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Federal Courts' Dismissal of Pre-emption Challenges to Illinois and New York ZEC Nuclear Subsidies Returns Focus to FERC

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Together with the U.S. Court of Appeals for the 2nd Circuit's recent *Allco* decision upholding Connecticut's renewable energy procurement program,[3] the decisions affirm the Supreme Court's holding in *Hughes* that states may enact laws subsidizing particular classes of resources even when those laws "incidentally affect areas within FERC's domain."[4] Such a reading—which is likely to guide states seeking to implement similar policies—underscores the need for FERC action to mitigate the tension between state energy policies and wholesale power markets. With its quorum recently restored, FERC now has the opportunity to address the ramifications of these decisions, through both its pending proceedings and state policy and wholesale markets initiative.

Background

On June 28, 2017, the 2nd Circuit rejected pre-emption and dormant Commerce Clause challenges to Connecticut's renewables program, distinguishing it from the Maryland program at issue in *Hughes*. In contrast to the Maryland program—which required the subsidy recipient to participate in a wholesale auction, but guaranteed a rate separate from that established by the auction—the 2nd Circuit explained that Connecticut's program relied on only bilateral power purchase agreements, which are transacted outside of a FERC-regulated auction and are subject to FERC review under Section 205 of the FPA. Given this distinction, the 2nd Circuit found that Connecticut's program did not "violate the bright line laid out in *Hughes*" by "requir[ing] bids that are '[]tethered to a generator's wholesale market participation' or that 'condition[] payment of funds on capacity clearing the auction.'" Instead,

Connecticut acted within its exclusive right to "specify[] the sizes and types of generators" necessary to satisfy the goals of the program.[5]

Shortly after *Allco*, the district courts in Illinois and New York dismissed preemption and dormant Commerce Clause challenges to the state ZEC programs, further cementing *Hughes*' holding regarding state authority over generation facilities within their borders. Where Connecticut's program focuses on the ownership of the electricity itself, the ZEC programs in Illinois and New York focus instead on the environmental attributes produced by each MWh of electricity (i.e., the amount of carbon emissions avoided by the production of carbon-free nuclear power). In Illinois, utilities are required to enter into contracts with nuclear generators to purchase ZECs, which are based on the Obama-era social cost of carbon minus a wholesale market price index "price adjustment." ZECs are funded through a surcharge on Illinois' retail electricity customers. New York's ZECs are based on a similar structure and serve a near-identical purpose of mitigating carbon emissions.

A group of mainly non-nuclear generator plaintiffs—the same named parties in each case[6]—challenged the ZEC programs in federal court, alleging that ZECs are "tethered" to wholesale market participation in the same way as Maryland's invalidated program in *Hughes*, thus directly affecting the FERC-approved wholesale rate. The plaintiffs further argued that the programs violate the dormant Commerce Clause by favoring in-state, nuclear generators at the expense of out-of-state, non-nuclear generators, thus placing an undue burden on interstate commerce.

In granting motions to dismiss the cases, the district courts found that (i) plaintiffs lacked a private right of action under the FPA to bring their pre-emption claims, (ii) the ZEC programs are neither field nor conflict pre-empted, and (iii) the ZEC programs do not violate the dormant Commerce Clause.

IL and NY ZEC Decisions

Right to Private Cause of Action

Both courts found that plaintiffs lack the right to bring a private cause of action under the FPA on the basis of pre-emption. As first explained by the Illinois district court, the FPA contains several express provisions that "signal Congress's intention to preclude other methods of enforcing the same substantive rule." Those methods include the FPA Section

206 process by which parties can bring a complaint to FERC to remedy rates or practices that they believe to be unjust or unreasonable, and FERC's ability to file federal lawsuits to enjoin practices that it finds to be unjust or unreasonable. In fact, certain of the Illinois plaintiffs filed a complaint at FERC seeking modifications to PJM's market rules to mitigate the price impacts of "out-of-market" subsidies, such as ZECs. That proceeding has been pending due, at least in part, to FERC's lack of quorum.[7] But, in the view of the court, plaintiffs' pending complaint was not enough to demonstrate that they had exhausted their administrative remedies, with the court noting that "FERC's [lack of quorum] does not change the structural limitations on judicial power."[8]

The district court also dismissed plaintiffs' request for a "declaratory judgment" on the issue of pre-emption, noting that such a declaration would require a court to "enter an arena" of "FERC's exclusive expertise" by instructing states "how not to interfere with wholesale rates while acting within" their authority (i.e., by forcing the court to determine just and reasonable rates).[9]

The New York district court likewise found that plaintiffs lacked a right to bring a private cause of action for many of the same reasons, but disagreed with the Illinois district court's reasoning that the FPA's just-and-reasonable standard is an arena of FERC's "exclusive expertise" and is therefore judicially unadministrable. Rather, the court noted that, by granting FERC the authority to file federal lawsuits, Congress "anticipated that courts might have to oversee the enforcement of the just-and-reasonable rate standard, albeit with deference to FERC."[10] Nonetheless, the court found that the FPA "tacitly forecloses" private parties from invoking equity jurisdiction to challenge state policies on the basis of pre-emption, since Congress provided a "sole remedy" via FERC's Section 206 complaint process and its ability to file federal lawsuits.

Pre-emption

The district courts proceeded to the merits of plaintiffs' pre-emption challenges despite their initial findings, invoking both *Allco* and *Hughes* to reject plaintiffs' claims that the ZEC programs are tethered to the FERC-regulated wholesale power market. In Illinois, plaintiffs—with the help of PJM through an amicus brief—argued that *Hughes* cannot be read to allow state actions that "'intrude on exclusive federal jurisdiction just because they do not contain express language to that effect.'"[11] In other words, while ZECs are awarded to a nuclear generator based on the environmental attributes of the energy, and not the wholesale "rate

or transaction terms," the implication is that a generator must produce that power in order to receive a ZEC. And, as plaintiffs argued, nuclear generators "can only dispose" of that power by selling it within PJM's auction, given that they have no alternative.

Rejecting this argument, the Illinois district court pointed to the 2nd Circuit's finding in *Allco* that Connecticut's program did not directly "compel" utilities and generators to enter into wholesale contracts and thus was properly insulated from federal pre-emption challenges. As the court explained, the "ZEC program does not mandate auction clearing in PJM" or "impos[e] a condition directly on wholesale transactions," since generators "can receive ZECs even if they do not clear the capacity auction and even if they do not participate in the energy auction." As such, the court concluded that *Hughes* "should not be extended to invalidate state laws that do not include an express condition, but that in practice . . . have the effect of conditioning payment on clearing the wholesale auction."[12]

A similar argument was also entertained and refuted by the district court in New York, which noted that the ZEC program's statutory language "does not require the nuclear generators to sell into the NYISO auction," since ZECs are awarded for the "production of energy, and not for the sale of that energy into the wholesale market."[13] Even if it were true that generators, "as a matter of fact," sell their power through the wholesale auction, the court noted that "this is a business decision," rather than a requirement imposed by the ZEC program. As such, the court concluded that, "like the challenged Connecticut program in *Allco*," the ZEC program "does not suffer from *Hughes*'s 'fatal defect'" of tethering the ZECs to the wholesale auction.[14]

Additionally, both courts analogized ZECs with renewable energy credits (RECs) and other forms of state subsidies to demonstrate that numerous programs incidentally affecting wholesale rates have been found to be within states' authority. In Illinois, the district court explained that ZECs "unbundle" environmental attributes from the sale of electricity in the same manner as RECs, which FERC has previously acknowledged are outside its jurisdiction.[15] As such, the court concluded, FERC's disclaimer of jurisdiction over RECs should "indicate[] that similar programs that authorize transactions in state-created credits that are distinct from wholesale transactions are not pre-empted."[16] In New York, the court found that plaintiffs' failure to distinguish between ZECs and RECs was the "fatal flaw" in their arguments, reasoning that, if RECs "are not conflict pre-empted—and plaintiffs do not argue that they are —then the Court fails to see how ZECs are."[17]

Finally, both courts rejected plaintiffs' allegations that the ZEC programs impact FERC's ability to set just-and-reasonable rates in the wholesale markets. Responding to plaintiffs' allegation that ZECs do "clear damage" to FERC's statutory goals, the Illinois district court noted that the "market distortion caused by subsidizing nuclear power can be addressed by FERC" through, for example, plaintiffs' pending complaint proceeding.[18] In New York, the court cited the 2nd Circuit's finding in *Allco* that "indirect and incidental" effects caused by state programs subsidizing particular types of generation resources "do not present the sort of 'clear damage' required for a plausible conflict preemption claim," since "[t]o hold otherwise would call into question RECs and all state subsidies."[19]

Dormant Commerce Clause

The courts similarly dismissed plaintiffs' allegations that the ZEC programs violate the dormant Commerce Clause by discriminating against out-of-state generators and placing an undue burden on interstate commerce by distorting market prices. In Illinois, the court rejected the allegation that the ZEC program places an undue burden on the interstate wholesale market, finding that its "incidental burden" "is not clearly excessive when balanced against . . . traditional areas of permissible state regulation," such as states' rights to enact environmental laws, create or participate in markets, and "encourage power generation of [their] choosing."[20]

The Illinois court also dismissed allegations that the ZEC program violated the Equal Protection Clause of the 14th Amendment by placing retail surcharges on the bills of Illinois customers purchasing energy from ZEC recipients, but not on the bills of customers in other states purchasing the same energy. Because the Constitution "only requires Illinois to treat equally the people within its jurisdiction," the court reasoned, the ZEC program does not violate the Equal Protection Clause.[21]

In New York, the court concluded that plaintiffs lack a cause of action to bring their claims because their alleged injuries fall outside of the dormant Commerce Clause's "zone of interests." Dismissing plaintiffs' claim that the ZEC program discriminates against out-of-state, non-nuclear generators, the court noted that plaintiffs never alleged that they own or represent nuclear generators in the original complaint—the only argument the court needs to consider in ruling on a motion to dismiss—and thus cannot allege an injury on that basis. Dismissing plaintiffs' claim that the ZEC program places an undue burden on interstate commerce by distorting market prices, the court reasoned that this alleged burden would

occur to a greater extent if ZECs were extended to out-of-state nuclear generators. As such, "because [p]laintiffs would be allegedly injured by the ZEC program's market distortion effect even if New York provided ZECs to in- and out-of-state nuclear power plants," the court concluded that plaintiffs are not harmed due to an "undue burden on out-of-state economic interests."[22]

But "[e]ven if plaintiffs had a cause of action," the New York court reasoned, their claims would fail because New York was acting as a market participant, and not as a regulator, in creating the ZEC program. Relying in part on *Allco*, the court concluded that "by distributing subsidies through the ZEC program to otherwise financially struggling nuclear power plants, New York is participating in the energy market and exercising its right to favor its own citizens."[23]

Implications

The courts' reading of *Hughes*—that states have broad authority to construct policy even though such policy might incidentally affect the FERC-regulated wholesale markets—has both immediate and long-term implications for the Commission. In Illinois, the court invited the Commission to submit a brief addressing its jurisdiction in light of the 2nd Circuit's *Allco* decision, and the Commission declined, citing plaintiffs' pending complaint and its inability to offer a definitive statement without quorum. With its quorum restored, the Commission now has an opportunity to make a definitive statement (or some form of it), either through an order on the complaint, or by choosing one of the pathways identified in its larger initiative to reconcile state policies and wholesale power markets.

In the long term, the courts' findings that parties lack a right of private action to bring FPA pre-emption challenges could lead to additional complaints with FERC, assuming increased state energy policy-making as a result of the decisions. Whatever path the Commission chooses to take to address the potential impacts of these "out-of-market" subsidies, it will need to tread lightly, given states' broad authority to make their own energy policy decisions.

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[1] *Vill. of Old Mill Creek v. Star*, Nos. 17-CV-1163, et al., 2017 WL 3008289 (N.D. Ill. July 14, 2017); *Coal. for Competitive Elec. v. Zibelman*, No. 16-CV-8164, 2017 WL 3172866 (S.D.N.Y. July 25, 2017).

[2] *Hughes v. Talen Energy Mktg., LLC*, 136 S.Ct. 1288, 1297 (2016) ("*Hughes*").

[3] *Allco Fin. Ltd. v. Klee*, 861 F.3d 82 (2017) *("Allco")*.

[4] *Hughes* at 1297.

[5] *Id.* at 101-02.

[6] Plaintiffs are participants within the same FERC-regulated markets as the ZEC recipients. These markets are administered by PJM Interconnection, L.L.C. (PJM) and the New York Independent System Operator (NYISO).

[7] The complaint was first filed in FERC Docket No. EL16-49 in response to potential energy subsidies in Ohio, but has been updated to respond to the ZEC program. For an analysis of the types of complaints that have been previously filed with FERC in response to state energy policies, see our blog here.

[8] *Star* at *8-9.

[9] *Star* at *9.

[10] *Zibelman* at *6.

[11] *Star* at *12.

[12] *Star* at *13.

[13] *Zibelman* at *10.

[14] *Zibelman* at *9.

[15] *Star* at *13 (citing *WSPP Inc.*, 139 FERC ¶ 61,061 (2012)).

[16] *Id.*

[17] *Zibelman* at *13-14, 17.

[18] *Star* at *14.

[19] *Zibelman* at *17.

[20] *Star* at *16-17.

[21] *Star* at *17.

[22] *Zibelman* at *20.

[23] *Zibelman* at *22.

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