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Federal Energy Regulatory Commission v. Electric Power Supply Association

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***Federal Energy Regulatory Commission v. Electric Power Supply Association*, 136 S. Ct. 760 (2016).**

Keatan Williams

In a 6-2 opinion delivered by Justice Kagan, the United States Supreme Court upheld FERC Order No. 745, which regulates the prices that wholesale market operators pay for demand response bids. At issue in the case was whether this regulation exceeded FERC’s wholesale regulation authority under the Federal Power Act, thereby impinging on retail markets under state regulation, and whether the pricing regulations within the rule were chosen in an arbitrary and capricious manner. The Court held Order No. 745 withstood both challenges.

I. INTRODUCTION

At issue in *Federal Energy Regulatory Commission v. Electric Power Supply Association* was the Electric Power Supply Association’s (“EPSA”) challenge to whether the Federal Energy Regulatory Commission (“FERC”) had the authority under the Federal Power Act (“FPA”) to promulgate Rule No. 745 (“Rule”), which regulates the prices that wholesale market operators pay for demand response bids.¹ The United States Court of Appeals for the District of Columbia Circuit vacated the Rule, holding that it “engage[d] in ‘direct regulation of the retail market’” and, that “alternatively, . . . the Rule [was] arbitrary and capricious under the Administrative Procedure Act.”²

The Supreme Court of the United States reversed and upheld the authority of the Rule using a three-step analysis.³ First, the Court held that the practices regulated by the Rule “directly affect wholesale rates,” and so are within FERC authority under the FPA.⁴ Second, the Court held that the Rule did not regulate retail sales and therefore complied with the FPA.⁵ Third, the Court held that vacating the Rule would conflict with the core purposes of the FPA.⁶ Additionally, the Court held that the Rule was not arbitrary and capricious in the manner that it

1. Fed. Energy Regulatory Comm’n v. Electric Power Supply Ass’n, 136 S. Ct. 760 (2016).

2. *Id.* at 772 (quoting *Electric Power Supply Ass’n v. Federal Energy Regulatory Comm’n*, 753 F.3d 216, 223-25 (D.C. Cir. 2014)).

3. *Id.* at 773.

4. *Id.*

5. *Id.*

6. *Id.*

regulated the sales, because FERC “addressed the issue seriously and carefully.”⁷ The Court rendered a 6-2 verdict, with Justice Samuel A. Alito abstaining.⁸ Justice Antonin G. Scalia, joined by Justice Clarence Thomas, dissented, suggesting that the Rule should have failed all three steps of the test and, additionally, was arbitrary and capricious.⁹ While Justice Scalia’s interpretation of the law provides insightful dicta, for now FERC is within its authority to regulate demand response transactions in the energy market.

II. FACTUAL AND PROCEDURAL BACKGROUND

The FPA authorizes and places limits on FERC’s regulation of the energy market.¹⁰ Under the act, FERC may regulate “‘the sale of electric energy at wholesale in interstate commerce,’ including both wholesale electricity rates and any rule or practice ‘affecting’ such rates.”¹¹ The language giving FERC authority to promulgate rules affecting such rates has been interpreted in case law to limit FERC’s authority to rules that “directly affect the whole sale rate.”¹² Additionally, FERC’s authority is limited by the prohibition that its rules may not regulate retail electricity sales.¹³ This provision does not, however, prohibit FERC rules “just because [they] affect[]—even substantially—the quantity or terms of retail sales.”¹⁴

The questions in this case apply these grants of authority specifically to the practice of demand response competition. In the current market, it is often beneficial to wholesale energy providers, called wholesale market operators (“WMO”), to pay “load-serving entities” (“LSE”) and other purchasers to use less power during peak hours.¹⁵ On the supply side, WMOs take bids from energy providers and then accept those bids starting at the lowest cost until the energy demand is met.¹⁶ The highest bid amount accepted is then paid to all bidders.¹⁷

7. *Id.* at 784.

8. *Id.* at 765

9. *Id.* at 784-89.

10. *Id.* at 766; *see* 16 U.S.C. §§ 791a-823d (2012).

11. *FERC*, 136 S Ct. at 766 (quoting 16 U.S.C. §§ 824(b), 824e(a) (2012)).

12. *Id.* (quoting *Cal. Indep. Sys. Operator Corp. v. FERC*, 372 F.3d 395, 403 (D.C. Cir. 2004)).

13. *Id.*; *see* 16 U.S.C. §824(b).

14. *FERC*, 136 S Ct. at 776.

15. *Id.* at 769-770.

16. *Id.* at 770.

17. *Id.*

Alternatively, the WMOs can pay wholesale purchasers to use less energy during peak hours, which allows the WMOs to accept lower bids and save money overall.¹⁸ Additionally, this scheme promotes lower energy use and helps to prevent overloading the electrical grid.¹⁹ These payments to buyers for not using electricity are called demand response.²⁰ WMOs, recognizing the potential for a more effective system, started implementing demand response bids into their auctions around 2000 with permission from FERC.²¹

In 2005, Congress encouraged demand response in the Energy Policy Act.²² Then, in 2008, FERC issued Order No. 719, which “require[d] wholesale market operators to receive demand response bids . . . except when the state regulatory authority . . . bar[red] such demand response participation.”²³ This order allowed WMOs to compensate demand response providers however they chose.²⁴ Lastly, in 2011, FERC issued Order No. 745, Demand Response Competition in Organized Wholesale Energy Markets.²⁵ This is the rule under review in this case.

Rule 745 “requires that demand response providers . . . receive as much for conserving energy as generators do for producing it.”²⁶ This requirement specified two conditions which would not apply. First, the bidder must have “the capability to provide the service,” and secondly, paying for the bid “must be cost-effective.”²⁷ Additional language in the Rule preserved states’ right to ban the practice under Order No. 719.²⁸ In promulgating the Rule, FERC rejected an alternative formula that would have allowed WMOs to pay the equal price minus retail price to demand response bidders.²⁹

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.*

22. *Id.*; see 16 U.S.C. § 2642 (2012).

23. *FERC*, 136 S. Ct. at 771; see 18 C.F.R. § 35.28(g)(1) (2015).

24. *FERC*, 136 S. Ct. at 771.

25. *Id.*; see 18 C.F.R. § 35.28(g)(1)(v).

26. *FERC*, 136 S. Ct. at 771.

27. *Id.*; see 76 Fed. Reg. 16,658, ¶¶ 48-49 (Mar. 24, 2011).

28. *FERC*, 136 S. Ct. at 772.

29. *Id.*

III. ANALYSIS

A. *The Rule Has an Affect on Wholesale Markets*

The Court used a three-step analysis to interpret the Federal Power Act. The first step in the Court's analysis was to determine whether the Rule regulates the wholesale market or affects the rates of those markets.³⁰ Affecting the rates means that the Rule "directly affect[s] the wholesale rate."³¹ Because the Rule focused on regulating a program with the primary goal of reducing wholesale rates, the Court held that it "directly affect[ed] wholesale prices" and it was "hard to think of a practice that does so more."³²

B. *The Rule Does Not Regulate Retail Sales*

To fall within FERC's authority under the FPA, the Rule must also "not regulate retail electricity sales."³³ This test on the limit of FERC's authority acknowledges that "transactions that occur on the wholesale market have natural consequences at the retail level."³⁴ The Court thus framed the jurisdictional argument in terms of markets, instead of sales, determining that the Rule focused "exclusively on the wholesale market and govern[ed] exclusively that market's rules."³⁵ To come to this conclusion, the Court looked to FERC's justification for the regulation and found it to be based entirely on improving the wholesale market.³⁶

The Court directly addressed EPSA's arguments on the regulation of retail versus wholesale jurisdiction. EPSA first argued that because large energy consumers purchase energy on the wholesale market, the Rule effectively raises retail rates because the "opportunity to make demand response bids in the wholesale market changes consumer's calculations."³⁷ For example, EPSA argued that if a factory could buy electricity for ten dollars or be paid five dollars to not use electricity, by sacrificing the opportunity to get paid for reducing use, the retail price

30. *Id.* at 773.

31. *Id.* at 774.

32. *Id.* at 775. The dissent did not consider this test appropriate for analysis under the FPA. *Id.* at 785 (Scalia, J., dissenting).

33. *Id.* at 775 (majority opinion).

34. *Id.* at 776.

35. *Id.*

36. *Id.*

37. *Id.*

“effectively” rises from ten dollars to fifteen dollars.³⁸ Without any specific citation, the Court held that their previous decisions “uniformly speak about rates, for electricity and all else, in only their most prosaic, garden-variety sense.”³⁹ Therefore, the Court rejected the argument of the “effective” rate and held that “EPSA’s theoretical construction thus runs head long into the real world.”⁴⁰

ESPA next argued that FERC promulgated the Rule to deliberately lure retail customers on to the wholesale market so that fewer purchasers were under state authority.⁴¹ The Court turned to its previous history of the rule to refute this claim.⁴² The Court reiterated that FERC only played a role in this type of market at the request of the WMOs and even when doing so, granted veto power to the states.⁴³ The Court rejected this argument without much discussion.

The dissent accepted and bolstered EPSA’s argument of “effective” price by including a definition from Black’s Law Dictionary, and using an analogy of airplane vouchers.⁴⁴ The majority gave this argument no credit, considering it “convoluted.”⁴⁵ Additionally, the dissent focused on purchasers instead of markets when analyzing whether the Rule regulates retail sales.⁴⁶ With this focus, the dissent held that the Rule exceeds its authority because some of the companies entering demand response bids are large consumers of electricity and not re-sellers and therefore the rule is regulating retail sales.⁴⁷ The majority did not discuss this theory.

C. Invalidating the Rule Would Subvert the FPA

The Court further held that invalidating the Rule using EPSA’s arguments would subvert the FPA.⁴⁸ The Court reasoned that if FERC was unable to regulate demand response at all, as the EPSA argued, then the whole system of demand response bidding would cease to exist because FERC could not have approved its implementation in the first

38. *Id.*
 39. *Id.* at 778.
 40. *Id.*
 41. *Id.* at 778-779.
 42. *Id.* at 779.
 43. *Id.*
 44. *Id.* at 787 (Scalia, J., dissenting).
 45. *Id.* at 778 n.9 (majority opinion).
 46. *Id.* at 785-86 (Scalia, J., dissenting).
 47. *Id.* at 786.
 48. *Id.* at 780 (majority opinion).

place.⁴⁹ If this were to occur, the Court reasoned, it would “flout the FPA’s core objects” and “halt a process that so evidently enables [the FPA objectives] of holding down prices and enhancing reliability in the wholesale energy market.”⁵⁰ The dissent devoted the majority of its opinion to addressing this reasoning, which it considered “alarmist hyperbole.”⁵¹ The dissent believed that, at most, invalidating the Rule would “eliminate this particular flavor of FERC-regulated demand response.”⁵²

D. The Rule Passes the APA Standard

Lastly, EPSA challenged FERC’s decision of how to formulate required prices under the Rule as “arbitrary and capricious” and therefore in violation of the APA.⁵³ EPSA argued that FERC arbitrarily chose to require WMOs to compensate bidders at the price they would have paid an energy provider bid instead of subtracting the retail price.⁵⁴ The Court relied heavily on agency deference and held that “[FERC] addressed [the] issue seriously and carefully.”⁵⁵

IV. CONCLUSION

The Court upheld Rule No. 745 with vigor, and in doing so, promoted the use of demand response bidders to enable a more efficient and reliable electricity market. The Court further established that in complicated issues of state and federal energy regulation, it will continue to differentiate by traditional definitions of markets and not get bogged down in the complexities of the energy market.

49. *Id.*
50. *Id.* at 781-82.
51. *Id.* at 788 (Scalia, J., dissenting).
52. *Id.*
53. *Id.* at 782 (majority opinion).
54. *Id.*
55. *Id.* at 784.