U.S. Supreme Court decision may undercut recent PUCO decisions approving ratepayer-subsidized power purchase agreements for Ohio utilities

April 20, 2016

The Federal Power Act reigns supreme over the wholesale electricity markets. On April 19, 2016, the Supreme Court of the United States, in Hughes v. Talen Energy Marketing, LLC, unanimously (8-0) struck down an order from Maryland's Public Service Commission which "impermissibly intrudes upon the wholesale electric market, a domain Congress reserved to [the Federal Energy Regulatory Commission] FERC alone." The ripples from the Court's decision may well affect two cases recently decided by the Public Utilities Commission of Ohio (PUCO) also involving subsidized power purchase agreements between regulated utilities (American Electric Power-Ohio (AEP) and FirstEnergy Corp. (FE)) and their unregulated generation affiliates. See PUCO Case Nos. 14-1297-EL-SSO (First Energy) and 14-1693-EL-RDR and 14-1694-EL-AAM (AEP).

Relevant to the Court's decision in Hughes is the annual capacity auction held by PJM, a regional transmission organization. For purposes of the capacity auction, PJM predicts electricity demand in its region three years into the future and allocates a portion of that demand to the relevant load-serving entities (LSEs). Owners/generators of electricity then bid into the auction to sell capacity at proposed rates. PJM then accepts bids starting at the lowest rate bid into the auction until sufficient capacity is purchased. The Court explained the bidding process as follows: "For example, if four power plants bid to sell capacity at, respectively, $10/unit, $20/unit, $30/unit, and $40/unit, and the first three plants provide enough capacity to satisfy projected demand, PJM will purchase capacity only from those three plants, each of which will receive $30/unit, the clearing price."

The state of Maryland, however, grew concerned that the PJM capacity auction was failing to adequately incentivize the

development of new, in-state electric generation facilities. As a result, Maryland's Public Service Commission promulgated an order by which the state selected a company (through a competitive bidding process) to construct a new gas-fired electric generation facility, and required LSEs to enter into 20-year contracts (often referred to as "contracts for differences") with the winning bidder, or new, in-state power generator. Under the state's plan, the approved generation facility would bid the capacity into the PJM auction itself and be guaranteed the contract price regardless of the PJM auction clearing price. If the auction clearing price was less than the contract price, then PJM would pay the generator the clearing price and the LSEs would pay the generator the difference between the contract price and the PJM clearing price. The difference in cost would be passed through to consumers via higher retail electric prices. On the other hand, if the clearing price exceeded the contract price, then the savings would be passed on to consumers via lower retail electric rates. This guarantee was designed to protect new generators from the risk that depressed energy prices, resulting from their entry into the PJM capacity auction, might prevent those generators from recovering all of their costs.

Following the approval of Maryland's program, competitors of the approved generation facility filed suit in federal district court in Maryland, alleging violations of the "Supremacy Clause by setting a wholesale rate for electricity and by interfering with FERC's capacity-auction policies." The district court struck down Maryland's program, and the Fourth Circuit Court of Appeals affirmed.

In again affirming the rejection of the Maryland program, the Court recognized that FERC has exclusive jurisdiction over wholesale electricity prices under the FPA. In contravention of this authority, "Maryland's program sets an interstate wholesale rate, contravening the FPA's division of authority between state and federal regulators." Central to the Court's rejection of Maryland's program was the recognition that it "mandates that LSEs and [the new generator] exchange money based on the cost of [the new generator's] capacity sales to PJM." While acknowledging that states are permitted to pursue the legitimate goal of encouraging the development of new, in-state power generation, the Court held that Maryland could not do so "through regulatory means that intrude on FERC's authority over interstate wholesale rates." Notably, the Court's decision was expressly limited to state programs that "condition payment of funds on capacity clearing the auction." The Court went out of its way to make clear that "[n]othing in this opinion should be read to foreclose Maryland and other states from encouraging production of new or clean generation through measures 'untethered to a generator's wholesale market participation.'"

The significance of the Court's decision will be felt in Ohio, especially in light of the PUCO's March 31, 2016 decisions approving ratepayer-subsidized PPAs for AEP and FE. Under the PPAs approved by the PUCO, both AEP and FE utilities would purchase the capacity, energy and ancillary services produced by existing, in-state coal plants and one nuclear generation plant owned by their unregulated affiliates, and sell the output into the PJM markets. Ratepayers would pay a charge if the PJM market prices were less than the generation affiliates' cost of service, or receive a credit if the PJM market prices were greater than the generation affiliates' cost of service, through a non-bypassable retail customer rider. This contractual arrangement produces results strikingly similar to the Maryland regulatory scheme declared unlawful by the U.S. Supreme Court in Hughes.

Opponents of the AEP and FE PPA arrangements have argued that the subsidy is not "untethered" to the wholesale electric market. The non-bypassable riders approved by the PUCO ensure that ratepayers will pay any difference between competitive generation revenues and the subsidized plants' revenue requirements. The effect of the subsidy, opponents argue, is to push the wholesale price down because the inefficient generator will lower its offer in the PJM capacity market, resulting in a lower market clearing price. The Ohio utilities have argued that the Ohio PPA regulatory scheme is distinguishable from the one in Maryland because the PUCO has regulatory oversight over the retail customer riders through which the PPA costs will be passed through to ratepayers. Further, the Ohio utilities likely will contend that the PPAs are valid bilateral contracts which can be struck down only by FERC or if the contracts harm public interest.

There are currently two related complaint cases pending before FERC, which were filed by electric generators and opponents of the PPA arrangements approved by the PUCO. The first cases, filed against AEP (FERC Docket No. EL16-33) and FE (FERC Docket No. EL16-34) by certain independent power producers and the Electric Power Supply Association, seek to invalidate the PPAs as improper affiliate transactions and as a result of their effects on the PJM market. The other, filed in FERC Docket No. EL16-49, requests that PJM adopt measures to prevent depressed PJM capacity prices anticipated to result from the PPAs. With

yesterday's decision in Hughes, there is certain to be additional litigation as interested parties evaluate its impact on the Ohio energy marketplace.

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