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Insights: Alerts

Supreme Court Ruling Spurs Energy Storage Possibilities

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On January 25, 2016, the Supreme Court issued a landmark decision ("Decision") -- reversing the D.C. Circuit's vacatur of Federal Energy Regulatory Commission ("FERC") Order 745, which provides crucial market incentives for demand response ("Demand Response" or "DR") resources including energy storage. [1] This legal alert will provide an overview of the factual and legal background leading to the Decision, the legal arguments made before the Supreme Court, the Decision itself and its implications on the energy storage sector.

Factual and Legal Background

As with other vital commodities, electricity may be sold in the retail market (i.e., direct sale to end-users) or in the wholesale market (i.e., sale by a producer to a utility or other load-serving entity, which then re-sells to another such entity or an end-user). Any of the foregoing types of transactions may occur intra-state or interstate. These classifications are important as they determine which regulator possesses jurisdiction. Namely, if a transaction is at "wholesale in interstate commerce", then the Federal Power Act ("FPA") provides the Federal Energy Regulatory Commission ("FERC") exclusive regulatory jurisdiction over it, including its rates and practices.[2] Regulation of transactions falling outside this definition (including its rates and practices) is beyond FERC's regulatory reach and, thus, reserved to the States. [3]

One of the central missions of any regulatory scheme is to assure the reliability and affordability of electric energy. This mission is especially challenging at times of high demand. From a reliability perspective, the challenge is to prevent grid overloads, blackouts or other service interruptions associated with the higher energy volume delivered to meet the elevated needs. From an affordability perspective, the challenge is to curb the rising energy prices caused when more expensive and less efficient energy sources are called to pitch-in to meet the soaring demand.

In striving to advance competition in the electric wholesale sector, FERC relies upon independent organizations also known as Independent System Operators ("ISO"s) or Regional Transmission Organizers ("RTO"s). These organizations, collectively referred as wholesale market operators, are fully regulated by FERC. FERC authorizes them to independently manage and control electricity transmission within the geographic area of their purview, with the purpose of ensuring the safety, reliability and cost-effectiveness of the electric energy service. Wholesale market operators achieve cost effectiveness by conducting a competitive auction system. Under this

system, bids are submitted either by energy producers[4] (in the form of dollars per unit of energy produced) or DR providers[4] (in the form of dollars per unit of energy not consumed). The compensation paid to the energy producers is known as the "locational marginal price". A key issue, heavily litigated in the case at hand, involved the way by which compensation to DR providers should be computed.

In October 2008, FERC issued Order 719, mandating for the first time that wholesale market operators accept DR bids in the wholesale market. However, the order also allowed wholesale market operators (if they so choose) to compensate DR providers differently from generators. This uneven and uncertain playing field inhibited the growth of DR participation in the wholesale market.[5] Realizing this, while acknowledging the capital costs DR providers incur to enter the market, and recognizing the growing importance of integrating DR bids in the wholesale market since they "can help improve the functioning and competitiveness of those markets… and support system reliability[6], FERC decided to augment the compensation granted to DR providers. FERC Order 745, issued in March 2011, did just that. It required wholesale market operators to equate the levels of compensation remitted to DR providers and generators of electric energy.[7] In adopting this approach, FERC rejected comments which challenged its authority to pass such regulation, as well as the logic behind equating the compensation as explained. In the latter context, the main claim was that FERC unjustly gave DR providers double payment: *first* payment for not using electric energy, and a *second* (effective) payment resulting from not deducting from the first payment the savings in electric energy costs associated with the reduced consumption.

On May 23, 2014 the U.S. Court of Appeals for the District of Columbia vacated Order 745, holding that by directly regulating the retail market, FERC intruded on the states' regulatory jurisdiction in contravention of the Federal Power Act.[8] The court concluded that a change to the compensation scheme for DR providers, who are retail market participants themselves, directly impacted their decision on whether and to what extent to transact in the retail market. The court viewed this as an unlawful retail market regulation. FERC petitioned for *certiorari* to the Supreme Court, which accepted the case.

Arguments Before the Supreme Court

FERC claimed that indirect impacts on the retail market by rule-making pertaining to the wholesale market is unavoidable since these markets are inexorably interlinked. FERC therefore argued that considering such rule-making as tantamount to proscribed retail market regulation, would in essence eviscerate FERC's undisputed authority and duty to regulate the wholesale market. FERC also contended that the Order's uniform compensation mechanism is predicated on a well-established wholesale price determination policy, that looks not at the costs each market participant incurs, but instead to the value of services provided to the wholesale market.

Respondents repeated the claim that the Order is ultra vires since it unlawfully regulates the retail market. They also argued that even if not found ultra vires, the Order should be stricken since it is arbitrary and capricious under the Administrative Procedure Act, 5 U.S.C. §706(2)(A) because FERC failed to adequately explain why it is just to ignore the savings in energy costs enjoyed by DR providers when computing the compensation thereto.

The Court's Decision

The Supreme Court, in a 6-2 decision (with Justice Alito recused), reversed the lower court's ruling and concluded that Order 745 did not encroach on the states' exclusive regulatory jurisdiction as set forth under the FPA. The Court first clarified that FERC's jurisdiction over rules and practices "affecting" the wholesale market should be read as "directly affecting" (as opposed to "relating to" or "in connection with", which may not be in FERC's jurisdiction). Since DR is a direct method of reducing wholesale rates, the Court concluded that Order 745 clearly met that standard.

On the question of whether Order 745 intruded on state jurisdiction, the Court adopted a purpose-guided interpretation of the FPA, holding that because the FPA charges FERC with the duties of improving the reliability, efficiency and competitiveness of the wholesale market, any action taken by FERC aimed at fulfilling those exact prescribed duties must be upheld. The Court noted that wholesale and retail markets are inextricably linked and thus regulatory action taken towards one necessarily affects the other. For this reason, direct regulation of the wholesale market by FERC cannot be vacated simply because of resultant impacts on the retail market (even if substantial). Such impacts, the Court stated, "are of no legal consequence" and do not transgress on states' exclusive jurisdiction. States lack jurisdiction over interstate wholesale rates and practices and vacating FERC's regulation thereof would leave a regulatory gap of the kind the FPA was intended to prevent.

As to the reasonableness of the compensation method for DR providers, the Court found that the heavy burden of convincing that a highly complex and technical regulatory decision is so unsubstantiated to merit finding it arbitrary and capricious, was not lifted.

Consequences to the Energy Storage Sector

With FERC's compensation regime for wholesale DR providers out of the woods, investments in this field (which had stagnated while the case was pending) are likely to increase. These investments are expected to strengthen current DR providers' role in the wholesale market and to simplify the entry of new DR providers, thereby encouraging competition and further driving down the entire wholesale market-prices.

Notable among infrastructure expected to become more financially attractive is energy storage related technology. By storing energy produced or consumed, a DR provider can more effectively, safely and flexibly reduce consumption per a utility company's directive, while mitigating the impact thereof on its business. The combined benefits of DR revenue streams along with energy sale revenue streams (which can be accomplished at economically advantageous times pursuant to Time-of-Use rate schemes), amplify the energy storage's value and therefore is likely to spur investments therein.

Moreover, as explained above, Demand Response actors generally comprise of large-scale individual end-users and aggregators of multiple end-users. This latter form of Demand Response activity manifests itself in the energy storage space by aggregating front-of-the-meter and behind-the-meter storage units into a single energy

storage resource. Such aggregation substantially increases the revenues generated by each energy storage system, improving system return on investment. Stimulated by Order 745, it is expected to see more aggregations of stored power form competitive wholesale bids, thereby contributing to lower wholesale market costs.

The field of energy storage is still relatively nascent but Order 745 serves as a potential significant stimulus for this growing market which, in turn, is expected to play a leading role in galvanizing the entire DR market.

It lastly should be noted that the energy storage technology is not alone in reaping the seeds of Order 745. All technologies that provide greater flexibility and control over energy load consumption, such as distributed generation, rooftop solar PV and other 'behind-the-meter' products, will also likely see meaningful growth as a result of the Decision.

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[1] *Demand Response Compensation in Organized Wholesale Energy Markets*, 134 FERC 61,187 (Mar. 15, 2011); 18 C.F.R. § 35.28(g)(1)(i)(A)

[2] 16 U. S. C. §824(b), 824d(a), 824e(a).

[3] *Id*. §824(b)

[4] Demand Response providers are aggregators of multiple end-users, as well as large-scale individual end-users voluntarily committed to reduce consumption when so requested

[5] Elec. Power Supply Ass'n v. F.E.R.C., 753 F.3d 216, 231 (D.C. Cir. 2014).

[6] *Demand Response Compensation in Organized Wholesale Energy Markets*, 132 FERC, 61,094 (2010)

[7] With one precondition – so long as the demand response bid can satisfy a "net benefits test"— meaning that it is sure to bring down costs for wholesale purchasers.

[8] Elec. Power Supply Ass'n v. F.E.R.C., 753 F.3d 216, 224 (D.C. Cir. 2014)

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