that in the immediately preceding section, the Energy Policy Act makes it the policy of the United States to encourage states to "coordinate, on a regional basis, State energy policies to provide reliable and affordable demand response services to the public."²⁶ If this argument is correct and states have exclusive authority over demand response, Justice Kagan asserted, then neither FERC nor the states could regulate wholesale demand response, resulting in untapped potential in the form of a "regulatory gap." This presumably runs counter to the Energy Policy Act's general thrust of encouraging demand response. When Mr. Clement responded that FERC could still have jurisdiction over demand response, but only in the wholesale market, Justice Kagan seemed unsatisfied.

F. Justice Sotomayor: FERC Acted Reasonably When Choosing LMP as the Demand Response Compensation Rate

Justice Sotomayor clearly expressed her support of FERC. She attacked Mr. Clement for re-characterizing the petitioner's argument, and in general used a hostile tone towards him. She also seemed unimpressed by Mr. Clement's assertion that federal and state powers must be separate in this area, as she spoke positively of concurrent jurisdiction over demand response between states and the federal government. Additionally, with regard to the arbitrary and capricious question, she adamantly asserted that this is a "classic" case whereby the agency considered all of the facts and decided that the LMP rate was the best way to compensate demand response. Justice Sotomayor unwaveringly

26. Energy Policy Act of 2005 § 1252(e)(1), 42 U.S.C. § 16448 (2012).

defended FERC, and she will likely support its demand response jurisdiction.

IV. CONCLUSION

Justice Thomas and Justice Ginsburg were silent throughout oral argument. Based on their past records, however, it is likely that Justice Thomas will side with Justices Scalia and Roberts, while Justice Ginsburg will side with Justices Kagan and Sotomayor. Justice Breyer, despite his concessions, will also likely side with the liberal wing of the court because his line of questioning veered in that direction. Finally, Justice Kennedy seemed to side with the conservative camp on these issues. Since Justice Alito recused himself, the court may split along these lines, resulting in the lower court's decision being upheld and eliminating FERC's jurisdiction over demand response. If FERC's jurisdiction is eliminated, then the Court likely will not take up the arbitrary and capriciousness issue because it is comparatively trivial.²⁷ However, if they do reach the issue, they will likely rule against FERC's choice of LMP as the compensation rate for demand response in light of the fact that there was almost no push back by the Justices against Mr. Clement's assertion that FERC's decision was arbitrary and capricious.

For the reasons above, and due to recent developments, the Court will likely split on the issue of FERC's jurisdiction. Six days after oral argument, the Supreme Court granted certiorari for *CPV Maryland, LLC v. PPL Energy Plus, LLC*, a case with similar scope as *FERC v. Electric Power Supply Association*.²⁸ The main issue centers on whether state-directed procurements of power plant contracts, and the resulting contract prices, are preempted as attempts to set interstate wholesale rates.²⁹ The court's grant of certiorari so soon after hearing *FERC v. Electric Power Supply Association* may indicate that the court recognized a potential split and decided to punt the issue of FERC's jurisdiction under the FPA until next spring. Regardless, the outcomes of these two cases will determine the extent of FERC's jurisdiction for years to come.

27. Seamon, *supra* note 9, at 16.

28. *CPV Maryland, LLC v. PPL EnergyPlus, LLC*, 136 S. Ct. 356 (2015) (No. 14-623).

29. *CPV Maryland, LLC v. PPL EnergyPlus, LLC*, SCOTUSBLOG, <http://www.scotusblog.com/case-files/cases/cpv-maryland-llc-v-ppl-energyplus-llc/> [<http://perma.cc/U2QC-FTBF>] (last visited Nov. 18, 2015).