ADMINISTRATIVE LAW — ENERGY LAW — D.C. CIRCUIT RULES THAT THE FEDERAL ENERGY REGULATORY COMMISSION LACKS JURISDICTION OVER RATES FOR NONCONSUMPTION OF ENERGY. — *Electric Power Supply Ass'n v. FERC*, 753 F.3d 216 (D.C. Cir. 2014).

The Federal Power Act[1] splits jurisdiction over the electricity system between the Federal Energy Regulatory Commission (FERC), which regulates the wholesale market and transmission, and state regulators, which have authority over retail markets.[2] However, the seeming clarity of this jurisdictional divide has been muddied by the recent advent of "demand response," in which consumers are paid for reducing their energy consumption.[3] Recently, in *Electric Power Supply Ass'n v. FERC*[4] (*EPSA*), the D.C. Circuit vacated a FERC order that attempted to regulate the wholesale prices paid for demand response, on the basis that the order was beyond FERC's jurisdiction due to its impermissible effect on retail markets.[5] The breadth of the court's holding risks confusion in the energy markets and unnecessarily limits FERC's regulatory options.

Demand response offers a partial solution to inefficiencies in the electricity market. The typical organizational model for the electricity market makes a division between wholesale and retail sectors.[6] The regional systems relevant to this case are run by "system operators," independent entities responsible for ensuring that energy supplied in the system's wholesale market meets the demand in the system's retail market.[7] Because the demand for electricity is not constant, at times of high demand system operators must buy power at high prices from less efficient generators.[8] Due to the unresponsive nature of retail

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1 16 U.S.C. §§ 791–828c (2012).

2 *See id*. § 824. The wholesale market involves the sale of energy for resale; the retail market is the sale of energy to end users. *See* Joel B. Eisen, *Who Regulates the Smart Grid?: FERC's Authority over Demand Response Compensation in Wholesale Electricity Markets*, 4 SAN DIEGO J. CLIMATE & ENERGY L. 69, 70 (2012–2013). Historically, "[t]his dual regulatory scheme [has] inevitably create[d] a conflict and has led to much litigation." FRED BOSSELMAN ET AL., ENERGY, ECONOMICS AND THE ENVIRONMENT 16 (3d ed. 2010).

3 FERC has been keen to encourage demand response, which it sees as a potentially useful tool in promoting efficient consumption of energy. *See* Wholesale Competition in Regions with Organized Electric Markets, 125 FERC ¶ 61,071, para. 1 (Oct. 28, 2008) (codified at 18 C.F.R. pt. 35.28) [hereinafter Order No. 719].

4 753 F.3d 216 (D.C. Cir. 2014).

5 *Id.* at 225.

6 *See* Eisen, *supra* note 2, at 70.

7 *Id.* at 70 & n.1. "System operators" comprise both Independent System Operators and Regional Transmission Organizations. *See id.* at 70 n.1. For the purposes of this discussion, the distinction is not important.

8 U.S. DEP'T OF ENERGY, BENEFITS OF DEMAND RESPONSE IN ELECTRICITY MARKETS AND RECOMMENDATIONS FOR ACHIEVING THEM, at v–vi (2006).

prices, consumers have little incentive to reduce consumption during these peak-demand periods.[9] Demand response offers a partial solution. At times of peak consumption, system operators can reduce the overall cost of electricity in the system by paying consumers or groups of consumers, dubbed "demand response resources" (DRRs),[10] to reduce their energy consumption.[11]

FERC's Order 745[12] attempted to address perceived problems with the compensation of demand response in the wholesale market.[13] Though FERC had previously issued orders governing the structure of this market as a whole,[14] Order 745 specifically addressed payments to DRRs.[15] FERC found that the rates paid to DRRs by some electric system operators were too low to adequately incentivize the development of demand response.[16] The Order mandated that, in certain circumstances, a system operator must pay to DRRs the same price for a forgone megawatt of consumption that the system operator would have paid a generator that had successfully bid that megawatt into the wholesale market.[17] After notice and comment, Order 745 was passed by four of FERC's five board members over the dissent of Commissioner Moeller.[18] The Commission received numerous requests for rehearing, which it denied.[19]

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[9] *Id.* at v.

[10] *Id.* at vi.

[11] *See id.* at v.

[12] Demand Response Compensation in Organized Wholesale Energy Markets, 134 FERC ¶ 61,187 (Mar. 15, 2011) [hereinafter Order No. 745].

[13] *Id.* para. 1. Demand response also occurs to some extent in the retail markets. *See id.* para. 9.

[14] *See* Order No. 719, *supra* note 3.

[15] *See* Order No. 745, *supra* note 12, para. 17.

[16] *See id.* para. 57. The chief barrier is the unresponsiveness of retail prices to the cost of electricity production, which reduces the incentive of electricity consumers to participate in demand response and thus stymies demand-response investment. *See id.*

[17] *Id.* para. 2. This requirement was triggered only when a "net benefits test" ensured that paying the DRR resulted in a price decrease in the market. *Id.* paras. 2, 78–85. Order 745 was also limited by a carve-out in a previous regulation that excepted from FERC's demand-response scheme those operators whose state regulators did not permit them to accept bids from DRRs. *See EPSA*, 753 F.3d at 230 (Edwards, J., dissenting) (citing 18 C.F.R. § 35.28(g)(1)(i)(A) (2014)).

[18] Commissioner Moeller argued that the rule violated the statutory mandate to ensure "just, reasonable, and not unduly discriminatory and preferential rates." Order No. 745, *supra* note 12, 2011 WL 890975, at *34 (Moeller, Comm'r, dissenting) (citing 16 U.S.C. § 824d (2012)). Because DRRs would be paid the full generation price of their forgone consumption *and* save what they would have paid for the electricity, they were in effect being overcompensated. *Id.* at *36–37. This compensation scheme would be unjust and distort the incentives of generators to invest in production facilities. *Id.* at *37.

[19] *See* Demand Response Compensation in Organized Wholesale Energy Markets: Order on Rehearing and Clarification, 137 FERC ¶ 61,215, para. 1 (Dec. 15, 2011) [hereinafter Order No. 745-A]. The Commission also clarified the triggering conditions for DRR payment. *Id.* paras. 81–97. Commissioner Moeller dissented from the denial of rehearing, citing substantially the same concerns as before. *See* Order 745-A, *supra*, 2011 WL 6523756, at *38 (Moeller, Comm'r, dissenting).

Electric Power Supply Association, a trade group of power suppliers,[20] petitioned the D.C. Circuit for review.[21]

The D.C. Circuit vacated Order No. 745.[22] Writing for the court, Judge Brown[23] found that FERC had exceeded the bounds of its jurisdiction in issuing Order 745,[24] and that Order 745 was "arbitrary and capricious."[25] To analyze FERC's claim that it had jurisdiction over wholesale demand response, Judge Brown outlined the relevant statutory provisions. The Act contains two sources of agency power, and two prohibitions, relevant to the court's decision. Section 201(b)(1) grants FERC jurisdiction over "the sale of electric energy *at wholesale* in interstate commerce,"[26] but not over "any other sale,"[27] which is the domain of the states. Sections 205 and 206 contain a broad ancillary grant of power over "'all rules and regulations *affecting* . . . rates' in connection with the wholesale sale of electric energy."[28] Finally, section 201(a) states that "FERC's reach 'extend[s] only to those matters which are not subject to regulation by the States.'"[29] To determine whether FERC had jurisdiction to regulate the wholesale price of demand response, the court recognized that it must apply the *Chevron* test, determining first "whether the statutory text forecloses the agency's assertion of authority,"[30] and, if instead the statute was "silent or ambiguous," deferring to "the agency's reasonable construction."[31]

The court began by analyzing the jurisdictional grants. FERC did not have jurisdiction under the "sale . . . at wholesale" language of section 201(b)(1) because demand response is a *non*-sale.[32] Next, the court considered FERC's argument that it had jurisdiction under the sections 205 and 206 authorization to regulate practices "directly affect[ing] wholesale rates."[33] The court accepted that wholesale demand response directly affects wholesale prices, but found that the Commission's characterization of its "affecting" jurisdiction "ha[d] no

[20] *See History*, ELECTRIC POWER SUPPLY ASS'N, https://www.epsa.org/about/index.cfm?fa=history (last visited Jan. 30, 2015) [http://perma.cc/4HT9-XQX5].

[21] *EPSA*, 753 F.3d at 218.

[22] *Id.*

[23] Judge Brown was joined by Judge Silberman.

[24] *EPSA*, 753 F.3d at 218.

[25] *Id.* at 224.

[26] *Id.* at 219 (quoting 16 U.S.C. § 824(b)(1) (2012)) (internal quotation marks omitted).

[27] 16 U.S.C. § 824(b)(1).

[28] *EPSA*, 753 F.3d at 221 (alteration in original) (quoting 16 U.S.C. § 824d(a)).

[29] *Id.* (alteration in original) (quoting 16 U.S.C. § 824(a)).

[30] *Id.* at 220 (quoting City of Arlington v. FCC, 133 S. Ct. 1863, 1871 (2013)) (internal quotation marks omitted).

[31] *Id.* (citing *City of Arlington*, 133 S. Ct. at 1868).

[32] *Id.* at 221 (citing Order 745, *supra* note 12, para. 64) ("[D]emand response is not a wholesale sale of electricity; in fact, it is not a sale at all.").

[33] *Id.* (quoting Brief for Respondent FERC at 32, *EPSA*, 753 F.3d 216 (No. 11-1486)) (internal quotation marks omitted).

limiting principle," "could ostensibly authorize FERC to regulate . . . the steel, fuel, and labor markets,"[34] and would allow the agency to "'lure' non-jurisdictional resources into the wholesale market . . . to create jurisdiction"[35] by requiring generous compensation.[36]

To provide a limiting principle for sections 205 and 206, the court turned to the "overall statutory scheme."[37] Noting that under section 201(a), FERC's "reach 'extend[s] only to those matters which are not subject to regulation by the States,'"[38] the court reasoned that "[t]he broad 'affecting' language of §§ 205 and 206 does not erase the specific limits of § 201."[39] Such limits could not come from section 201(b)(1)'s exclusion from regulation of "any other sale": demand response is not a sale.[40] Instead, the "statutory scheme as a whole" showed that demand response, "while not necessarily a retail *sale*, is indeed part of the retail *market*, which . . . is exclusively within the state's jurisdiction."[41] Finding that the Act unambiguously foreclosed FERC jurisdiction, the D.C. Circuit invalidated Order 745.

The court also held that the agency had acted arbitrarily and capriciously in issuing Order 745.[42] FERC had failed, in light of Commissioner Moeller's "persuasive"[43] argument that "overcompensation cannot be just and reasonable,"[44] to "adequately explain[] how [Order 745] results in just compensation."[45]

Judge Edwards dissented. He agreed that Order 745 appeared to fall under FERC's "affecting" jurisdiction,[46] but thought that the limit the D.C. Circuit had previously read into sections 205 and 206 — that FERC could regulate only conduct with "direct" effects on wholesale prices — was sufficient.[47] Because wholesale demand response direct-

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[34] *Id.*

[35] *Id.* (citing Oral Argument at 29:52, *EPSA*, 753 F.3d 216 (No. 11-1486), http://www.cadc.uscourts.gov/recordings/recordings2014.nsf/10DEDEBABC41ED2585257BEF0060D9B0/$file/11-1486.mp3 [http://perma.cc/9LCZ-VMX2] [hereinafter Oral Argument]). The "lure" for consumers participating in demand response was the incentive payments.

[36] *See id.* at 223.

[37] *Id.* at 221 (citing FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 132–33 (2000)).

[38] *Id.* (quoting 16 U.S.C. § 824(a) (2012)) (alteration in original).

[39] *Id.* at 222.

[40] *Id.*

[41] *Id.* at 222 n.1.

[42] *Id.* at 224.

[43] *Id.* at 225.

[44] *Id.* (quoting Order 745-A, *supra* note 19, 2011 WL 6523756, at *38 (Moeller, Comm'r, dissenting)) (internal quotation marks omitted).

[45] *Id.*

[46] *Id.* at 232 (Edwards, J., dissenting).

[47] *Id.* at 235 (citing Cal. Indep. Sys. Operator Corp. v. FERC, 372 F.3d 395 (D.C. Cir. 2004)). Judge Edwards pointed out that, due to the conditions Order 745 placed on payments, *see supra* note 17, payments could occur *only* when they had a direct effect on the wholesale electricity price. *EPSA*, 753 F.3d at 235 (Edwards, J., dissenting).

ly affects wholesale prices,[48] Order 745 was a valid exercise of FERC's "affecting" jurisdiction unless barred by section 201(b)(1)'s preclusion of FERC regulation of "any other *sale* of electric energy."[49] As demand response could be reasonably construed not to be a sale, section 201(b)(1) did not unambiguously preclude regulation.[50] Moreover, section 201(a) could not control because the Supreme Court had previously interpreted it to be a "*mere policy declaration*."[51] As the Act did not speak unambiguously to the precise question of whether demand response was a retail sale,[52] *Chevron* deference to FERC's interpretation of the jurisdictional grant was required.[53]

Although the majority established new limits on sections 205 and 206, the preexisting limits of the Act and case law adequately cabined FERC's jurisdiction.[54] The existence of these limits, the paucity of statutory grounding for a limiting principle, and the availability of an alternative holding all should have counseled the court either to have avoided announcing a limiting principle at all or to have delineated the limits of sections 205 and 206 more narrowly. Even assuming that FERC had overstepped in this instance, the potential breadth of the court's holding has caused uncertainty in the industry and has unduly foreclosed the possibilities of beneficial regulation.

The statutory grounding for the court's limiting principle was shaky; by looking to the "statutory scheme,"[55] the court derived a limiting principle from two provisions, neither of which would have provided that restriction alone. Although section 201(a) appears an appealing candidate to supply limits to FERC's jurisdiction, Supreme Court precedent forecloses this possibility. Section 201(a) "declare[s] that . . . Federal regulation . . . [is] to extend only to those matters which are not subject to regulation by the States."[56] However, it begins a section entitled "[d]eclaration of policy; application of subchap-

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[48] *EPSA*, 753 F.3d at 235 (Edwards, J., dissenting).

[49] *Id.* at 233 (quoting 16 U.S.C. § 824(b)(1) (2012)) (internal quotation marks omitted).

[50] *Id.*

[51] *Id.* (quoting New York v. FERC, 535 U.S. 1, 22 (2002)) (internal quotation mark omitted). After the decision, FERC filed a petition requesting a rehearing en banc, which the D.C. Circuit denied. *Client Alert: D.C. Circuit Denies Rehearing of Its Decision Limiting FERC Authority over Demand Response*, CROWELL & MORING (Sept. 30, 2014), http://www.crowell.com/NewsEvents/All/DC-Circuit-Denies-Rehearing-of-Its-Decision-Limiting-FERC-Authority-Over-Demand-Response/pdf [http://perma.cc/99NE-NFGX].

[52] *EPSA*, 753 F.3d at 233 (Edwards, J., dissenting).

[53] *Id.* at 236. Judge Edwards also thought that FERC's decision was not arbitrary or capricious because the Commission had produced an adequately reasoned response to the criticisms raised in Commissioner Moeller's dissent and various public comments. *Id.* at 237–39.

[54] As Judge Edwards argued, the limits previously imposed — that effects on wholesale rates must be direct — "foreclose the parade of horribles marshaled by Petitioners." *Id.* at 235.

[55] *Id.* at 221 (majority opinion).

[56] 16 U.S.C. § 824(a) (2012).

ter,"[57] and the Supreme Court has determined section 201(a) to be a "mere 'policy declaration.'"[58] Had the court sought a jurisdictional limit in section 201(a) alone, the decision to deny *Chevron* deference to FERC would have been difficult to support: while (as the court recognized) a *specific* limit should trump a general grant of jurisdiction,[59] it is not clear that section 201(a), a statement "of great generality,"[60] would *unambiguously* trump the general language of sections 205 and 206, even in light of a separate "retail sale" limit in section 201(b)(1). The court's reading of section 201(a) as part of a statutory scheme setting internal, implicit limits on sections 205 and 206 ignored the section's status as a general policy declaration.

Likewise, the court could not have relied solely upon section 201(b)(1)'s denial of FERC jurisdiction over "any other sale[s]" than those "at wholesale."[61] The problem in using section 201(b)(1) to limit the grant of "affecting jurisdiction" in sections 205 and 206 is that the plain meaning will not easily support it — section 201(b)(1) speaks of retail and wholesale "sales," not markets.[62] A reliance on section 201(b)(1) to supply limits would also have been in tension with the court's own earlier reading of an identical term. The term "sale" is used both to grant and to limit FERC jurisdiction within the same sentence of section 201(b)(1): "[The Commission's jurisdiction] shall apply to . . . the *sale* of electric energy *at wholesale* in interstate commerce, but . . . shall *not* apply *to any other sale* of electric energy . . . ."[63] In dismissing FERC's claim of section 201(b)(1) authority, the court relied on the plain meaning of "sale": "[D]emand response is

[57] *Id.* § 824.

[58] New York v. FERC, 535 U.S. 1, 22 (2002) (quoting FPC v. S. Cal. Edison Co., 376 U.S. 205, 215 (1964)); *see also* Conn. Light & Power Co. v. FPC, 324 U.S. 515, 527 (1945); Jersey Cent. Power & Light Co. v. FPC, 319 U.S. 61, 74 (1943) (announcing that "section 201(a) is a declaration of the end sought by [the Act]" and construing its limitations narrowly). The court could plausibly have distinguished this precedent. The precedent minimizing section 201(a)'s weight considered section 201(a) against provisions with more specific jurisdictional grants than appear in the broad "affecting" language of sections 205 and 206. *See, e.g.*, *New York*, 535 U.S. at 21. Additionally, *Connecticut Light & Power* stated that section 201(a) "cannot be wholly ignored." 324 U.S. at 527.

[59] *See EPSA*, 753 F.3d at 222 (citing *New York*, 535 U.S. at 22).

[60] *Conn. Light & Power*, 324 U.S. at 527.

[61] 16 U.S.C. § 824(b). The extent of the court's reliance on this provision is unclear. Although the court claimed to "look to the statutory scheme as a whole," *EPSA*, 753 F.3d at 222 n.1, rather than to "base [its] conclusion on the 'any other sales' language of § 201(b)(1)," *id.*, its reference to the "specific limits of § 201," *id.* at 222, suggests that section 201(a)'s general language was not the sole source.

[62] Congress may have chosen the discrete "sale" over the more capacious "market" to give clarity to the limits of section 201(b)(1). Prior courts have more closely adhered to this language. *See, e.g.*, *New York*, 535 U.S. at 17 ("[T]he [Act] does limit FERC's *sale* jurisdiction to that at wholesale." (citing 16 U.S.C. § 824(b))).

[63] 16 U.S.C. § 824(b)(1) (emphases added).

not a wholesale sale of electricity; in fact, it is not a sale at all."[64] If section 201(b)(1) were construed to limit FERC's jurisdiction over the retail market, it should logically also be construed to grant authority over the wholesale market. Because demand response falls somewhere between the two,[65] section 201(b)(1) would not unambiguously preclude FERC regulation of wholesale demand response.

The court's search for limits led to a principle derived from the statutory scheme that nonetheless is in tension with the rest of the statute. As the court acknowledged, the plain text of sections 205 and 206 supports jurisdiction.[66] Further, it is difficult to find in the statutory scheme a clear intent against demand response, which did not exist at the time of the Act's passage. In *New York v. FERC*,[67] the Supreme Court made the same point about another emergent phenomenon, "unbundled transmissions."[68] The Court reasoned that because unbundled transmissions "ha[d] been a recent development"[69] and "ha[d] never been 'subject to regulation by the States,'"[70] section 201(a) did not preclude FERC jurisdiction. The same argument applies to demand response — an emergent phenomenon not previously subject to state regulation.

The court had several options besides broadly holding that FERC lacks jurisdiction over demand response, even if it did not want to follow Judge Edwards in deferring to the agency. The fact that the court arrived at the alternative holding that Order 745 was arbitrary and capricious meant that the court did not need to reach the jurisdictional question at all.[71] An alternative would have been to rule the present regulation ultra vires on very narrow grounds. In particular, the court

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[64] *EPSA*, 753 F.3d at 221.

[65] *See id.* at 219 ("The Commission concedes that 'demand response is a complex matter that lies at the confluence of state and federal jurisdiction.'" (quoting Order 745, *supra* note 12, para. 114)).

[66] *See id.* at 221.

[67] 535 U.S. 1.

[68] *Id.* at 21. "Unbundling" is the practice of allowing purchasers to buy electrical energy and its transmission from separate providers. *Id.* at 11. Previously, energy and transmission had been "bundled" together in the same transaction. *Id.* An analogue would be a consumer purchasing physical goods from one company and paying another company to transport the goods.

[69] *Id.* at 21.

[70] *Id.* (quoting 16 U.S.C. § 824(a) (2012)).

[71] It is worth noting that objectors to Order 745 were most animated about the price calculation, which was the ground for the "arbitrary and capricious" ruling. *See, e.g.*, Sharon Jacobs, *FERC's Demand Response Strategy Hits a Snag: D.C. Circuit Vacates Order 745 in* Electric Power Supply Association v. FERC, ENERGY COLLECTIVE (June 10, 2014), http://theenergycollective.com/sharonbjacobs/397181/fercs-demand-response-strategy-hits-snag-dc-circuit-vacates-order-745-electric- [http://perma.cc/W8FU-HKW9] (describing the pricing scheme as "[t]he most controversial part of Order 745").

recognized that FERC's "lur[ing]"[72] of customers from the retail to the wholesale market through preferential rates was "the heart of the Petitioners' challenge."[73] The court could have found that this way of attracting customers made the regulation an impermissible intrusion on the retail markets. Such a finding would have enabled the court to address the conduct that most troubled the petitioners, while still leaving room for wholesale demand response that did not distort retail customers' incentives.

The capaciousness of the court's decision to locate demand response unambiguously within the retail "market" has the potential to lead to jurisdictional confusion. As the case itself demonstrates, regulation that occurs at the first instance in the wholesale market can now be ruled ultra vires if it has an impermissibly direct effect on the retail market (unless it directly regulates a wholesale sale of electric energy). This result is problematic, given the court's recognition that "a change in one market will inevitably beget a change in the other."[74] The development of both new technologies and FERC's regulatory program means that questions that do not neatly fall in one or the other of section 201(b)(1)'s categories are likely to arise more often.[75] Already, FERC's entire system of wholesale demand response, widely agreed to be beneficial,[76] is being challenged in a FERC hearing.[77]

In *EPSA*, the court turned to the statutory scheme to infer a limiting principle that the provisions of the Federal Power Act taken individually did not provide. Given the statute's limitations for supplying such a principle, the court should have moved more carefully to limit the upheaval caused by its holding and to allow FERC greater room to maneuver in the face of technological change in the energy sector.

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[72] *EPSA*, 753 F.3d at 221 (citing Oral Argument, *supra* note 35, at 29:52) (internal quotation marks omitted).

[73] *Id.*

[74] *Id.*

[75] *See, e.g.*, CROWELL & MORING, *supra* note 51 (warning that, along with other cases, *EPSA* "send[s] unclear signals to regulators and market participants alike," *id.* at 1, and "almost certainly will lead to arguments that they be extended to other resources that participate in the . . . [wholesale] markets," *id.* at 2).

[76] *See, e.g.*, Order 745, *supra* note 12, 2011 WL 890975, at *34 (Moeller, Comm'r, dissenting) ("[On] the benefit of having demand response resources participate in the organized wholesale energy markets . . . there is no debate. . . . [D]emand response plays a very important role . . . ."). Although FERC's regulatory decisions did not turn on environmental factors, some commentators have argued that demand response also offers a way to address climate concerns. *See* Eisen, *supra* note 2, at 88–89.

[77] *See* Complaint of FirstEnergy Service Co., FirstEnergy Service Co. v. PJM Interconnection, LLC (FERC May 23, 2014) (No. EL14-55-000), http://elibrary.ferc.gov/idmws/common/opennat.asp?fileID=13554068 [http://perma.cc/7T94-QSLP].