Circuits Affirm State Role in Regulations Affecting Wholesale Electricity Markets

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Earlier this week, the United Nations Intergovernmental Panel on Climate Change (IPCC) released its first report commissioned under the Paris agreement. Among the report's startling findings is that the most severe effects of climate change could occur as a result of a 2.7 degree Fahrenheit increase above preindustrial levels, rather than at the 3.6 degree increase that scientists previously considered the threshold for such effects. The IPCC concludes human activity has already caused a 1.8 degree increase in atmospheric temperatures, and at the current rate of greenhouse gas emissions, atmospheric temperatures will reach the 2.7 degree increase threshold by 2040. The report projects this would result in costs of $54 trillion (over an unspecified time period), roughly three times the GDP of the United States.

Emissions regulations received a lot of attention last month when the Trump administration announced its plan to replace the Obama-proposed Clean Power Plan with the Affordable Clean Energy Rule, which charges the states with developing plans to regulate greenhouse gas emissions from power plants. In addition to these types of command-and-control regulations, states will assume an increasingly important role in establishing market-based mechanisms for achieving emissions reductions. However, because wholesale electricity markets transcend state boundaries, questions remain about the limits of state authority. Two recent circuit court opinions considered whether state programs providing incentives to nuclear electricity generators impermissibly interfered with wholesale electricity markets. Concluding that the programs do not interfere with federal regulatory authority, the courts indicated that state authority to create clean energy policies is to be interpreted broadly.

Electricity markets are regulated jointly by the federal government, through the Federal Energy Regulatory Commission (FERC), and the states. In accordance with the Federal Power Act (FPA), regulation of generation facilities is reserved to the states, 16 U.S.C. Section 824(b), while FERC has jurisdiction to regulate wholesale electricity markets to ensure, "all rates and charges made, demanded, or received by any public utility for or in connection with [electricity sales at wholesale are] … just and reasonable," 16 U.S.C. Section 824d(a). To set rates that are just and reasonable, FERC has authorized the New York Independent System Operator (NYISO) to manage energy and capacity auctions. In energy auctions, generators bid the lowest price at which they would sell a stated amount of electricity. Capacity auctions are offers for NYISO to purchase options to demand a quantity of output in the future. In both auctions, bids are stacked from lowest to highest until demand is satisfied. The highest accepted bid sets the price which all bids that clear the auction receive.

At the end of September, the U.S. Court of Appeals for the Second Circuit reviewed a challenge to New York's Zero Emissions Credit (ZEC) program. See *Coalition for Competitive Electricity, Dynergy v. Zibelman*, F.3d (2d Cir. 2018). Under the program, select nuclear generation facilities receive one ZEC for each megawatt-hour (MWh) of electricity the plant produces. The New York Public Utility Commission (PUC) selects facilities to receive ZECs based on criteria such as whether the facility would otherwise retire due to insufficient wholesale revenues and a cost-benefit analysis relative to other clean energy alternatives. The New York

State Energy Research and Development Authority (NYSERDA) purchases ZECs from the selected facilities, and then NYSERDA requires utilities to purchase such ZECs. The PUC calculates the ZEC price based on the social cost of carbon as determined by a federal inter-agency task force. The ZEC price is to be recalculated every two years, and through 2019, a selected nuclear power generator will receive $17.48 for each MWh of electricity on top of the closing price it receives in the NYISO market.

A group of electrical generators challenged the ZEC program on grounds that the subsidy influences the results of the wholesale auction system, and "distorts the market mechanism for determining which energy generators should close." Accordingly, the plaintiffs contend that the program is preempted under the FPA because it influences wholesale markets over which FERC has authority, and violates the dormant Commerce Clause.

The Second Circuit began its pre-emption analysis with caution, noting that "When 'coordinate state and federal efforts exist within a complementary administrative framework, and in the pursuit of common purposes, the case for federal pre-emption becomes a less persuasive one," (*quoting New York Department of Social Services v. Dublino*, 413 U.S. 405, 421 (1973)). The court applied the standard the Supreme Court articulated in *Hughes v. Talen Energy Marketing,* 136 S. Ct. 1288 (2016). In that case, the court found a Maryland program, which required utilities to enter into a contract-for-differences with a particular power plant, was pre-empted by FERC's regulatory authority. The Maryland program insulated the facility from market fluctuations completely by "guaranteeing a rate distinct from the auction clearing price," and was conditioned on the generator's sale of electricity into the FERC-regulated market.

The Supreme Court nevertheless left the door open for states to encourage "production of new or clean generation through measured untethered to a generator's wholesale market participation." As long as the state program did not condition a subsidy payment on the facility's capacity clearing the auction, the Court held that such program would likely not be pre-empted. The Second Circuit found that the New York program is not so "tethered" to wholesale market participation because the price of the ZEC is fixed for a two-year period, and, moreover, is tied to market *prices*, not market *participation*. In other words, the ZECs do not compel generators to make wholesale sales.

The Seventh Circuit decided a similar case a few weeks earlier upholding an Illinois program that required coal- and gas-based electricity producers to purchase ZECs from nuclear facilities at a fixed price, *see Electric Power Supply v. Star*, — F.3d — (7th Cir. 2018). The court reiterated the *Hughes* holding that state subsidy programs not dependent upon market participation would be permitted. Although the state program arguably increased the supply of electricity in the wholesale market and indirectly depressed the amount of the auction clearing price, the court held that because the state regulation merely affects market prices without being tethered to market participation, it does not infringe on FERC authority.

Notably, both cases readily discharged the claims of dormant Commerce Clause violations, with the Second Circuit finding the plaintiffs lacked Article III standing, and the Seventh Circuit finding that the Illinois program does not overtly discriminate and the FPA authorizes states to regulate electricity generation.

These cases are significant not only for the specific state programs they uphold, which provide a lifeline to emission-free electricity sources, but also as a potential signal that courts are

inclined to permit states a fair amount of latitude to achieve emissions reductions through market constructs. The IPCC report brings the scope of state authority into renewed focus. For example, a key finding of the IPCC report is that putting a price on carbon, through cap-and-trade programs or a direct tax, is critical for limiting emissions sufficient to forestall the most significant effects of climate change. The IPCC report estimates that a price of carbon between $135 and $5,500 per ton is required by 2030 to keep atmospheric warming below the 2.7 degree increase threshold. Meanwhile, the Obama administration estimated that a ton of carbon emissions resulted in approximately $50 of harm, while the Trump administration's estimate is between $1 and $7 per ton. As this suggests, while these recent circuit court cases indicate that a state program implementing a price on carbon has a strong likelihood of surviving a legal challenge, the obstacles of political will and international cooperation nevertheless remain formidable.

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