Holland & Knight

SUPREMACY AND CLEAN ENERGY COMMERCE:
UNDERSTANDING FEDERALISM VS. STATES' RIGHTS IN RENEWABLE ENERGY FOR BUSINESS LAWYERS

Stephen J. Humes, Esq. | Holland & Knight LLP | New York, NY

A Hot Topics Presentation at ABA Annual Meeting | August 7, 2016

AMERICAN BAR ASSOCIATION
Business Law Section

Copyright © 2016 Holland & Knight LLP. All Rights Reserved

Introduction

States and federal energy regulators are increasingly challenging each other's traditional understanding of the balance of power between the federal government and states' rights to adopt incentives to promote renewable energy.

This year's recently-concluded U.S. Supreme Court term involved a trio of energy decisions that clarify the balance of energy regulatory power between federal and state governments when it comes to electricity and natural gas industries.

Introduction *(continued)*

Renewable energy project developers and their financiers are finding new legal frameworks that help clarify a renewed spirit of cooperative federalism across the U.S., especially in organized competitive wholesale power markets.

These recent decisions explain the applicability of the Federal Power Act's balance of powers to emerging clean energy demand response technologies, including the roles of demand response, energy efficiency and net metering policies across state lines. These decisions also shed light on federalism and states' rights over natural gas.

Examples of Relevant Impacts of These Legal Developments

- Here are some examples of projects impacted by the recent decisions:
  - Projects offering distributed (i.e., behind the meter) rooftop solar, demand response or energy efficiency
  - Businesses that offer to aggregate demand resources and sell them in the wholesale market. (Think of Nest thermostats in many homes being aggregated and offered into wholesale markets during peak hours to avoid expensive power generation.)
  - Power plant developers and grid scale renewable energy developers who are counting on state-supported long-term contracts to guarantee offtake revenues
  - Natural gas pipelines facing state regulation

Examples of Relevant Impacts of These Legal Developments *(continued)*

In the following presentation, we will discuss why the referenced scenarios and many others are impacted by recent legal shifts and movements confirmed by the U.S. Supreme Court in three cases.

Learning Objectives for Today

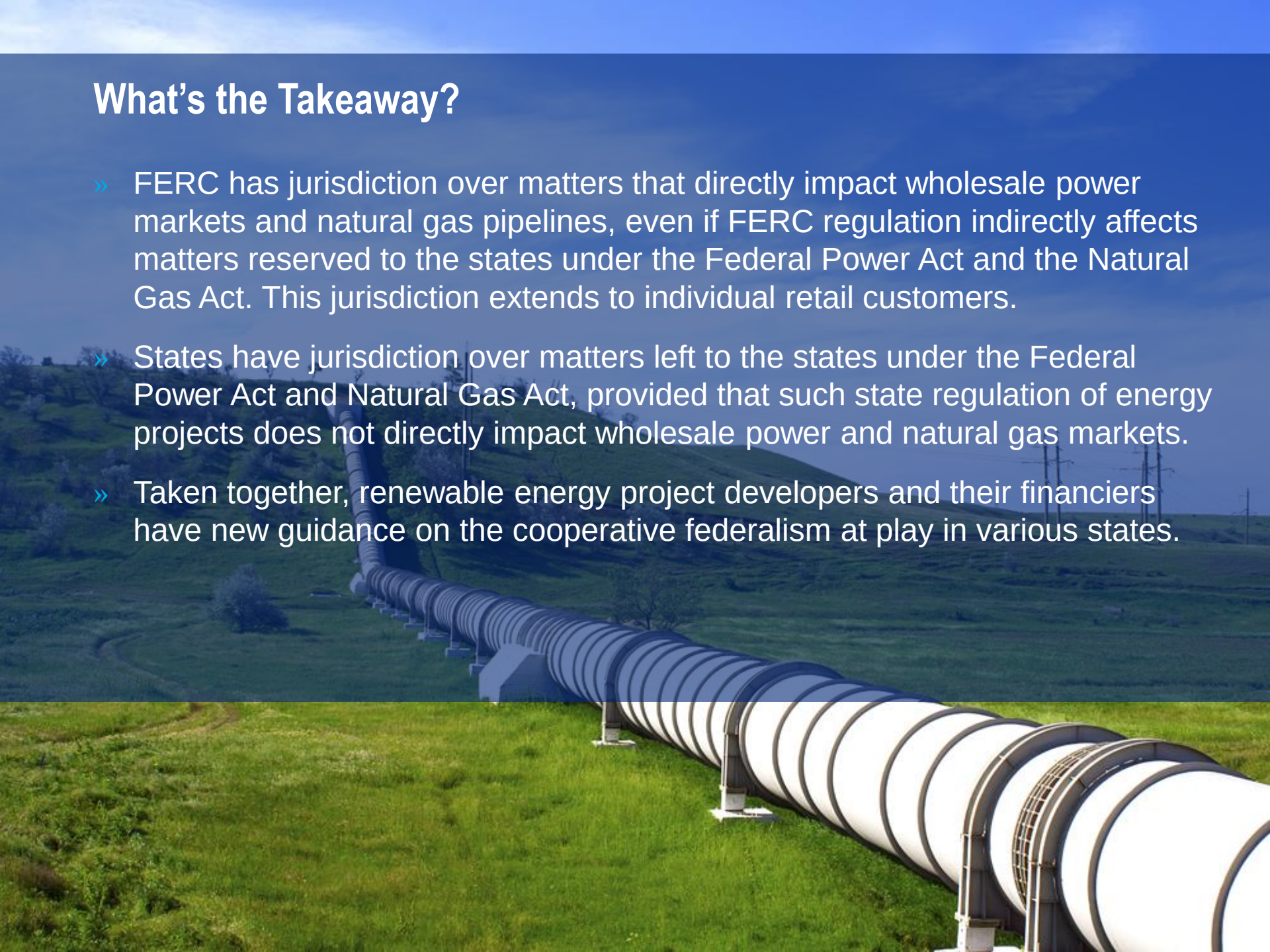
- Understand the key federal statutes involved in energy and natural gas projects
  - Federal Power Act
  - Natural Gas Act
- Learn about the trio of recent U.S. Supreme Cases interpreting Federal vs. States' energy roles
  - *Oneok, Inc. v. Learjet, Inc.*
  - *FERC v. Electric Power Supply Association*
  - *Hughes v. Talen Energy Marketing*
- Identify the federalism vs. states' rights issues in renewable energy project development
- Obtain practical guidance to reduce legal risk and avoid surprises in renewable energy project deal structuring

Setting the Stage – Do States or Federal Government Authorize Energy Projects?

- One recent case dealt with whether the Federal Energy Regulatory Commission (FERC) went too far and infringed on states' rights when FERC issued a 2010 rule, called Order No. 745, that requires competitive wholesale power market operators to pay end-use electric consumers for commitments not to use power at certain key times. Order No. 745 also required that these payments be equal to compensation paid to wholesale power generators for building power plants and generating electricity. In this way, FERC was essentially ordering that "negawatts" equal megawatts.
- Another case claimed that FERC preempted Maryland and New Jersey state efforts to incentivize new wholesale power plants with long-term contracts. Plaintiffs argued states interfered with the wholesale markets.
- A third case dealt with the ability under state antitrust law to review transactions in the wholesale natural gas industry regulated by FERC. State law regulation of natural gas pipelines is preempted, plaintiffs claimed.

What's the Takeaway?

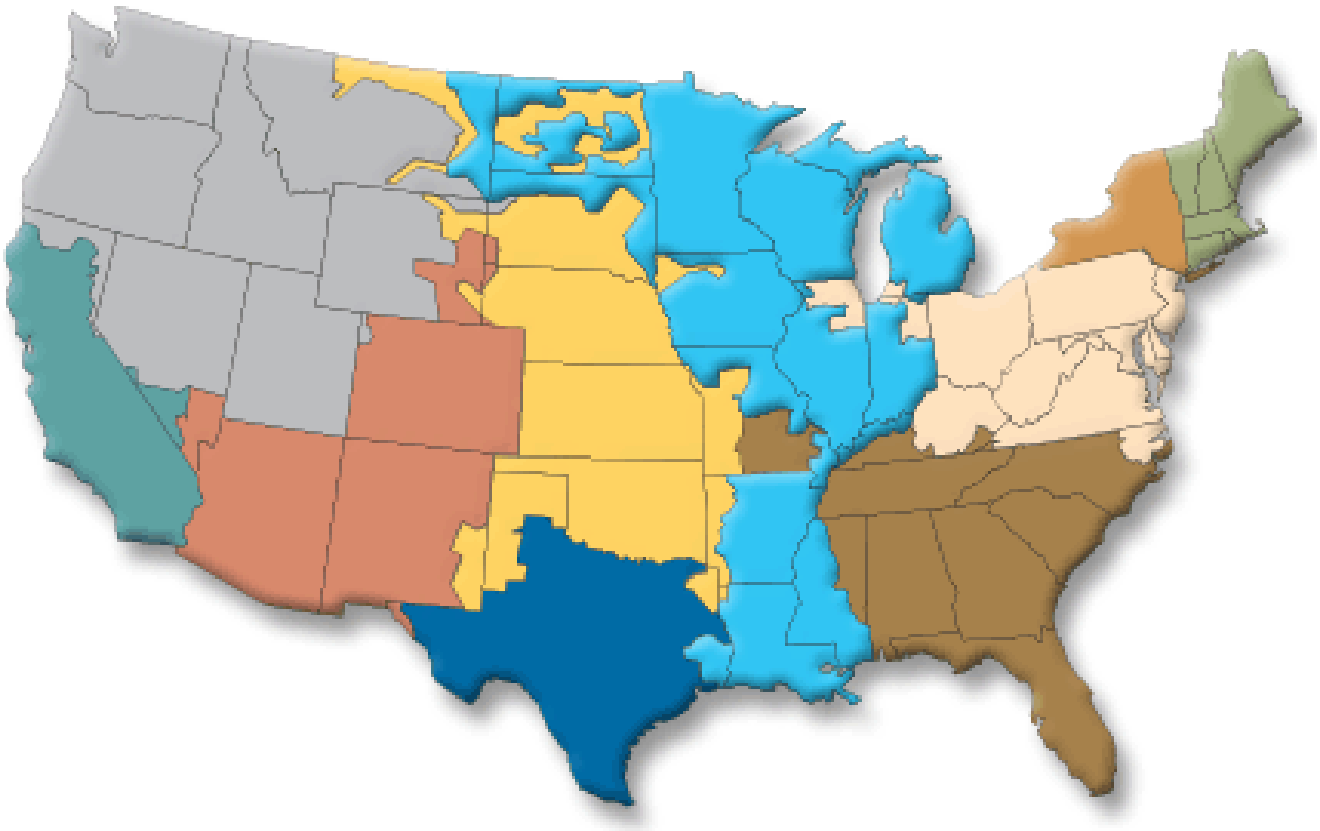
- FERC has jurisdiction over matters that directly impact wholesale power markets and natural gas pipelines, even if FERC regulation indirectly affects matters reserved to the states under the Federal Power Act and the Natural Gas Act. This jurisdiction extends to individual retail customers.
- States have jurisdiction over matters left to the states under the Federal Power Act and Natural Gas Act, provided that such state regulation of energy projects does not directly impact wholesale power and natural gas markets.
- Taken together, renewable energy project developers and their financiers have new guidance on the cooperative federalism at play in various states.



Understanding the Federal Power Act, 16 USC § 824 et seq.

- The business of transmitting and selling electric energy for ultimate distribution to the public is affected with a public interest and has subjected certain matters relating to the generation of electric energy, the transmission of electric energy in interstate commerce, and the sale of such energy at wholesale in interstate commerce to federal regulation. However, federal regulation extends only to those matters that are not subject to regulation by the states.
- For purposes of the Federal Power Act (FPA), electric energy is deemed "transmitted in interstate commerce" if electrons are transmitted from a state and consumed at any point that is outside that state and within the United States.
  - Thus, sales of electric energy by a utility that is a member of an integrated multi-state electric power system that meets its system loads with power generated in various states are sales in interstate commerce.
  - But if an electric utility is not connected to a power grid that crosses state lines, sales on that in-state utility would be deemed intrastate and exempt from the FPA.

FERC Regulation of Wholesale Power Markets



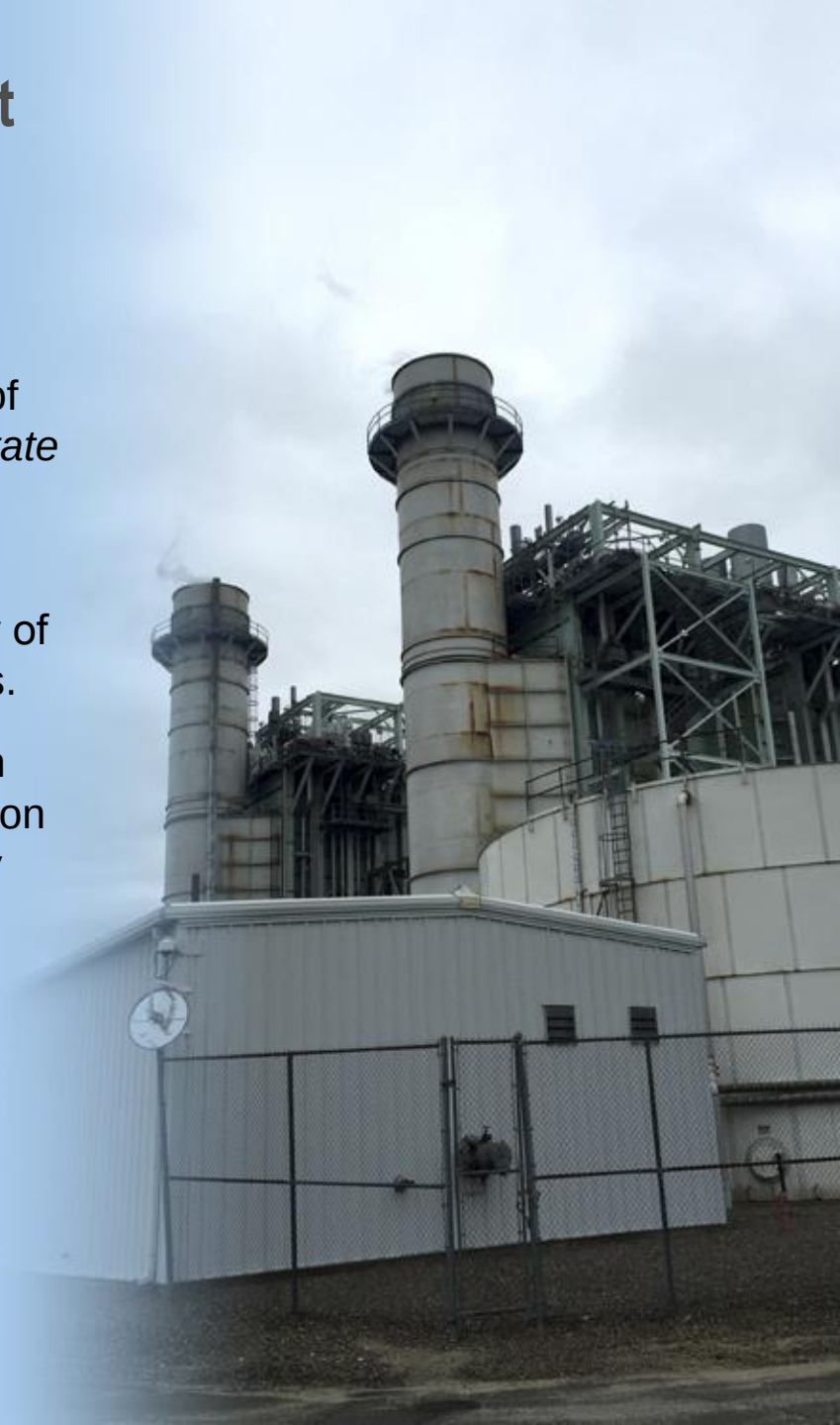
FERC regulates wholesale power in all states except Texas.

Understanding the Federal Power Act *(continued)*

- The FPA:
  - Authorizes Federal Energy Regulatory Commission (FERC)
  - Defines the FERC's authority and jurisdiction over the wholesale transmission and sale of electric power and energy in interstate commerce
  - Declares standards through which FERC must perform its duties
- Under one part of the FPA:
  - FERC has jurisdiction over the issuance of licenses for the construction of electric power projects on navigable waters or public lands or reservations of the United States
  - FERC regulates companies granted licenses for such projects

Understanding the Federal Power Act *(continued)*

- Under Part II of the FPA:
  - FERC regulates the transmission and sale of wholesale electric energy products in *interstate* commerce, including interconnection and coordination of wholesale facilities.
  - FERC's job is to assure an abundant supply of electric energy throughout the United States.
  - The FPA specifically gives FERC jurisdiction over all facilities for the *interstate* transmission or sale of electric energy, and the regulatory power of FERC extends, and is confined to, public utilities engaged in *interstate* transmission and sale of wholesale power.
  - Case law shows that FERC may have jurisdiction even though some facilities are used both in *interstate* and *intrastate* commerce.



Understanding the Federal Power Act *(continued)*

- FERC does not have jurisdiction over facilities used only for the *intrastate* generation of electric energy or over facilities used in local distribution or only for the transmission of electric energy in *intrastate* commerce.
- FERC also has no jurisdiction over facilities for the transmission of electric energy consumed wholly by the transmitter or generator. This exemption from FERC jurisdiction for facilities used in local distribution of electric energy is not limited to those which do not carry any trace of out-of-state energy; the test for exemption is whether facilities are purely local distribution facilities and carry no energy out of state.
- Prior cases have held, however, that in the exercise of its broad regulatory powers, FERC may determine whether a particular electric power company is covered by the FPA.

Understanding the Federal Power Act *(continued)*

- FERC's authority, therefore, is paramount as to matters affecting the transmission of electricity in interstate commerce, and neither a state public service commission nor state court can control the decisions of FERC when it is acting within the scope of its authority in matters involving wholesale transmission and sale of energy in interstate commerce.
- Preemptive effect of FERC jurisdiction does not turn on whether a particular matter has actually been determined by FERC.

Understanding the Natural Gas Act, 15 USC §717 *et seq*.

- FERC's Natural Gas Act (NGA) regulatory jurisdiction applies to the transportation of natural gas in interstate commerce, the sale for resale of natural gas in interstate commerce for ultimate public consumption for domestic, commercial, industrial, or any other use, to natural-gas companies engaged in such transportation or sale, and to the importation or exportation of natural gas in foreign commerce and to persons engaged in such importation or exportation.
- FERC does not have jurisdiction over any *intrastate* transportation or sale of natural gas or to the rates and regulation of local distribution companies or to the facilities used for such distribution or to the production or gathering of natural gas.
- The NGA is similar to the FPA.

Understanding the Natural Gas Act *(continued)*

- NGA allows FERC to determine whether:
  - "any rate, charge, or classification . . . collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of [FERC]," or
  - "any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential"
- The NGA limits the scope of FERC's authority to activities "in connection with any transportation or sale of natural gas.
  - Specifically, FERC has jurisdiction over:
    - "the transportation of natural gas in interstate commerce,"
    - "the sale in interstate commerce of natural gas for resale," and
    - "natural-gas companies engaged in such transportation or sale"

Understanding the Natural Gas Act *(continued)*

- FERC regulation of the natural gas industry evolved over the decades from a comprehensive and strict regulatory framework at time of initial enactment in 1938 to a competitive model that began to emerge in 1985. By 1992, with FERC's adoption of Order 636, FERC was undertaking deregulation and allowing "open access" to pipelines so that consumers could pay to ship their own gas).
- With that approach, FERC began to rely on the competitive marketplace, rather than classical regulatory rate-setting, as the main mechanism for keeping wholesale natural gas rates at a reasonable level. Order 636 allowed FERC to issue blanket certificates that permitted jurisdictional sellers (typically interstate pipelines) to charge market-based rates for gas, provided that FERC had first determined that the sellers lacked market power.

Understanding the Natural Gas Act *(continued)*

- The new system under Order 636 led many large industrial and commercial gas customers to buy their own gas directly from gas producers at the wellhead, and to arrange with interstate pipelines (and often pay separately) for transportation from the field to the place of consumption.
- In the 2000s, post Enron and other market misconduct cases, FERC adopted industry codes of conduct.

Relevant Constitutional Law Principles on Federalism and States' Rights

- Supremacy Clause: provides that "the Laws of the United States" (as well as treaties and the Constitution itself) "shall be the supreme Law of the Land . . . anything in the Constitution or Laws of any state to the Contrary notwithstanding." Art. VI, cl. 2.
- Preemption: Congress may invalidate a state law through federal legislation. It may do so through express language in a statute or by implication.
  - Implied Preemption: Even where a statute does not refer expressly to preemption, Congress may implicitly preempt a state law, rule, or other state action. It may do so either through "field" preemption or "conflict" preemption.
    - Field Preemption: Congress may have intended "to foreclose any state regulation in the area," irrespective of whether state law is consistent or inconsistent with "federal standards." In such situations, Congress has forbidden the State to take action in the field that the federal statute preempts.
    - Conflict Preemption: Arises when "compliance with both state and federal law is impossible," or where "the state law 'stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."
  - In either field preemption or conflict preemption, federal law must prevail.

Judicial Deference to Administrative Agencies

- The courts have a limited scope of review over FERC orders.
  - While they may not supplant well-reasoned judgments with those more nearly to their liking, they must assure that the commission or agency has given reasoned consideration to each of the pertinent factors.

- The Courts have held that FERC must be free to devise methods of regulation capable of equitably reconciling diverse and conflicting interests, and must be given every reasonable opportunity to formulate methods of regulation appropriate for the solution of practical difficulties.
  - FERC therefore enjoys substantial discretion in balancing competing interests and may interpret statutes on a case-by-case basis.
  - FERC must give reasoned consideration to the pertinent factors.

Oneok, Inc. v. Learjet, Inc., 135 S.Ct. 1591, (April 21, 2015)

- Large industrial customers believed pipelines were manipulating natural gas indices and sued interstate pipelines in state courts.
  - Pipelines removed cases to federal court and claimed preemption.
  - District Court of Nevada held state law antitrust claims were preempted by the NGA, but the Ninth Circuit reversed, emphasizing that the price-manipulation alleged affected not only jurisdictional (i.e., wholesale) sales, but also nonjurisdictional (i.e., retail) sales.
- The Ninth Circuit construed the NGA's preemptive scope narrowly in light of Congress' intent to preserve for the States the authority to regulate nonjurisdictional sales.
- The court held that the Act did not preempt state-law claims aimed at obtaining damages for excessively high retail natural-gas prices stemming from interstate pipelines' price manipulation, even if the manipulation raised wholesale rates as well.

Oneok, Inc. v. Learjet, Inc., 135 S.Ct. 1591, (April 21, 2015) *(continued)*

- The Supreme Court held that the NGA – a statute similar to the FPA in many respects – does not preempt a state law antitrust investigation of sales of natural gas.
- The Court nonetheless observed that "Congress occupied the field of matters relating to wholesale sales and transportation of natural gas in interstate commerce."

Oneok, Inc. v. Learjet, Inc. *(continued)*

- Supreme Court: The key difference for preemption purposes was the distinction between "measures aimed *directly* at interstate purchasers and wholesale for resale, and those aimed at" subjects left to the states. Where a state law can be applied to non-jurisdictional (i.e., state's realm) as well as jurisdictional (i.e., FERC's realm) sales, the Court will only find preemption where the matter falls within the preempted field. Antitrust laws, the Court said, like blue sky laws, are not aimed at natural gas companies in particular, but rather at all businesses in the marketplace.
- This broad applicability of non-jurisdictional enforcement, not aimed solely at wholesale natural gas sellers, convinced the Court to find no preemption.
- NGA precedents emphasize the importance of considering the *target* at which the state law *aims* in determining whether that law is preempted.
- After *Oneok v. Learjet*, NGA still preempts states but . . . State laws may be used to regulate energy sector as long as regulation is not aimed solely at a FERC jurisdictional matter.

FERC Order 745: Prelude to *FERC v. Electric Power Supply Assn*.

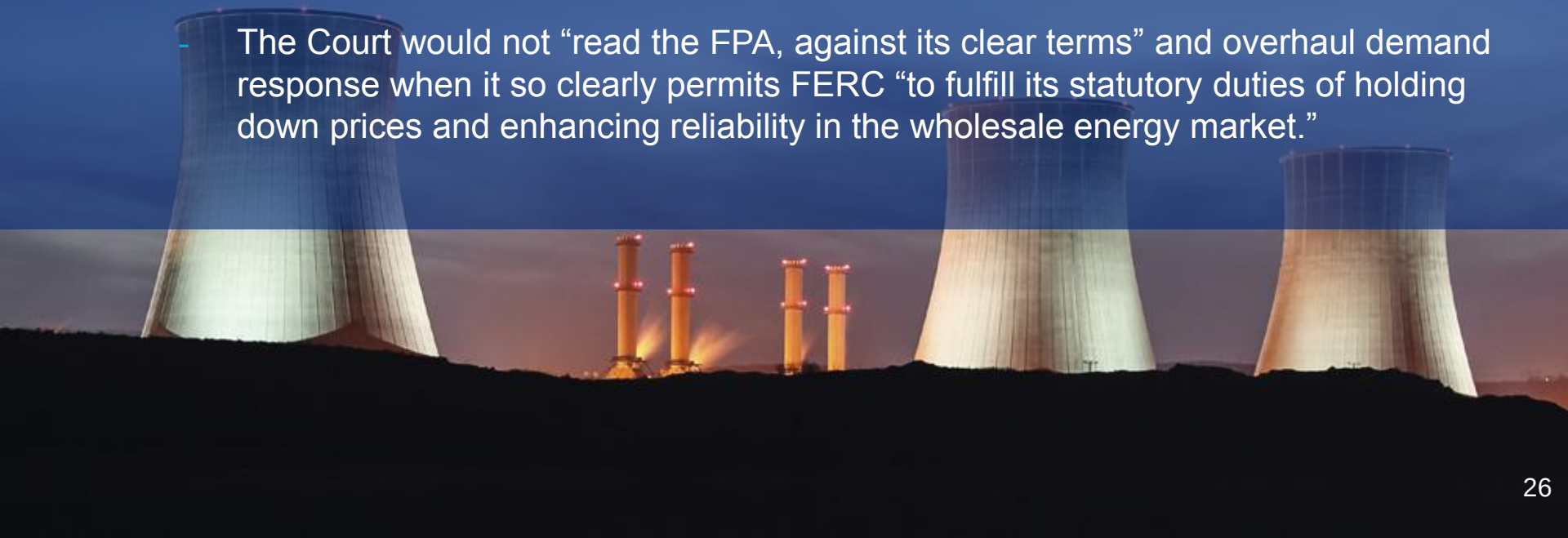
- Competitive wholesale power markets, run by ISOs/RTOs, buy power from power generators to meet demand for electricity in their grid areas. If they could find a way to encourage large reductions in usage, less wholesale power generation capacity would need to be built and compensated.
- FERC issued Order 745 under the FPA in 2010 to require wholesale power market operators to pay electric consumers for their commitments not to use power at certain key times (such as when demand is particularly high).
  - Order 745 required that these payments for not using electricity be equal to the rates wholesale power generators are paid for generating electricity.
  - FERC thus sought to establish the principle that “negawatts” equal megawatts.

FERC v. Electric Power Supply Assn. *(continued)*

- Wholesale generators, seeing FERC's position as a threat to their markets, challenged Order 745.
  - First, they argued, FERC has no jurisdiction under the FPA over the electric consumption of end-use customers at their homes or places of business; they argued such retail use is the exclusive province of the states. (They argued the FPA states FERC does not have jurisdiction over matters reserved to the states.)
  - Second, they argued that FERC acted arbitrarily and capriciously by determining that negawatts equal megawatts. After all, why should customers that make the inexpensive decision to stay out of the market be paid the same amount as companies that invest millions to erect the massive machinery that actually generates electricity?

FERC v. Electric Power Supply Assn. *(continued)*

- In a 6-2 decision (Justice Alito recused himself), the Court sided with FERC.
- Order 745 only *indirectly* impacted retail market prices; the order's *direct* effect was on wholesale markets, thus putting it within FERC's jurisdiction.
- Justice Kagan:
  - FERC had "amply explained how wholesale demand response" helps to achieve the FPA's dual core objectives – to protect "against excessive prices" and ensure "effective transmission of electric power."
  - The Court would not "read the FPA, against its clear terms" and overhaul demand response when it so clearly permits FERC "to fulfill its statutory duties of holding down prices and enhancing reliability in the wholesale energy market."



FERC v. Electric Power Supply Assn. *(continued)*

- Given the FPA's purposes (which no one disputed), the Court rejected claims that FERC was impinging on states' rights to regulate retail rates and local utilities. "[A]lthough (inevitably) influencing the retail market too, [Order 745] does not intrude on the States' power to regulate retail sales."
- FERC approved compensation (that negawatts equal megawatts) was result of reasoned judgment. FERC took full account of the alternative policies proposed, and adequately supported and explained its decision."

Hughes v. Talen Energy Marketing

- Hughes is essentially the mirror image of *FERC v. Electric Power Supply Assn.*, this time testing whether states ventured too far into FERC's exclusive realm under the FPA.
- Both Maryland and New Jersey adopted programs to solicit wholesale power plant development and construction supported by long-term contracts at guaranteed prices (cost plus reasonable return on equity), but the projects were to participate in wholesale power markets run by PJM. *Hughes v. Talen Energy Marketing*, No. 14-614, and CPV Maryland v. Talen Energy Marketing, No. 14-623.
- The key issue was whether the FPA preempts states from offering guaranteed contract prices to build wholesale power plants in organized competitive wholesale power markets.
- Both the Third and Fourth Circuits determined that similar procurement programs in two states were preempted by the FPA.

Hughes v. Talen Energy Marketing *(continued)*

- Supreme Court (8-0 decision by Justice Ginsburg, 4/19/16), affirmed state actions in MD and NJ were preempted by FERC by implied preemption.
- "States many not seek to achieve ends, however legitimate, through regulatory means that intrude on FERC's authority over interstate wholesale rates" as Maryland and New Jersey has done here."
- States cannot regulate in a domain Congress assigned to FERC and then require FERC to accommodate the states' intrusion.
- Court concluded states were attempting to fiddle with the wholesale power markets by guaranteeing wholesale power generator compensation at rates that differed from what the plants could receive in the PJM power market.
- FPA leaves no room either for direct state regulation of interstate wholesale power prices or for regulation that would indirectly achieve the same result.

Hughes v. Talen Energy Marketing *(continued)*

- States may regulate within domain Congress assigned to states even when state laws incidentally affect areas within FERC's domain. (*Oneok v. Learjet*)
- States may 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.
- States still have the right to take actions "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 program would not be fatally flawed.

Hughes v. Talen Energy Marketing *(continued)*

- Justice Sotomoyor concurred, writing to emphasize the collaborative federalism at stake:
  - Court's decision recognizes importance of protecting states' ability to contribute, within their regulatory domain, to the FPA's goal of ensuring a sustainable supply of efficient and price-effective energy.
  - Collaborative federalism involves careful balance between federal and states' rights over energy policy.
- Justice Thomas, concurring, would not have found implied preemption (the states' actions violated the FPA outright):
  - "By fiddling with the effective price that [the generator] receives for its wholesale sales, Maryland has regulated wholesale sales no less than does direct ratesetting."

Federalism and States' Rights Issues When Developing Energy Projects

- States retain jurisdiction over retail rates and energy markets involving local electric and natural gas utilities, even if they indirectly impact wholesale markets in exercising their jurisdiction.
- States have general powers, reserved under the FPA to the states, to regulate location and environmental permitting of electric generating facilities.
- States have power to regulate industry generally, including the natural gas sector, as long as states are not specifically targeting regulations aimed at natural gas but rather the regulation impacts broader economy and only indirectly impacts the natural gas industry itself.
- FERC has broad jurisdiction to regulate wholesale electric power markets, even if such regulation indirectly impacts states' jurisdiction.
- FERC's authority extends to all electric resources on the customer side of the meter, not just demand response. This includes solar panels on rooftops, energy efficiency programs, energy storage, and demand response.

Practical Guidance to Reduce Legal Risk and Avoid Surprises

- States often issue RFPs or encourage utilities to conduct procurements of electric power or renewable energy to address state priorities – watch out for contracts or programs that promise specific compensation while requiring the resource to bid into competitive wholesale markets.
  - After *Hughes v. Talen Energy*, these programs may be preempted.
  - Long-term contracts should have some fair and reasonable unwinding provision if such projects are later deemed illegal.
- While much of the natural gas sector is regulated exclusively by the federal government, states retain jurisdiction over retail natural gas industry intrastate.
- States also have the right to generally enforce state laws, even if the enforcement indirectly impacts the natural gas industry.

Practical Guidance to Reduce Legal Risk and Avoid Surprises

- State incentive programs for renewables, such as renewable portfolio standards and renewable energy certificate programs, are alive and well after *FERC v. Electric Power Supply Assn.* and *Hughes v. Talen Energy*.
- However, these resources and other qualifying resources can be offered into competitive wholesale power markets run by Independent System Operators and Regional Transmission Organizations at the same price as wholesale generation.
- FERC-approved tariffs allowing these resources are alive and well. States cannot “fiddle with” these wholesale markets.

Holland & Knight

QUESTIONS

STEPHEN J. HUMES
Holland & Knight LLP
31 West 52nd Street
New York, New York 10019

T 212.513.3473
steve.humes@hklaw.com
www.hklaw.com