Electric Power Supply Ass'n v. Federal Energy Regulatory Comm'n
No. 11-1486 (D.C. Cir. May 23, 2014)

(*edit by Joel B. Eisen*)

BROWN, Circuit Judge:

Electric Power Supply Association and four other energy industry associations ("Petitioners") petition this court for review of a final rule by the Federal Energy Regulatory Commission ("FERC" or "the Commission") governing what FERC calls "demand response resources in the wholesale energy market." The rule seeks to incentivize retail customers to reduce electricity consumption when economically efficient. Petitioners complain FERC's new rule goes too far, encroaching on the states' exclusive jurisdiction to regulate the retail market. We agree and vacate the rule in its entirety.

I

Under the Federal Power Act ("FPA" or "the Act") the Commission is generally charged with regulating the transmission and sale of electric power in interstate commerce. The FPA "split[s] [jurisdiction over the sale and delivery of electricity] between the federal government and the states on the basis of the type of service being provided and the nature of the energy sale." Niagara Mohawk Power Corp. v. FERC, 452 F.3d 822, 824 (D.C. Cir. 2006). Section 201 of the Act empowers FERC to regulate "the sale of electric energy at wholesale in interstate commerce." 16 U.S.C. § 824(b)(1) (emphasis added). Thus, "FERC's jurisdiction over the sale of electricity has been specifically confined to the wholesale market." New York v. FERC, 535 U.S. 1, 19 (2002).

The Commission concedes that "demand response is a complex matter that lies at the confluence of state and federal jurisdiction." See Demand Response Compensation in Organized Wholesale Energy Markets, 134 FERC ¶ 61,187, 2011 WL 890975, at *30 (Mar. 15, 2011) [hereinafter Order 745]. For more than a decade, FERC has permitted demand-side resources to participate in organized wholesale markets, allowing Independent System Operators (ISOs) and Regional Transmission Organizations (RTOs) to use demand-side resources to meet their systems' needs for wholesale energy, capacity, and ancillary services.

Order 745 establishes uniform compensation levels for suppliers of demand response resources who participate in the "day-ahead and real-time energy markets." Order 745, 2011 WL 890975, at *1. The order directs ISOs and RTOs to pay those suppliers, including aggregators of retail customers, the full locational marginal price (LMP), or the marginal value of resources in each market typically used to compensate generators. The Commission conditioned the payment of full LMP on the ability of a demand response resource to replace a generation resource and required demand response to be cost effective. Cost effectiveness would be determined by a newly devised "net benefits test," which FERC directed ISOs and RTOs to implement.

Commissioner Moeller dissented, arguing the Commission's retail customer compensation scheme conflicted both with FERC's efforts to promote competitive markets and with its statutory mandate to ensure supplies of electric energy at just, reasonable, and not unduly preferential or discriminatory rates.

II

If FERC lacks authority under the Federal Power Act to promulgate a rule, its action is "plainly contrary to law and cannot stand." See Michigan v. EPA, 268 F.3d 1075, 1081 (D.C. Cir. 2001). We address FERC's assertion of its statutory authority under the familiar Chevron doctrine. See City of Arlington, Tex. v. FCC, 133 S. Ct. 1863, 1870–71 (2013). The question is "whether the statutory text forecloses the agency's assertion of authority." Id. at 1871. If, however, the statute is silent or ambiguous on the specific issue, we must defer to the agency's reasonable construction of the statute. Id. at 1868.

FERC claims when retail consumers voluntarily participate in the wholesale market, they fall within the Commission's exclusive jurisdiction to make rules for that market. Petitioners protest that retail sales of electricity are within the traditional and "exclusive jurisdiction of the States" and regulating consumption by retail electricity customers is a regulation of retail, not wholesale, activity. Reply Br. 11–12. The problem, Petitioners say, is the Commission has no authority to draw retail customers into the wholesale markets by paying them not to make retail purchases.

FERC acknowledges "wholesale demand response" is a fiction of its own construction. See Oral Arg. Tape, No. 11-1486, at 27:31 (Sept. 23, 2013) (conceding "selling" demand response resources in the wholesale market "is a bit of a fiction"). Demand response resources do not actually sell into the market. Demand response does not involve a sale, and the resources "participate" only by declining to act.

As noted, and as the Commission concedes, demand response is not a wholesale sale of electricity; in fact, it is not a sale at all. See Order 745, 2011 WL 890975, at *18 ("[T]he Commission does not view demand response as a resale of energy back into the energy market."). Thus, FERC astutely does not rely exclusively on its wholesale jurisdiction under § 201(b)(1) for authority. See Niagara Mohawk Power Corp., 452 F.3d at 828 & n.7.

Instead, FERC argues §§ 205 and 206 grant the agency authority over demand response resources in the wholesale market. These provisions task FERC with ensuring "all rules and regulations affecting . . . rates" in connection with the wholesale sale of electric energy are "just and reasonable." 16 U.S.C. § 824d(a) (emphasis added); see also id. § 824e(a). Thus, the Commission argues it has jurisdiction over demand response because it "directly affects wholesale rates." FERC Br. 32–34; see also Order 745, 2011 WL 890975, at *30.

We agree with the Commission that demand response compensation affects the wholesale market. Reducing retail consumption—through demand response payments—will lower

the wholesale price. See Oral Arg. Tape, at 33:13. Demand response will also increase system reliability. FERC Br. 33. Because incentive-driven demand response affects the wholesale market in these ways, the Commission argues §§ 205 and 206 are clear grants of agency power to promulgate Order 745.

The Commission's rationale, however, has no limiting principle. Without boundaries, §§ 205 and 206 could ostensibly authorize FERC to regulate any number of areas, including the steel, fuel, and labor markets.

States retain exclusive authority to regulate the retail market. See Niagara Mohawk Power Corp., 452 F.3d at 824. Absent a "clear and specific grant of jurisdiction" elsewhere, see New York, 535 U.S. at 22, the agency cannot regulate areas left to the states. The broad "affecting" language of §§ 205 and 206 does not erase the specific limits of § 201. FERC can regulate practices affecting the wholesale market under §§ 205 and 206, provided the Commission is not directly regulating a matter subject to state control, such as the retail market. *Cf. Conn. Dep't of Pub. Util. Control v. FERC*, 569 F.3d 477, 479 (D.C. Cir. 2009) (finding FERC could regulate the installed capacity market under its affecting jurisdiction because FERC did not engage in direct regulation of an area subject to exclusive state control).

Demand response—simply put—is part of the retail market. It involves retail customers, their decision whether to purchase at retail, and the levels of retail electricity consumption. A buyer is a buyer, but a reduction in consumption cannot be a "wholesale sale." FERC's metaphysical distinction between price-responsive demand and incentive-based demand cannot solve its jurisdictional quandary.

Because the Federal Power Act unambiguously restricts FERC from regulating the retail market, we need not reach Chevron step two. But even if we assumed the statute was ambiguous—as Judge Edwards argues, we would find FERC's construction of it to be unreasonable for the same reasons we find the statute unambiguous. Because FERC's rule entails direct regulation of the retail market—a matter exclusively within state control—it exceeds the Commission's authority.

IV

Alternatively, even if we assume FERC had statutory authority to execute the Rule in the first place, Order 745 would still fail because it was arbitrary and capricious. A review of the record reveals FERC failed to properly consider—and engage—Commissioner Moeller's reasonable (and persuasive) arguments, reiterating the concerns of Petitioners and other parties, that Order 745 will result in unjust and discriminatory rates.

V

Ultimately, given Order 745's direct regulation of the retail market, we vacate the rule in its entirety as ultra vires agency action.

EDWARDS, Senior Circuit Judge, dissenting:

Under the Federal Power Act, regulatory authority over the nation's electricity markets is bifurcated between the States and the federal government. In simplified terms, the Federal Energy Regulatory Commission ("FERC" or "Commission") has authority over wholesale electricity sales but not retail electricity sales, with the latter solely subject to State regulation. See 16 U.S.C. § 824(a), (b)(1). The consolidated petitions before the court call on us to parse this jurisdictional line between FERC's wholesale jurisdiction and the States' retail jurisdiction – a line which this court and the Supreme Court have recognized is neither neat nor tidy. See New York v. FERC, 535 U.S. 1, 16 (2002).

It is easy to see why FERC stated in its rulemaking that "jurisdiction over demand response is a complex matter that lies at the confluence of state and federal jurisdiction." Order 745, 2011 WL 890975, at *30. On one view, the demand response resources subject to the rule directly affect the wholesale price of electricity. That is, the final rule's conditions operate to ensure that every negawatt of forgone consumption receiving compensation reduces both the quantity of electricity produced and its wholesale price. Focusing on this direct effect – direct, it bears repeating, because under the rule's conditions all demand response resources receiving compensation reduce the market-clearing price – it is easy to conceive of Order 745 as permissibly falling on the wholesale side of the wholesale-retail jurisdictional line. On another view, however, the electricity not consumed thanks to the rule's compensation payments would have been consumed first in a retail market. Focusing on the market in which the consumption would have occurred in the first instance, one can conceive of Order 745 as impermissibly falling on the retail side of the jurisdictional line.

The task for this court, of course, is not to divine from first principles whether a demand response resource subject to Order 745 is best considered a matter of wholesale or retail electricity regulation. Rather, our task is one of statutory interpretation within the familiar Chevron framework. The Commission has interpreted the Federal Power Act to permit it to issue Order 745. And it falls to this court to determine whether the Act unambiguously "sp[eaks] to the precise question," 467 U.S. at 842 (Chevron step one), and, if not, whether the Commission's interpretation is a permissible construction of the statute, id. at 843 (Chevron step two).

Because the Act is ambiguous regarding FERC's authority to require ISOs and RTOs to pay demand response resources, we are obliged to defer under Chevron to the Commission's permissible construction of "a statutory ambiguity that concerns the scope of the agency's statutory authority (that is, its jurisdiction)." City of Arlington v. FCC, 133 S. Ct. 1863, 1868, 1874-75 (2013). Absent an affirmative limitation under section 201, there is no doubt that demand response participation in wholesale markets and the ISOs' and RTOs' market rules concerning such participation constitute "practice[s] . . . affecting" wholesale rates under section 206 of the Act. 16 U.S.C. § 824e(a); see also id. § 824d(a) (providing that "all rules and regulations affecting or pertaining to [wholesale] rates or charges shall be just and reasonable"). Petitioners' arguments to the contrary ignore the direct effect that the ISOs' and RTOs' market rules have on wholesale

electricity rates squarely within FERC's jurisdiction. The Commission has authority to "determine the just and reasonable . . . practice" by setting a level of compensation for demand response resources that, in its expert judgment, will ensure that the rates charged in wholesale electricity markets are "just and reasonable." Id. § 824e(a). It was therefore reasonable for the Commission to conclude that it could issue Order 745 under the Act's "affecting" jurisdiction. See id. §§ 824e(a), 824d(a).

In addition to challenging FERC's jurisdiction, Petitioners argue that its decision to mandate compensation equal to the LMP was arbitrary and capricious. Petitioners believe that the LMP overcompensates demand response resources since they also realize savings from not having to purchase retail electricity. The Commission, Petitioners insist, should have set the compensation level at the LMP minus the retail cost of the forgone electricity. But the Commission's decision in this regard was reasonable and adequately explained.

Having identified a problem in the wholesale electricity market, the Commission has a statutory obligation to do what it can to fix it. That is because FERC is charged under the Federal Power Act with ensuring that wholesale electricity rates are "just and reasonable." 16 U.S.C. §§ 824d(a), 824e(a). It must ensure that all "rates and charges made, demanded, or received by any public utility for *or in connection with* the . . . sale of electric energy subject to the jurisdiction of the Commission" are "just and reasonable." Id. § 824d(a) (emphasis added); see also id. § 824(a). And when FERC determines that a "practice . . . affecting" such a rate is unjust or unreasonable, it must itself determine and fix "the just and reasonable . . . practice . . . to be thereafter observed." Id. § 824e(a).

Consistent with its statutory duty and in view of the market distortions caused by inelastic wholesale demand, the Commission has initiated a series of reforms to open wholesale markets to "demand response resources."

For some years now, FERC has recognized that the direct participation of demand response resources in wholesale markets improves the functioning of these markets in several respects. First, it lowers wholesale prices because "lower demand means a lower wholesale price." Order 719-A, Wholesale Competition in Regions with Organized Electric Markets, 128 FERC ¶ 61,059, 2009 WL 2115220, at **12 (July 16, 2009). Second, it mitigates the market power of suppliers of electricity because they have to compete with demand response resources and adjust their bidding strategy accordingly. See id. ("[T]he more demand response is able to reduce peak prices, the more downward pressure it places on generator bidding strategies by increasing the risk to a supplier that it will not be dispatched if it bids a price that is too high."). Third, demand response "enhances system reliability," for example, by "reducing electricity demand at critical times (e.g., when a generator or a transmission line unexpectedly fails)." Id. at **12 & n.76; see also Order 745-A, 2011 WL 6523756, at *6 ("[D]emand response generally can be dispatched by the [ISO or RTO] with a minimal notice period, helping to balance the electric system in the event that an unexpected contingency occurs.").

Petitioners argue that Order 745 is "in excess" of FERC's "statutory jurisdiction." Br. of Pet'rs Elec. Power Supply Ass'n, et al. ("Br. of Pet'rs") at 27 (citing 5 U.S.C. § 706(2)(C)). We evaluate this contention under Chevron and defer to FERC's permissible construction of its authorizing statute, regardless of "whether the interpretive question presented is 'jurisdictional.'" City of Arlington, 133 S. Ct. at 1874-75; see also Connecticut, 569 F.3d at 481. The proper question is thus whether the Act unambiguously forecloses FERC from issuing Order 745 under its "affecting" jurisdiction. See 16 U.S.C. § 824e; Chevron, 467 U.S. at 842.

FERC's explanation of its jurisdiction under the Federal Power Act is straightforward and sensible. FERC has the authority and responsibility to correct any "practice . . . affecting" wholesale electricity rates that the Commission determines to be "unjust" or "unreasonable." 16 U.S.C. § 824e(a); see also id. § 824d(a). In its view, the ISOs' and RTOs' rules governing the participation of demand response resources in the nation's wholesale electricity markets are "practices affecting [wholesale electricity] rates." Order 745-A, 2011 WL 6523756, at *10 (quoting 16 U.S.C. §§ 824d, 824e). That is, an ISO's or RTO's market rules governing how a demand response resource may compete in its wholesale market, including the terms by which a demand response resource is to be compensated in the market, are "practices affecting" that wholesale market's rates for electricity. And FERC has determined that an ISO's or RTO's "practice" is unjust and unreasonable to the degree that it inadequately compensates demand response resources capable of supplanting more expensive generation resources.

FERC's explanation is consistent with our case law. In *Connecticut*, we considered whether FERC has jurisdiction to review an ISO's capacity charges. 569 F.3d at 478-79. Capacity is not electricity but the ability to produce it when needed, and in *Connecticut* the ISO had established a market where capacity providers – generators, prospective generators, and demand response resources – competitively bid to meet the ISO's capacity needs three years in the future. *Id.* at 479-81. Generation, like retail sales, is expressly the domain of State regulation under section 201, 16 U.S.C. § 824(b)(1), and the petitioners argued that by increasing the overall capacity requirement the ISO was improperly requiring the installation of new generation resources. 569 F.3d at 481. We disagreed and held that FERC had "affecting" jurisdiction under section 206 because "capacity decisions . . . affect FERC-jurisdictional transmission rates for that system without directly implicating generation facilities." *Id.* at 484. That the capacity requirement helped to "find the right price" was enough of an effect to satisfy section 206. *Id.* at 485.

Order 745 does not require anything of retail electricity consumers and leaves it to the States to decide whether to permit demand response. All Order 745 says is that *if* a State's laws permit demand response to be bid into electricity markets, and *if* a demand response resource affirmatively decides to participate in an ISO's or RTO's wholesale electricity market, and *if* that demand response resource would in a particular circumstance allow the ISO or RTO to balance wholesale supply and demand, and *if* paying that demand resource would be a net benefit to the system, *then* the ISO or RTO must pay that resource the LMP. That is it. This requirement will no doubt affect how

much electricity is consumed by a small subset of retail consumers who elect to participate as demand response resources *in wholesale markets*. But that fact does not render Order 745 "direct regulation" of the retail market. Authority over retail rates and over whether to permit demand response remains vested solely in the States.

To bolster their case, Petitioners invoke the specter of limitless federal authority if FERC is permitted to exercise "affecting" jurisdiction to issue Order 745. They caution that "the Commission's expansive interpretation of its 'affecting' jurisdiction would allow it to regulate any number of activities – such as the purchase or sale of steel, fuel, labor, and other inputs influencing the cost to generate or transmit electricity – merely by redefining the activities as 'practices' that affect wholesale rates." Br. of Pet'rs at 33.

This argument ignores the limitations we announced in CAISO, 372 F.3d 395. There, we held that FERC exceeded its jurisdiction when it replaced the board members of an ISO on the theory that the composition of the ISO's board was a "practice . . . affecting [a] rate" under section 206(a). Id. at 399. We held that "section 206's empowering of the Commission to assess the justness and reasonableness of practices affecting rates of electric utilities is limited to those methods or ways of doing things on the part of the utility that directly affect the rate or are closely related to the rate, not all those remote things beyond the rate structure that might in some sense indirectly or ultimately do so." Id. at 403 (emphasis added).

These limits foreclose the parade of horribles marshaled by Petitioners. Like replacing the ISO's board of directors in CAISO, FERC could not, consistent with Circuit precedent, regulate markets in steel, fuel, labor, and other inputs for generating electricity, which constitute "remote things beyond the rate structure that might in some sense indirectly or ultimately" affect the wholesale rate of electricity. Order 745 passes the *CAISO* test quite comfortably because the demand response resources subject to the rule have a quintessentially "direct" effect on wholesale rates. There can be little doubt that FERC has the authority to review the justness and reasonableness of rates that are so closely connected with the healthy functioning of its jurisdictional markets; this, as we said in *Connecticut*, is the "heartland of the Commission's section 206 jurisdiction." 569 F.3d at 483.

This court has no business second-guessing the Commission's judgment on the level of compensation. See La. Pub. Serv. Comm'n v. FERC, 551 F.3d 1042, 1045 (D.C. Cir. 2008) (noting that "[w]here the subject of our review is . . . a predictive judgment by FERC about the effects of a proposed remedy . . . , our deference is at its zenith"); Pub. Serv. Comm'n of Ky. v. FERC, 397 F.3d 1004, 1009 (D.C. Cir. 2005) (holding that "more than second-guessing close judgment calls is required to show that a rate order is arbitrary and capricious" (citation omitted)); Envtl. Action, Inc. v. FERC, 939 F.2d 1057, 1064 (D.C. Cir. 1991) ("[I]t is within the scope of the agency's expertise to make . . . a prediction about the market it regulates, and a reasonable prediction deserves our deference notwithstanding that there might also be another reasonable view.").

Whatever policy disagreements one might have with Order 745's decision to compensate demand response resources at the LMP (and there are legitimate disagreements to be had), the rule does not fail for want of reasoned decisionmaking. FERC's judgment is owed deference because it has put forth a reasonable multi-step explanation of its decision to mandate LMP compensation. First, responsive demand is a necessary component of a well-functioning wholesale market, and FERC understood that its obligation to ensure just and reasonable rates required it to facilitate an adequate level of demand response participation in its jurisdictional markets. *See* Order 745, 2011 WL 890975, at *16. Second, FERC concluded that market barriers were inhibiting an adequate level of demand response participation. *See id.* Third, FERC concluded that mandating LMP would provide the proper incentives for demand response resources to overcome these barriers to participation in the wholesale market.

FERC had jurisdiction to issue Order 745 because demand response is not unambiguously a matter of retail regulation under the Federal Power Act, and because the demand response resources subject to the rule directly affect wholesale electricity prices. *See* 16 U.S.C. §§ 824d, 824e. And the Commission's decision to require compensation equal to the LMP, rather than LMP - G, was not arbitrary or capricious. The majority disagrees on both points. The unfortunate consequence is that a promising rule of national significance – promulgated by the agency that has been authorized by Congress to address the matters in issue – is laid aside on grounds that I think are inconsistent with the statute, at odds with applicable precedent, and impossible to square with our limited scope of review. I therefore respectfully dissent.