Justice Scalia's Electric Industry: Four Thought-Provocations

Scott Hempling
March 2016

Justice Scalia's passing this month reminded me of four opinions in which his words made us think.

Arcadia: The PUHCA-FPA overlap

There was an overlap between Federal Power Act and the 2005-repealed Public Utility Holding Company Act. PUHCA section 13 subjected certain interaffiliate transactions to review by the SEC. FPA section 205 subjects wholesale rates to review by FERC. In Arcadia, Ohio v. Ohio Power Company, 498 U.S. 73 (1990), a FERC-SEC conflict came to the Court.

Ohio Power Co. (OPCO), a utility affiliate of American Electric Power, proposed to buy coal from AEP affiliate Southern Ohio Coal Company (SOCCO). The SEC approved the sale, finding that the coal price would not exceed SOCCO's actual costs. Then, to recover its coal costs OPCO asked FERC to raise its wholesale rates. The City of Arcadia, OPCO's wholesale customer, objected. So did FERC. Finding that the SEC-approved coal cost exceeded market prices, FERC excluded the cost from OPCO's rates.

Ohio Power appealed. At issue was FPA section 318, which provides that when the two agencies regulate "the same subject matter," the SEC prevails:

> Conflict of jurisdiction: If, with respect to the issue, sale, or guaranty of a security, or assumption of obligation or liability in respect of a security, the method of keeping accounts, the filing of reports, or the acquisition or disposition of any security, capital assets, facilities, *or any other subject matter*, any person is subject both to a requirement of the Public Utility Holding Company Act of 1935 or of a rule, regulation, or order thereunder and to a requirement of this chapter [in the Federal Power Act] ... the requirement of the Public Utility Holding Company Act of 1935 shall apply to such person, and such person shall not be subject to the requirement of this chapter, with respect to the *same subject matter*..."

The D.C. Circuit held that the phrase "same subject matter" included interaffiliate transactions. Since the two agencies were thus regulating "the same subject matter," FERC was required to include in OPCO's rates the coal costs approved by the SEC.

The Supreme Court reversed. Wasting no words on policy, legislative history, or statutory purpose, Justice Scalia looked solely at the text. The "same subject matter," he held, must be "one of those specifically enumerated, and not some different, more general 'other subject matter'" like interaffliate transactions. To reach this result, he analyzed the multiple uses

of "or," counted and organized the commas and sub-clauses, and applied the interpretive rule of *ejusdem generis* ("of the same kind"). Pity his law clerks, who had to find, master and footnote nearly two dozen long, complicated Federal Power Commission and SEC cases, back to 1938 (when opinion writers were far less succinct than Justice Scalia), to support his conclusion that "[n]ever before this case has section 318 been used as a general conflicts provision, policing the entire regulatory border between the two agencies."

On remand, the D.C. Circuit wryly noted that Justice Scalia had "adopted a reading of section 318 not advanced by 'the parties, the interested agencies, [or] the Court of Appeals,'" (quoting Justice Stevens' concurrence). (Full disclosure: I filed an *amicus* brief for the American Public Power Association. Like everyone else's efforts, mine found no home in Justice Scalia's opinion.)

Barasch: Prudence does not guarantee recovery

In *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989), the utility had prudently invested dollars in a nuclear plant's construction, then prudently stopped construction. The Pennsylvania Supreme Court held that the state commission must exclude the abandoned plant's costs from the utility rates, because a state statute prohibited recovery of costs not "used and useful in service to the public." The utility appealed, arguing that the statute violated the Constitution's Takings Clause (which prohibits the government from taking property without just compensation). Under the Constitution, Duquesne argued, rates must reflect all prudent costs.

The U.S. Supreme Court disagreed. A "state scheme of utility regulation does not 'take' property simply because it disallows recovery of [prudent] capital investments that are not 'used and useful in service to the public.'" (Full disclosure: I filed an amicus brief for Consumer Federation of America and the Environmental Action Foundation.)

Justice Scalia's concurrence began by succinctly stating the result: The constitutional concern is with the "consequences a governmental authority produces rather than the techniques it employs." Then, on this distinction between techniques and consequences, he identified an uncertainty that remains today: While "prudent investment ... need not be taken into account as such in ratemaking formulas, it may need to be taken into account in assessing the constitutionality of the particular consequences produced by those formulas." The issue did not arise in the case because Duquesne had "challenge[d] techniques rather than consequences." But, Justice Scalia warned,

> [w]e cannot determine whether the payments a utility has been allowed to collect constitute a fair return on investment, and thus whether the government's action is confiscatory, unless we agree upon what the relevant 'investment' is. For that purpose, all prudently incurred investment *may well have to be counted*.

(emphasis added). That "may well" wording casts a cloud on a standard regulatory technique: assigning to shareholders the business risk that a prudent investment will produce an uneconomic result. Under Justice Scalia's suggested approach, if a regulator disallows an investment (because

it's not "used and useful"), and a court then "takes that disallowed investment] into account" in determining the return on all investment, the court would compute return by placing the disallowance-reduced profit in the numerator and the *full* investment in the denominator. If the return thus calculated falls below "fair," the regulator could be reversed. How does that result square with responsible risk-taking, not to mention the "free market" that regulation is supposed to emulate? Was Justice Scalia suggesting that a regulator cannot, with notice, require utilities to bear the risks of the investments they make? With trillions of new investment dollars ahead, expect these questions to return.

Morgan Stanley: Mobile-Sierra applies even when markets are "dysfunctional"

Morgan Stanley Capital Group Inc. v. Public Utility District No. 1, 554 U.S. 527 (2008), dealt with the *Mobile-Sierra* doctrine. [1] The doctrine creates a presumption: Any FERC-jurisdictional contract, if reached without coercion or fraud, is "just and reasonable" and therefore lawful. And if the contract is thus lawful, it cannot be changed by FERC. Neither a party to the contract nor a non-party may ask FERC to change the contract, nor may FERC on its own change it, unless the contract itself authorizes FERC to make the change. The only exception is the "public interest" exception—available if FERC finds that contract change is necessary to avoid "serious harm" to the public. Such a finding, made by FERC only three times in 80 years, is available only in circumstances of "unequivocal public necessity."

Recall California's 2000 energy crisis. Wholesale buyers signed contracts having extraordinarily high electricity prices—prices produced by a market FERC staff later termed "dysfunctional." (FERC had previously granted sellers the right to charge "market prices," i.e., whatever prices they wished, on the grounds that the sellers lacked "market power.") When the buyers later asked FERC to reduce the contract prices, FERC refused, citing the *Mobile-Sierra* presumption.

Supporting FERC in part, the Supreme Court rejected arguments that the market's dysfunctionality itself was reason to remove the presumption. *Mobile-Sierra*'s central purpose is sanctity of contracts, however imperfect are the markets producing those contracts. As Justice Scalia explained:

> Markets are not perfect, and one of the reasons that parties enter into wholesale-power contracts is precisely to hedge against the volatility that market imperfections produce. ... It would be a perverse rule that rendered contracts less likely to be enforced when there is volatility in the market.

His opinion cut through a frequent source of confusion. Whether FERC should have authorized market prices in a dysfunctional market was a valid question, but the buyers were raising it in the wrong place:

> [W]e do not address the lawfulness of FERC's market-based-rates scheme, which assuredly has its critics. But any needed revision in that scheme is properly

addressed in a challenge to the scheme itself, not through a disfigurement of the venerable *Mobile-Sierra* doctrine. We hold only that FERC may abrogate a valid contract only if it harms the public interest.

Having confirmed that *Mobile-Sierra* applies even in dysfunctional markets, the Supreme Court remanded because FERC had made two errors. FERC (a) had failed to examine whether the contracts' prices were excessive "'down the line,' relative to the rates they could have obtained (but for the contracts) after elimination of the dysfunctional market"; and (b) had not clearly determined whether sellers had engaged in unlawful market manipulation (a factor that, like fraud and duress, would have removed the presumption of the contracts' justness and reasonableness).

EPSA: FERC may order wholesale market operators to accept demand response bids

Last month, the U.S. Supreme Court upheld FERC's Order 745. *FERC v. Electric Power Supply Association*, No. 14-840 (Jan. 25, 2016). That order requires operators of wholesale energy markets to treat demand side bids comparably to generation bids. FERC acted within its FPA authority—and therefore did not invade the states' territory—because demand response is a "practice ... affecting" wholesale rates. For a detailed discussion, see my essay, *The Supreme Court Saves Demand Response: Now What?*

Justice Scalia dissented. Among his reasons was one which has worried me too. Recall Order 745's "state veto": Market operators must reject demand resource bids from states that prohibit the practice. But allowing a state veto puts FERC in an awkward position, because FERC has found that absent bids from demand resources, wholesale generation prices will not be "just and reasonable." Justice Scalia's dissent exposed the awkwardness:

> If inducing retail customers to participate in wholesale demand-response transactions is necessary to render wholesale rates 'just and reasonable,' how can FERC, consistent with its statutory mandate, permit States to thwart such participation? ... Although not legally relevant, the fact that FERC—ordinarily so jealous of its regulatory authority, ... is willing to let States opt out of its demand-response scheme serves to highlight just how far the rule intrudes into the retail electricity market.

FERC's internal contradiction does not affect its jurisdiction, but it does require correction. FERC needs either to end the state vetoes (my preference), or investigate the lawfulness of wholesale prices in markets affected by those vetoes.

* * *

Notice the tallies: *Arcadia* (8-0), *Barasch* (8-1), *Morgan Stanley* (5-2), *EPSA* (6-2). These cases not only illustrate Justice Scalia's thoughtfulness and clarity; they remind us that our field

is blissfully free of ideological warfare. Even with Justice Scalia on the bench, utility regulation does not produce 5-4 votes.

---

[1] An interpretation of the Natural Gas Act and the Federal Power Act, the doctrine is named for two cases decided under those Acts: *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956); and *Federal Power Comm'n v. Sierra Pacific. Power Co.*, 350 U.S. 348 (1956).