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Supreme Court Addresses Limits on State Authority to Promote New Generation Development

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On April 19, 2016, the Supreme Court affirmed the Fourth Circuit's decision holding that a Maryland "contract for differences" subsidy program for a new generation facility was preempted by the federal regulation of generation capacity markets under the Federal Power Act. *Hughes v. Talen Energy Marketing, LLC*, 578 U.S. ___ (2016).

Background

The PJM Interconnection (PJM) administers a mandatory forward capacity market in the Mid-Atlantic region, as well as other electricity markets. Portions of Maryland fall within a constrained region within PJM's footprint. After several years of concern that PJM's capacity market had failed to sufficiently incent the construction of new generation within the Maryland constraint, resulting in higher prices and reliability concerns, the Maryland Public Service Commission (MPSC) issued an order soliciting proposals for construction of a new gas-fired power plant in Maryland. The MPSC ultimately accepted the proposal of CPV Maryland, LLC (CPV) to construct a 725 MW gas-fired generator and required its regulated load serving entities (LSEs) to enter into a 20-year "contract for differences" with CPV. Under the contract, CPV retained title to the generator's capacity, and was required to bid the capacity into the PJM market. The LSEs would continue to purchase capacity from the PJM forward capacity market as before. However, the contract provided for periodic payments to CPV, or by CPV to the LSEs, for the difference between the fixed contract price and the PJM capacity market clearing price for the capacity CPV bid into the PJM capacity market, such that PJM capacity payments and the contract payments netted to the fixed contract price for CPV. The obligation to make payments under the contract was contingent on the CPV generator clearing in the PJM capacity market. The CPV generator did clear in its first capacity auction and has participated ever since.

Several existing generators in PJM, including what is now called Talen Energy, sued the MPSC in federal district court arguing that the MPSC order requiring the contract for differences was preempted by Federal Energy Regulatory Commission (FERC) regulation under the Federal Power Act (FPA). Among other things, the plaintiff generators were concerned that the effect of the contract for differences would be to decrease capacity prices in the PJM forward capacity market. The district court found that the Maryland order was preempted under the Supremacy Clause because it functionally set the rate that CPV received for its capacity sales in the PJM capacity market (and the LSEs paid for capacity), while the FPA assigned the role of regulating rates for wholesale electricity sales to FERC. In 2014, the Fourth Circuit affirmed that district court decision.

The Supreme Court's *Hughes* Decision

In an opinion written by Justice Ginsburg, the Supreme Court affirmed the Fourth Circuit's holding that Maryland's contract for differences subsidy program is preempted by the FPA. The Court held that the program impermissibly set a rate for capacity sales by CPV in contravention of FERC's exclusive jurisdiction over rates and charges for wholesale sales of electricity. Because FERC has approved the PJM capacity auction as the ratesetting mechanism for capacity sales and deemed the auction clearing price *per se* just and reasonable, and the Maryland program guaranteed CPV a rate distinct from that clearing price, the Court found that the Maryland program "adjust[s] an interstate wholesale rate" and "invades FERC's regulatory turf." The Court found applicable the established principles of *Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, 487 U. S. 354 (1988) and *Nantahala Power & Light Co. v.*

Thornburg, 476 U. S. 953 (1986), in which the Court invalidated attempts by the States to second-guess the reasonableness of wholesale electricity rates.

The Supreme Court noted that the contract for differences invalidated in the case is distinguishable from traditional bilateral capacity contracts, which continue to be permitted under FERC's capacity market regime, in that the contract for differences did not involve the sale of capacity from CPV to the LSEs. In this circumstance, the Court found that the contract for differences effectively altered the price paid to CPV and the price paid by the LSEs in the capacity auction.

The Supreme Court concluded its ruling by noting that its holding is a limited one that does not address other generation-related policy incentives that states might employ that are not linked to wholesale capacity markets:

We reject Maryland's program only because it disregards an interstate wholesale rate required by FERC. We therefore need not and do 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. 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.

Justice Sotomayor issued a concurring opinion in which she emphasized that preemption inquiries relating to collaborative federalism statutes such as the FPA are delicate, and that courts should not confuse congressionally designed interplay between state and federal regulation with impermissible tension requiring preemption. Justice Thomas also concurred separately, noting that he would not rest the holding on principles of implied preemption, but solely on the text and structure of the FPA, because Maryland's program intrudes on FERC's exclusive federal jurisdiction over wholesale electricity rates.

Implications

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."

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Justice Sotomayor's concurrence is notable for its reference to the nature of the preemption inquiry under statutes such as the FPA that call for collaborative federalism. She suggests that in such instances, the preemption inquiry becomes less persuasive and more delicate. This signals an instinct to be careful in applying preemption under the FPA to state actions.

With the issuance of *FERC v. EPSA* on demand response resources in organized markets in January 2016 (see VNF alert) and now *Hughes*, the Court has issued a pair of significant decisions on the respective roles of FERC and state authorities in regulating electricity markets and suppliers in 2016. In both cases, the relatively conservative Court found in favor of federal regulatory authority in these gray areas.

For more information

For assistance or additional information, please contact Doug Smith, David Yaffe, Justin Moeller, or anyone within the firm's Electricity practice group.

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