US SUPREME COURT UPHOLDS PREEMPTION OF MARYLAND RESOURCE PLANNING EFFORTS

Understanding the potential consequences for California

On April 19th, the US Supreme Court issued a decision *Hughes v. Talen Energy Marketing*. The Court affirmed the 4th Circuit and held that Maryland's effort to promote the development of new local generation is preempted under the Federal Power Act. The implications for California are potentially significant.

In 2006, the PJM Regional Transmission Organization developed a centralized capacity market through a settlement joined by all participating states (including Maryland). The settlement specified that states within PJM retained the right to direct, via regulation or legislation, the development of new generating capacity as needed to satisfy local resource needs and bid the capacity into the PJM market as a "price taker" (willing to accept any price set by the market). This settlement provision was critical to gaining state support for the new market and was designed to ensure that states could act if the capacity market failed to produce new local generation at reasonable prices. When Maryland subsequently determined that the PJM capacity market was not successfully encouraging needed new local generation, the state first petitioned FERC to change the capacity market rules to provide 10-year payments to new generation (rather than the 3-year payments for new generation authorized under the rules). When FERC rejected this petition, Maryland initiated processes pursuant to the settlement to provide long-term revenue guarantees as incentives for new local generation.

Under the approach originally adopted by Maryland, the state held an auction for new local generation and picked winning bids on a least-cost basis. The winning generator was required to participate in (and clear) the capacity market, meaning they would effectively bid their capacity as "price takers". Maryland load-serving entities would execute 20-year "contracts for differences" allowing the generator to receive a long-term fixed price with Maryland ratepayers responsible for any differences (positive or negative) between the guaranteed contract price and the market clearing price received from the PJM capacity market. In short, the states would get needed local generation built by having the retail customers of the Maryland load-serving entities taking on all of the capacity market risk.

In response to these state initiatives, private generating companies successfully lobbied PJM in 2011 to propose a change to its own tariff to remove the relevant settlement provision that allowed PJM states to direct the development of new local resources that are bid into the capacity market as a "price taker". Over the objections of the states that had originally insisted upon this right in exchange for their support for the settlement, FERC approved the modification and eliminated this provision. Private generators subsequently sued Maryland arguing that their actions were preempted under the Federal Power Act.

The Supreme Court's decision in *Hughes* concludes that Maryland's actions were preempted by the Federal Power Act. The decision explains that interstate wholesale rates can be set through auctions run by a grid operator that set prices for day ahead energy, real-time energy, and future capacity. Any effort by a state to "intrude on FERC's authority over interstate wholesale rates" (page 13) is subject to preemption under the Federal Power Act. The decision primarily focuses on the specific mechanism used by Maryland to promote in-state generation through the "contract for differences" approach. The

Court distinguishes this arrangement from a traditional bilateral contract between a utility and a generator by noting that the contract for differences specified that the capacity would be sold from the generator into the PJM auction rather than transferred to the utilities outside the auction (as would be the case in a traditional bilateral contract). As a result, the Court found that the Maryland policy was an effort to circumvent the interstate wholesale rate set in the PJM capacity auction. The Court notes that Maryland's goal of encouraging the development of new in-state generation "does not save its program" because "states may not seek to achieve ends, however legitimate, through regulatory means that intrude on FERC's authority over interstate wholesale rates" (pages 12-13).

The decision claims that "our holding is limited" and asserts that the decision does not "address the permissibility of various other measures States might employ to encourage development of new or clean generation, including tax incentives, land grants, direct subsidies, construction of state-owned generation facilities, or re-regulation of the energy sector." (page 15) The Court also states "nothing in this opinion should be read to foreclose Maryland and other States from encouraging production of new or clean generation through measures 'untethered to a generator's wholesale market participation.' So long as a State does not condition payment of funds on capacity clearing the auction, the State's program would not suffer from the fatal defect that renders Maryland's program unacceptable" (page 15).

While some instant analysis has characterized the decision as having a limited impact on states' rights, a leading commenter on Supreme Court decisions (SCOTUSblog) observes that the decision "reinforced the authority of the federal government's energy regulators in the ongoing national-state competition to manage the markets for electricity."[1] Any analysis of the potential impacts of this decision on California and other states must consider the following relevant issues:

(1) States have a poor record defending against preemption challenges brought under the Federal Power Act (FPA) in federal courts. The Court's holding continues a near-perfect string of losses by states seeking to preserve their authority. There is no specific reason to hope that future challenges brought against state resource planning efforts will fail simply because the facts are somewhat different than those presented in the Maryland case.

(2) Maryland and New Jersey originally agreed to the PJM capacity market through a settlement that guaranteed these states a right to direct the development of local resources that could bid into the capacity market as a "price taker". Several years later, this provision was eliminated by FERC in response to a PJM proposal. The lesson is that conditions originally obtained by states in exchange for their support for a regional market can be eliminated after the market is operating even if the states protest these changes. Any deal to retain specific states' rights is neither durable nor enforceable once jurisdiction is transferred to FERC.

(3) The Court did not hold that other types of state resource planning initiatives are protected against preemption in a regional market. The decision ONLY addresses the limited issue of the mechanism adopted by Maryland. There is no basis to conclude that any other state program to promote local

[1] http://www.scotusblog.com/2016/04/opinion-analysis-u-s-energy-regulators-authority-grows/

resources would necessarily survive a similar challenge.

(4) The decision references extraordinarily limited measures states may adopt without being subject to preemption (tax incentives, land grants, direct subsidies, state-owned generation). None of these are comparable to the kind of resource planning and direct contracting requirements used in California. The decision also references “re-regulation” but that would seem to suggest the highly improbable situation where FERC-regulated wholesale markets are eliminated and utilities are fully vertically integrated. Missing from this list are renewable portfolio standards, preferred resource carve-outs, utility procurement requirements, and distribution-level incentives to generation selling into wholesale markets. None of California’s policy tools designed to move towards a low carbon grid appear on the Court’s safe harbor list.

(5) The Decision points to a variety of “competitive wholesale auctions” that could justify preemption. These include "a 'same-day auction' for immediate delivery of electricity to LSEs facing a sudden spike in demand; a 'next-day auction' to satisfy LSEs’ anticipated near-term demand; and a 'capacity auction' to ensure the availability of an adequate supply of power at some point far in the future” (page 3). The CAISO already runs two of these three types of “wholesale auctions” in the form of day ahead and real-time energy markets. Any state policies that direct load-serving entities to procure resources and have a direct effect on prices in these markets could be subject to challenge.

(6) Although no centralized capacity market currently exists for California, the California Independent System Operator (CAISO) has historically favored this type of centralized auction to promote new generation and compensate existing units. Prior efforts by CAISO have failed due to stiff opposition from the CPUC and other California stakeholders. If CAISO regional expansion occurs, there is a serious risk that the new ISO will propose (and FERC will approve) a region-wide capacity market in the coming years. Even if California obtains an assurance from CAISO that no capacity market will be created in the future, the experience with PJM demonstrates that any conditions obtained by a state (even in a settlement) can be eliminated at a later date.

(7) If a regional capacity market is established in the future, it is not clear that new preferred and renewable resources located in California could bid into such a market as “price takers” due to FERC’s preference for Minimum Offer Price Rules (MOPRs) designed to prevent this type of bidding behavior. Under a MOPR, new clean generation under contract to California utilities could fail to clear a regional capacity market. This outcome could lead to additional and unnecessary expenditures on dirty fossil plants that do clear the capacity auction, resulting in an oversupply of resources and higher costs to California customers.

(8) The Court’s suggestion that states may encourage new or clean generation through measures “untethered to a generator’s wholesale market participation” may be difficult to accomplish in practice. All generation built in California (except for resources located in the service territories of non-CAISO member utilities, such as SMUD, IID and LADWP) participates in wholesale energy markets and receives compensation based on the day ahead and/or real-time prices. California’s preferred resource policies guarantee fixed prices (paid by retail customers) to resources that sell their output into FERC-regulated markets and act as “price takers”. As a result, there may be few meaningful

differences between the mechanisms prohibited in *Hughes* and those favored by California to promote clean, local generation.

(9) The risks of federal court challenges to California policy are likely to increase if the CAISO expands to become a regional transmission operator (like PJM). Once freed from obligations to act consistent with California law, CAISO would be emboldened to develop new regional energy and capacity markets regardless of objections raised by California political leaders and state regulators. This evolution would increase the likelihood of conflicts between FERC-regulated wholesale markets and California policy measures. Claims could be raised in federal court or at FERC by private parties (as was the case in *Hughes*) claiming that the innovative policies favored by California are distorting wholesale markets and disadvantaging fossil fuel generation.

Although it is impossible to predict the outcome of future litigation, the trend towards greater reliance on FERC-authorized regional markets significantly increases the risk that California will find itself in the crosshairs and potentially on the losing end of a preemption challenge. Policymakers concerned about this possibility should carefully consider whether the expansion of FERC-regulated wholesale markets will ultimately serve California's goal of being an international leader on clean energy and climate policy.

EXCERPTS OF CONCERNS RAISED IN ANALYSIS BY OTHER PRACTITIONERS

Hughes v. Talen

Analysis by Van Ness Feldman LLP[2]

"The Court's opinion is narrowly drafted, and explicitly does not address the permissibility of state-level regulatory incentives that are not linked directly to wholesale markets for energy and capacity, such as tax incentives, land grants, direct subsidies, and the construction of state-owned generation facilities. Thus, state regulators retain flexibility to incent new or clean generation in a variety of ways, and for a variety of purposes, without running afoul of the Court's opinion. For instance, state policies to encourage in-state generation development to support renewable energy goals are permissible as long as the incentives are "untethered to a generator's wholesale market participation.

The opinion is less clear about the continued viability of state regulatory incentives that have a direct link to wholesale markets. In invalidating the Maryland contract for differences program, the Court appears to provide very specific guidance to States that want to incent generation: "So long as a State does not condition payment of funds on capacity clearing the auction, the State's program would not suffer from the fatal defect that renders Maryland's program unacceptable." Yet in other places within the opinion, the Court described the program's defect more broadly as "adjusting an interstate wholesale rate" or "disregard[ing] an interstate wholesale rate." These broader statements echo the Court's prior holdings in *Mississippi* and *Nantahala.* Elsewhere, the Court identifies the fact that the Maryland program did not transfer ownership of the capacity from the generator to the LSE as problematic. Thus, while the Maryland program has been held invalid, the Court did not clearly state which of these characteristics was dispositive. It is unclear whether different state regulatory incentives that possess one or two of these characteristics, but not all three, would be vulnerable under the Court's opinion. A broad reading of the Court's opinion, taking cues from Justice Thomas' concurring opinion, might suggest that any state program that adjusts a wholesale energy or capacity market outcome impermissibly "invades FERC's regulatory turf."

Analysis by Stinson Leonard Street[3]

The decision will be disappointing to some advocates of state regulatory authority, as was the decision in *EPSA*. Both cases signify a substantial shift in authority to FERC with unbundling of the electric industry. Still, the full reach of FERC authority over investor owned utility generation, and potential limitations, remains untested for now.

Analysis by Pillsbury Winthrop Shaw Pittman LLP[4]

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[2] http://www.vnf.com/supreme-court-addresses-limits-on-state-authority-to

[3] Analysis by Stinson, Leonard, Street (http://www.stinson.com/Resources/Alerts/2016_Alerts/Supreme_Court_Hands_FERC_Win_on_Authority_Over_Capacity_Markets.aspx)

[4]http://www.pillsburylaw.com/siteFiles/Publications/AlertMay2016EnergyImplicationsforthePowerSectorofRecentRulingsbyU.S.SupremeCourtandFERC.pdf

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.

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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." 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.

"The U.S. Supreme Court decision in Hughes v. Talen Energy Marketing, LLC, 136 S. Ct. 1288 (2016) does not directly bar power purchase agreements. It does, however, cast uncertainty over state-mandated contracts that parties may argue interfere with federally supervised wholesale markets." (NY Public Service Commission, Order Adopting A Clean Energy Standard, Case 15-E-0302/16-E-0270, August 1, 2016, Page 100)