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Supreme Court Argument on Demand Response Marked by Ideological Divisions

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FERC sought Supreme Court review of the issue of its jurisdiction only to regulate the rules used by operators of wholesale electricity markets to pay for demand response and recoup those payments through adjustments to wholesale rates, effectively conceding that the compensation scheme set out in Order No. 745 should be revised to provide something less than full LMP. However, the Supreme Court, somewhat surprisingly, nevertheless announced that it would also consider the compensation issue. Thus, the two issues before the Court are whether (1) FERC "reasonably concluded" that it has authority to regulate payment for demand response in wholesale electricity markets (i.e., the jurisdictional issue), and (2) "the Court of Appeals erred in holding that [Order No. 745] is arbitrary and capricious" (i.e., the compensation issue).

The stakes in this case are big. For the Electric Power Supply Association (EPSA) (i.e., the generators), eliminating demand response from the wholesale markets will result in higher market clearing prices and thus higher revenues. For example, generators in the PJM RTO region have said that DR's participation in the May 2014 auction lowered gross revenue in just that auction by $9 billion. Concomitantly, demand response providers face the elimination of a lucrative market for their product, leaving them with little, except the herculean task of attempting to organize retail markets, or other compensation regimes, on a state-by-state basis. FERC faces the prospect of losing the ability to effectively marshal demand response as both a grid reliability and price-lowering resource. Also, the Environmental Protection Agency, which is not a party here, understands that having demand response resources participate in wholesale markets offers another tool to advance carbon reduction goals under the Clean Power Plan.

FERC issues rarely trigger the ideological divisions between the conservative and liberal wings of the high court. This case, however, is proving to be different. Within the first few minutes of argument, the justices¾minus Justice Samuel Alito, who is recused¾focused their attention on where the balance of regulatory authority between the federal government (FERC) and the state governments should lie with respect to demand response resources.

Justice Anthony Kennedy set the stage early, noting that, while wholesale rates and retail rates are interlinked as a purely economic matter, the Federal Power Act distinguishes between them for purposes of determining regulatory jurisdiction, requiring the Court to determine "what the distinction is that marks the end of Federal power and the beginning of local power." Justice Antonin Scalia was more direct, asking whether FERC was not "fiddling around with [state-regulated] retail rates." The solicitor general responded that demand response, which is provided by retail customers, can participate in the wholesale market only "if States agree that they can go into the wholesale market," and characterized the situation as "cooperative Federalism." Justice Scalia seemed unconvinced, and Justice Kennedy followed up, asking whether FERC, by compensating demand response in the wholesale market, "is luring retail customers into the wholesale market?" Justice Kennedy appeared concerned that full LMP pricing is a subsidy that interferes unduly with retail ratemaking. Chief Justice John Roberts returned to the more legalistic question that Justice Kennedy originally posed, querying what the limiting principle on FERC's authority is in this situation and where, in FERC's view, it would overstep into state authority. The solicitor general responded that, to overstep its authority, FERC would have to take an action that has a **direct** effect on retail rates. Here, he argued, FERC setting a wholesale price for demand response had only an **indirect** effect on retail rates.

Justice Stephen Breyer, an ex-law professor who taught economic regulation at Harvard, tried to move the argument away from the discussion of the balance of federal and state power, and instead to the language of the Federal Power Act. He agreed that demand response sales in the wholesale market will affect retail prices, but queried whether there is "any law that prevents raising or lowering wholesale price[s] despite the fact that that affects retail price?" EPSA responded that, "when you regulate wholesale prices, essentially as Justice Scalia suggested, through the retail market, that crosses a very important boundary in the Federal Power Act." EPSA concluded, "These retail customers don't belong in the wholesale market. Whether you think they were lured in or you think they walked in the door, it doesn't matter. They are in a market where they don't belong. The fact that [FERC is] regulating in this context, retail customers directly, is a profound signal that they've overstepped their

jurisdictional bounds." Justice Sonia Sotomayor took issue with this conclusion: "You seem to posit that [allowing retail customers to sell DR in a wholesale market] is horrible. . . .[But] what's the horror here of concurrent jurisdiction?" Justice Elena Kagan asked EPSA a summing-up question, "[So,] your argument is that FERC can't do anything with respect to demand response; is that right?" EPSA replied that FERC can "work cooperatively with the States and the LSEs, and encourage [the Load Serving Entities] . . . to do all sorts of things to reduce their demand, and then there's just less demand bid in to the auction in the first place. And so supply meets demand at a much lower level." Justice Kagan did not seem to agree that this really means that FERC can do something, since she concluded, "[So, you are saying,] in other words, FERC can't do anything nor can the States do anything."

While the Supreme Court argument was a fascinating exchange of views about federal-state authority boundaries and electricity market functioning, the future of Order No. 745 and the participation of demand response in wholesale electricity markets remains murky. The Court could go either way on either question before it, although it is unlikely to be unanimous. Indeed, the argument indicated the possibility that it could deadlock 4 to 4 on both issues (with Justice Alito recused), meaning that the decision below, striking down Order No. 745 on jurisdictional and substantive grounds, would stand. The Court is certain to work very hard to ensure that it does not become deadlocked. Were that result to occur, however, the job of determining the full scope of the D.C. Circuit's jurisdictional ruling, and the market changes required by that ruling, would then fall to FERC in the first instance.

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