Supreme Court Rules
Maryland Power Contract Structure Unconstitutional

Changing Energy Landscape Increases Litigation Risk for Utilities and Generators Contracting with States

Key Takeaways:

- The Supreme Court has rejected a Maryland program to subsidize the participation of a new power plant in the wholesale energy market for infringing on the Federal Energy Regulatory Commission’s (FERC) exclusive jurisdiction over wholesale electricity rate
- The Court limited its ruling to the contractual structure of the Maryland program and specified that states may promote generation as long as they do not intrude on FERC authority
- The need for regulatory certainty will increase with continued jurisdictional overlap and the changing energy landscape as states set plans to comply with environmental mandates

Entities Mentioned:

- American Wind Energy Association
- American Public Power Association
- Federal Energy Regulatory Commission
- Maryland Public Service Commission
- National Association of Regulatory Utility Commissioners
- New York State Public Service Commission
- Public Utility Commission of Ohio

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Insight for Industry – Supreme Court Defends FERC Authority over Wholesale Electricity Rates, Suggests State Generation Measures Untethered to Wholesale Market Participation

On April 19, 2015, the U.S. Supreme Court ruled that a Maryland program to subsidize the participation of a new power plant in the wholesale energy market infringed on the Federal Energy Regulatory Commission’s (FERC) exclusive jurisdiction over wholesale electricity rates. The decision marks the second time the Supreme Court has ruled in recent months to reinforce FERC authority in the ongoing tug-of-war over federal-state jurisdictional overlap in electricity markets.

Maryland’s arrangement – called a “Contract for Differences” (CfD) – would have guaranteed the developer a rate distinct from the clearing price for its interstate capacity sales to PJM – essentially guaranteeing a capacity price different from the one approved by FERC. Under the program, the generator would sell its capacity to PJM through its auction, but receive the contract price. While Maryland’s intent was to encourage new in-state generation, the Court found that the incentive program, by adjusting the interstate wholesale rate, contravened the division of federal-state authority under the Federal Power Act. According to the ruling, “Maryland…requires CPV (the generator) to participate in the PJM capacity auction, but guarantees CPV a rate distinct from the clearing price for its interstate sales of capacity to PJM. By adjusting an interstate wholesale rate, Maryland’s program invades FERC’s regulatory turf.”

The Supreme Court limited its ruling to the Maryland’s program and was clear that Maryland and other states may encourage the development of generation through other measures, such as tax incentives, land grants, direct subsidies, construction of state-owned generation or re-regulation of the energy sector. The ruling also distinguishes Maryland’s contractual arrangement from permissible bilateral contracts – such as power purchase agreements (PPAs) that do not modify the FERC-approved price for a sale in the PJM market – which bodes well for states envisioning such PPAs to procure generation capacity. Nevertheless, the decision provides no additional directions or criteria to help states in designing these programs with less-than-incidental effects on FERC’s authority. The Court acknowledged that the states’ exercise of regulatory powers may incidentally affect FERC’s regulatory domain, but ruled that states may not implement regulations that directly infringe on FERC’s authority over interstate wholesale rates.

The decision will have consequences for programs under scrutiny in other states as well. On April 27, FERC blocked two Ohio-approved PPAs of FirstEnergy and American Electric Power, subjecting them to the Commission’s affiliate abuse test. The PPAs would have prolonged the operation of several aging coal-fired plants and a nuclear plant operated by FirstEnergy and AEP, with contractual arrangements strikingly similar to the Maryland contractual structure – namely, that ratepayers would pay any difference between PJM market prices and the generation affiliates’ cost of service. The ruling also will also directly affect New Jersey, which has Long Term Capacity Agreement Pilot...
Program (LCAPP) pending in the Court. Under the New Jersey LCAPP, generators would have received capacity agreements wherein electric distribution companies would have paid the difference between actual development costs and the market clearing price for capacity.

Although FERC has exclusive jurisdiction over wholesale markets and states have jurisdiction over retail markets, the evolution of interstate markets have blurred those lines. Impacts of activities at the wholesale level affect the retail level as well. This FERC-state jurisdictional overlap will continue to grow as the energy landscape further evolves to incorporate renewable technologies and new generation portfolios, creating uncertainty that could significantly hinder the states' ability to ensure resource adequacy and comply with federal environmental requirements.

**Supreme Court Rejects Maryland’s Power Generation Incentive Program for Disregarding FERC Interstate Wholesale Rate**

The Supreme Court, in its unanimous 8-0 opinion in Hughes v. Talen Energy Marketing LLC (Case no. 14-614), ruled that Maryland’s program was preempted because it disregarded the interstate wholesale rate required by FERC. The case is consolidated with CPV Maryland LLC v. Talen Energy Marketing LLC (Case No. 14-623). While Maryland’s intent was to encourage new in-state generation, the Court found that the incentive program, by adjusting the interstate wholesale rate, interfered with FERC’s authority under the Federal Power Act. FERC has approved PJM’s capacity auction as the sole rate-setting mechanism for capacity sales to PJM, deeming the clearing price just and reasonable. The Supreme Court ruling upheld a U.S. Court of Appeals Fourth Circuit June 2014 decision in favor of FERC (Case No. 13-2419).

At issue is a 2012 order (Case No. 9214) of the Maryland Public Service Commission (MD PSC) requiring electric distribution companies to enter into 20-year pricing contracts – “Contracts for Differences” – with Competitive Power Ventures (CPV) selected through a competitive procurement process for new natural-gas fired generation. To provide a stable revenue stream, the generator would bid its electricity into the wholesale market. If the auction clearing price fell below the price set in the state-mandated contracts, the electric distribution companies would have to pay the difference between the clearing price and the contract price to the generator; and if the auction clearing price rose above the contract price, the generators would have to pay the difference to the electric distribution companies.

The Court ruled that the “Contract for Differences” could not be likened to traditional bilateral contracts as it did not transfer ownership of capacity from one party to another outside the auction. Instead, the contracts operated within the auction, mandating distribution companies and the generator to exchange money based on the cost of generator’s capacity sales to PJM.

While Maryland’s intent was to encourage new in-state generation, the Court found that the incentive program, by adjusting the interstate wholesale rate, interfered with FERC’s authority under the Federal Power Act.
LLC et al.), the Court of Appeals for the Third Circuit invalidated New Jersey's 2011 LCAPP, finding that it, too, was preempted by federal regulation of interstate capacity markets. Following this, Maryland and New Jersey sought Supreme Court review of lower court rulings, saying that they hindered the ability of state regulators to ensure adequate generation for reliability. In October 2015, the Supreme Court granted certiorari to the Maryland case despite the U.S. Solicitor General’s view that the petitions for writs of certiorari should be denied.

Maryland and New Jersey – both located in the PJM service territory – created the programs to finance new generation facilities to address perceived supply shortfall and potential reliability issues and lack of incentives to encourage new generation capacity in their states. Electric distribution companies serving retail customers in the PJM region procure energy and capacity through PJM’s markets and through bilateral contracts with generators.

**Court Decision Reinforces FERC Authority over Wholesale Electricity Markets despite Retail-Level Impacts**
The Maryland decision marks the second time the Supreme Court has ruled in favor of FERC authority in wholesale markets. In a January decision, the Supreme Court upheld FERC Order 745 in *FERC v. Electric Power Supply Association* allowing demand response resources that function as alternatives to generation resources in wholesale energy markets to receive the same payment as generation resources.

In its ruling, the Court established FERC's authority over demand response programs in wholesale markets despite indirect impacts on retail market conditions. That decision gave substantial deference to FERC, broadening the federal agency’s authority in resolving jurisdictional overlap issues. In rejecting the respondents’ contention that the rulemaking usurped state regulatory authority, the Supreme Court explained that while wholesale market transactions had natural consequences at the retail level, FERC’s justifications to regulate demand response only pertained to wholesale market improvement and every aspect of the regulatory plan occurred exclusively on the wholesale market regardless of the effects at the retail level. According to the Court, any wholesale market action, such as setting rates, changing market rules, or allocating electricity between purchasers would have some effect on retail rates and therefore had no legal consequence.

The American Public Power Association (APPA) called the Maryland decision a setback for restructured states in RTO regions which were committed to ensure that retail customers had reliable, affordable, and environmentally responsible electric service. However, APPA also noted that the decision was narrow, implying that it would not impair the ability of public power utilities to serve retail customers with owned and contracted-for generation resources. APPA and the National Rural Electric Cooperative Association had filed briefs in the Appeals Court supporting the state program.
FERC Rulings Add to List of Actions against State Power Programs
In a similar ruling, on April 27, FERC blocked a pair of power purchase agreements (PPAs) that would have prolonged the operation of several power plans in Ohio. On March 31, the Ohio Public Utility Commission (OH PUCO) had approved requests from (Docket No. 14-1297-EL-SSO and 14-1693-EL-RDR) American Electric Power (AEP) and FirstEnergy to guarantee revenue for several coal plants and one nuclear plant through eight-year PPAs over objections from ratepayer groups and competing generators. While FirstEnergy and AEP each said that the closure of the plants would lead to reliability risks – as Ohio depends primarily on coal and nuclear generation (Figure 1), complainants argued that the PPAs would have allowed the utilities’ distribution units to impose billions in above-market costs on Ohio customers and would artificially distort prices in PJM by subsidizing the continued operation of generation that would have otherwise retired.

Figure 1: Ohio Net Generation by Source (January 2016)

By blocking the pair of PPAs, FERC rescinded waivers it had granted to AEP and FirstEnergy to purchase power from their affiliate generators, leaving the companies to prove that they were not guilty of affiliate abuse. FERC found that although Ohio ratepayers would continue to have a statutory right to choose between retail suppliers, ratepayers would have no choice with regard to payment of the non-bypassable generation-related charges incurred under the affiliate PPA.

FERC blocked two Ohio-approved PPAs of FirstEnergy and American Electric Power, rescinding waivers it had granted to purchase power from their affiliate generators, and subjecting them to the Commission’s affiliate abuse test.
Supreme Court Ruling Leaves Multiple Options to Incentivize New Generation

The Supreme Court emphasized that its decision was limited to the Maryland program for disregarding an interstate wholesale rate required by FERC. The Court noted that Maryland and other states are free to encourage production of new generation through measures that do not condition payment of funds on capacity clearing the auction. By limiting the ruling in this scope, the Court left untouched other possible incentives to new generation, including tax incentives, land grants, direct subsidies, construction of state-owned generation facilities, or re-regulation of the energy sector. Clean energy advocates commended this aspect, saying that a broad ruling could have impacted states’ ability to develop solar and wind projects.

For example, the New York State Public Service Commission (NY PSC) is considering PPAs under its Clean Energy Standard. In a cost study (Docket No. 15-E-0302) examining the Clean Energy Standard, NY PSC found that the state will benefit from significantly lower costs and higher benefits if distribution companies enter into PPAs compared with the traditional renewable portfolio standard structure that relies on renewable energy credits.

The narrow decision also reflects the American Wind Energy Association’s (AWEA) request in its amicus brief supporting Maryland’s generation program that the Court ruling be narrowly construed to the specific facts in the case. AWEA noted that a broad decision could negatively impact the ability of states to set and maintain their energy portfolios. The Association emphasized that if the Court affirmed the Fourth Circuit decision, it would be important to clearly distinguish between two cases: a state directing establishment of wholesale rates; and a state ordering utilities to purchase energy for lawful state-mandated solicitations and long-term contracts, including renewable energy promotion to achieve environmental objectives, without affecting FERC’s jurisdiction over wholesale rates.

The ruling distinguishes between contracts for differences and other bilateral contracts, such as PPAs that do not modify the FERC-approved price for a sale in the PJM market. Hence, the decision could bode well for states envisioning PPAs to procure generation capacity. Similar to a PPA, a contract for differences guarantees the seller long-term revenues. The main difference is that utilities do not actually buy electricity or capacity from the seller (in the case of Maryland, CPV), but rather require the seller to bid the electricity and capacity into the PJM markets. Bilateral contracts, on the other hand, involve a separate transaction, after which the buyer bids into PJM markets (Table 1).
Table 1 – Distinction between CfDs and Bilateral Contracts

<table>
<thead>
<tr>
<th>Maryland’s Contracts for Differences (CfD)</th>
<th>Bilateral Contracts for Capacity</th>
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<tbody>
<tr>
<td>• CfD does not transfer ownership of capacity from one party to another outside the auction, but operates within the auction.</td>
<td>• Bilateral contracts involve separate transactions between two parties, after which the buyer bids into PJM markets.</td>
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<td>• CfD mandates that load-serving entities and the seller exchange money based on the cost of capacity sales to PJM.</td>
<td>• Load-serving entities’ sales into the auction count toward their assigned share of PJM-projected demand, thereby reducing net costs of required capacity purchases.</td>
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<tr>
<td>• Guarantee the seller (CPV) a rate distinct from the clearing price for its interstate sales of capacity to PJM; by adjusting an interstate wholesale rate, Maryland’s program invades FERC’s authority.</td>
<td>• Bilateral contracts do not modify the FERC-approved price for a sale in the PJM market.</td>
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<tr>
<td>• Load-serving entities do not actually buy electricity or capacity from the seller (CPV), rather they require the seller to bid the electricity and capacity into the PJM markets.</td>
<td>• A load-serving entity which acquires capacity through a long-term bilateral contract with a generator is considered the owner of the capacity (and not the generator).</td>
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Source: SCOTUS

In a statement issued in response to the Court decision, MD PSC Chairman Kevin Hughes expressed disappointment that the state program was found impermissible, but commended the decision for reaffirming states’ rights to procure new generation, with regard to providing some clarity for how states can encourage new, clean, and renewable generation.

The National Association of Regulatory Utility Commissioners (NARUC) President Travis Kavulla said the ruling did not alter the line between the federal and state jurisdictions, pointing out that states characteristically govern the need for new power facilities, their economic feasibility, and rates and services. However, the narrow ruling will result in further litigation of these issues by leaving many open questions despite the logical implication that Maryland could have accomplished the same result – obtaining in-state generating capacity – without conditioning the generator’s compensation on the wholesale market’s clearing price for capacity. NARUC also underscored the need for greater certainty by consumers, utilities, power generators, and regulators regarding what is and is not permissible on the part of federal and state regulators.

NARUC had filed an amicus brief supporting the Maryland program, arguing that the Circuit Court decision impermissibly limited crucial state functions necessary to ensure long-term grid reliability, threatened states’ jurisdiction over integrated resource planning, and hindered timely construction of new generation. NARUC also noted that FERC acknowledged the states’ continued authority to create incentives for the construction of new capacity through long-term bilateral agreements.
Decision Leaves Broader Questions on Permissible Incentive Programs Unanswered as States Attempt to Comply with Clean Power Plan

The Maryland decision, in keeping with the landmark ruling upholding the FERC demand response rule, reinforces FERC’s broad authority to oversee interstate rules under the Federal Power Act. And, while the Court was careful to specify that the decision was program-specific and does not indicate that other state efforts to encourage generation or address resource adequacy would necessarily be challenged, the narrowness of the ruling will likely result in future litigation. For example, a number of state programs could have an indirect impact on the wholesale rate, including renewable portfolio standards.

Due to the increasing complexity of electricity markets in the U.S., the FERC-state jurisdictional overlap is expected to increase in the future, creating uncertainty that could significantly hinder state planning efforts. In particular, the jurisdictional overlap could have broader implications in areas where wholesale market rules are likely to have natural consequences in retail markets. Such areas include regulations affecting capacity requirements, resource adequacy, environmental standards, and reliability planning.

Moving forward, as states devise individual plans to achieve compliance with Clean Power Plan mandates—plans that include market-based mechanisms—these energy policies will be subject to increased scrutiny. The recent Maryland, Ohio, and New Jersey cases point to future actions as states attempt to comply with generation requirements, presenting increased legal risk for investor owned utilities and power generators entering into contracts with states seeking to incentivize power generation.
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