Maryland's Supreme Court Loss:
A Win for Consumers, Competition and States

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Due to generation shortages in transmission-constrained areas, PJM capacity auctions were producing high wholesale prices in Maryland. The Maryland Commission designed a three-part solution: (1) Select through competition a wholesale generator to serve in the constrained area. (2) Order Maryland's retail utilities to contract for long-term capacity from the winning generator, at the price offered by that generator in that competition. (3) Draft the contract so that the utility, using retail ratepayer dollars, will pay the generator any difference between the FERC-authorized PJM price and the generator's contract price—with the payment conditioned on the generator being selected in the PJM capacity auction. New Jersey passed a statute mandating a similar solution.

Federal district courts and circuit courts struck both efforts, holding that the Federal Power Act preempted the state actions. Maryland appealed to the U.S. Supreme Court.

In April 2016, the Supreme Court invalidated Maryland's order.[1] By guaranteeing the wholesale generator a level of compensation different from PJM's FERC-authorized compensation, Maryland had "disregard[ed] an interstate wholesale rate required by FERC." Because under the Federal Power Act, Congress had made wholesale rate-setting FERC's exclusive domain, the state order was invalid under the doctrine of "field preemption." The Court's vote was 8-0.

The real winners

Consumers: The decision blocks states from using captive ratepayers to subsidize generator bids in organized wholesale markets. States facing high wholesale prices will need to turn to more productive paths. One such path is reducing customer demand: through time-of-use rates that align prices with costs; through new meters and thermostats that help consumers control their costs; and through solar panels and energy efficiency investments for our lower-income citizens, so that they too can control their costs.[2] States also may, wrote the Court, use "tax incentives, land grants, direct subsidies, construction of state-owned generation facilities, or re-regulation of the energy sector....So long as a State does not condition payment of funds on capacity clearing the auction, the State's program would not suffer from the fatal defect that renders Maryland's program unacceptable."

Competition: Competition promotes the public interest when sellers compete on the merits—on quality and cost. In organized regional markets, quality is covered through minimum standards for reliability and through penalties for failure to show up. So in the actual auctions, competition is based on cost. The Maryland-ordered financial assistance, when conditioned on the generator being selected by the auction, enabled the generator bid below its cost—the precise

behavior that defeats the theory of competition. Maryland's favored generation source can still compete and win—but it must compete and win on its inherent merits, not on artificial merits assisted by Maryland's captive customers. When the winners are the least cost rather than the most subsidized, competition works and the public benefits.

States: The decision eliminates one way in which one state can act adversely to other states. Yes, Maryland's legal position was supported by multiple states. Think circular firing squad. For if each state did what Maryland did—substitute state-preferred compensation for FERC-authorized compensation—then each state-assisted bidder would bid below its actual cost. The PJM price for generation capacity would fall below the long-term replacement cost. Short-term price drops would lead to long-term generation shortages.

States could address shortages, and protect against high wholesale prices, by ordering their utilities to build their own generation rather than buy from wholesale markets. But then we would return to rate-of-return regulation rather than regional competition, risking both loss of regional scale economies and over-spending by utilities—the latter due to utilities' well-known "Averch-Johnson" bias toward rate-based assets.[3] As any practitioner from the 1980s knows, the regulator's only weapon against rate base bias is cost disallowance. But cost-disallowance does not work well in too-big-to-fail settings. Indeed, the Louisiana Supreme Court once upheld a state commission decision allowing imprudent costs in rates, on the grounds that disallowance would weaken the utility to an extent inconsistent with the public interest.[4] Want a current example? Check out Mississippi Power Company's Kemper plant. In seeking state commission approval, company witnesses insisted they were "confident" in their cost estimate of $2.4 billion but opposed a Commission-set cost cap. The cost now exceeds $6 billion and the company is asking for ratepayer help.[5]

State boundaries constrain creativity. When we act as states, we think small rather than big—relieving a local constraint rather than building a regional market. We think us vs. them—favoring renewable projects built in our state over lower-cost projects built in other states. And we think of our own-state costs vs. total costs—opposing projects that help a region because we don't like the cost-share assigned to our state.[6]

Price-setting vs. curve-shifting

Some skeptics of the Supreme Court's reasoning are wondering: What distinguishes Maryland's version of generation support from other state actions the Court left untouched? My understanding: States are preempted from *setting* the wholesale price, but they are not preempted from *affecting* the wholesale price. The Federal Power Act's "bright line"[7] separates (a) policies that fix compensation for particular wholesale sellers from (b) policies that *shift supply and demand* curves in the wholesale market for all buyers and sellers. The FPA separates price-setting from curve-shifting. Curve-shifting *affects* the market price but it does not set the market price. Nothing prevents states from acting on the supply curve and the demand curve. Consider these two examples:[8]

State shifts supply curve. A state can lower the cost of inputs for in-state generation: It can, for example, reduce taxes on property, sales or income; donate or subsidize land and improvements; provide employee training; and reduce environmental requirements. Each such state action shifts the state's generation company supply curves rightward. This supply curve shift means that at any given market price, the state's companies will be willing to increase supply because their production costs will be lower (all else equal). This rightward shift in one state's generator supply curves will lead to a rightward shift in the regional market's supply curve, thus lowering the regional market price (all else equal). The state's policies will have affected, indirectly, the FERC-jurisdictional market price. But each seller's compensation will still be determined, directly and entirely, by that FERC-jurisdictional market price. There is no "correcting" of any wholesale seller's compensation through a state-ordered, ratepayer-subsidized payment, as occurred with Maryland's invalidated order.

State shifts demand curve. The state can give away sweaters and compact fluorescent lightbulbs, tighten building codes, tax consumption, set high retail prices during peak periods, or pay consumers to reduce demand and consumption. These actions shift that state's demand curve leftward, causing it to intersect the wholesale market supply curve at a lower price. Again, that lower price—a FERC-jurisdictional price—is affected by the state but it is not set by the state. The state's effect on price is indirect, not direct.

So here are the relevant distinctions for states: between curve-shifting (yes) and price-setting (no), between affecting the price (yes) and setting the price (no), between affecting prices indirectly (yes) and directly (no). There was never an issue about states being able to give financial assistance, in some way, to sellers or buyers—that's curve-shifting. Maryland's mistake was to change the compensation for a specific wholesale seller, by tying the ratepayer-guaranteed subsidy to the seller's participation in the wholesale market.

Useful soul-searching

A lot of time and money went into a losing case—even after two trial courts and two circuit courts—eight judges total—explained the states' error in nearly identical terms. As detailed in last month's essay, “FPA "Power Grab": On Whose Foot is the Shoe?” nearly every modern state challenge to FERC jurisdiction has failed.[9] State commissions, and we who advise them, will need to identify and correct the internal cultural forces that lead to these losses. Such soul-searching will be more productive than persisting in the view that every one of 16 jurists—the judges who addressed Maryland's and New Jersey's decisions—got it wrong.

The right form of cooperation

"[T]he Federal Power Act, like all collaborative federalism statutes, envisions a federal-state relationship marked by interdependence."[10] Interdependence requires cooperation. But "cooperation" must mean cooperation toward the statutory goal of just and reasonable rates.[11] "Cooperation" does not mean states cooperating to undermine FERC's policies. And "cooperation" does not mean FERC deviating from its own obligations just to buy peace with

states. If granting a state-requested exemption from the minimum offer price rule would lead to sub-competitive prices, that is not useful cooperation. If ordering RTOs to reject demand response bids from states that ban them leads to supra-competitive prices, that also is not useful cooperation. (The latter was Order 745's only error. When a state limits demand response participation, the demand curve remains artificially rightward, causing unnecessarily high prices for consumers in all the region's states.) FERC should not say "yes" to states just to win points for "cooperation."

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Taking office in August 1974, President Gerald Ford said: "Our Constitution works." So it did here. The Constitution's Supremacy Clause protects the commons—the national good as defined by Congress—from actions by one state that can harm citizens in other states. The Supreme Court got it right. Now it's the states' turn.

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[1] *Hughes v. PPL EnergyPlus*, No. 14-614 (Apr. 19, 2016).

[2] On this last subject, don't miss the remarkable report by the National Association for the Advancement of Colored People, *Just Energy Policies: Reducing Pollution and Creating Jobs* (2014).

[3] Averch and Johnson, "Behavior of the Firm Under Regulatory Constraint," 52 *Am. Econ. Rev.* 1052 (1962).

[4] *Gulf States Utilities Co. v. Louisiana Pub. Serv. Comm'n*, 578 So.2d 71 (La. 1991) (upholding commission allowance of imprudent River Bend nuclear costs).

[5] Full disclosure: I was a consultant to the Commission in the case approving the plant.

[6] For reasons to reduce the influence of "state," see Parag Khanna, "A New Map for America," *The New York Times* (Apr. 17, 2016). The author writes: "The states aren't about to go away, but economically and socially, the country is drifting toward looser metropolitan and regional formations....[We should] "focus[] not on state lines but on existing lines of infrastructure, supply chains and telecommunications routes....[T]oo often, decisions about infrastructure investment are made at the state (or even county) level, and end at the state border."

[7] *Federal Power Comm. v. Southern Calif. Edison Co.*, 376 U.S. 205, 215-16 (1964) (holding that "Congress meant to draw a bright line, easily ascertained, between state and federal jurisdiction").

[8] The next two paragraphs are based on my article, "Pricing in Organized Wholesale Electricity Markets: Can We Make the Bright Line any Brighter?" in *Infrastructure* (American Bar Association Spring 2015).

[9] That essay listed 8 losses. There are actually 10: The Supreme Court's *Hughes* decision, and a Third Circuit decision I omitted from last month's essay: *New Jersey Bd. of Pub. Util. v. FERC*, 744 F. 3d 74, 79-80 (Third Cir. 2014) (rejecting New Jersey's challenge to FERC's elimination of the state-supported generation exemption).

[10] *Hughes, supra*, Sotomayor, J., concurring.

[11] See again Justice Sotomayor's concurrence, explaining that the Court "[u]se[d] the purpose of the Federal Power Act as the 'ultimate touchstone' of its pre-emption inquiry."