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# Why the Supreme Court's Decision in Hughes Is Good for Clean Energy

April 26, 2016

- [Miles Farmer](#)

The Supreme Court's [decision](#) in *Hughes v. Talen Energy Marketing, LLC*, is good news for clean energy, as we briefly discussed in a [post](#) last week. The Court's decision is very important because, in holding that Maryland exceeded its authority in adopting a program to spur the construction of a natural gas plant, the Court went to great lengths to ensure that its holding does not prevent the adoption of a wide range of state policies designed to spur clean energy development.

The factors contributing to the decision's implications are complex, in large part due to the intricate scheme of regulation surrounding the case. Here, we dig into the technical and legal details of the case to help explain its impact on clean energy development.

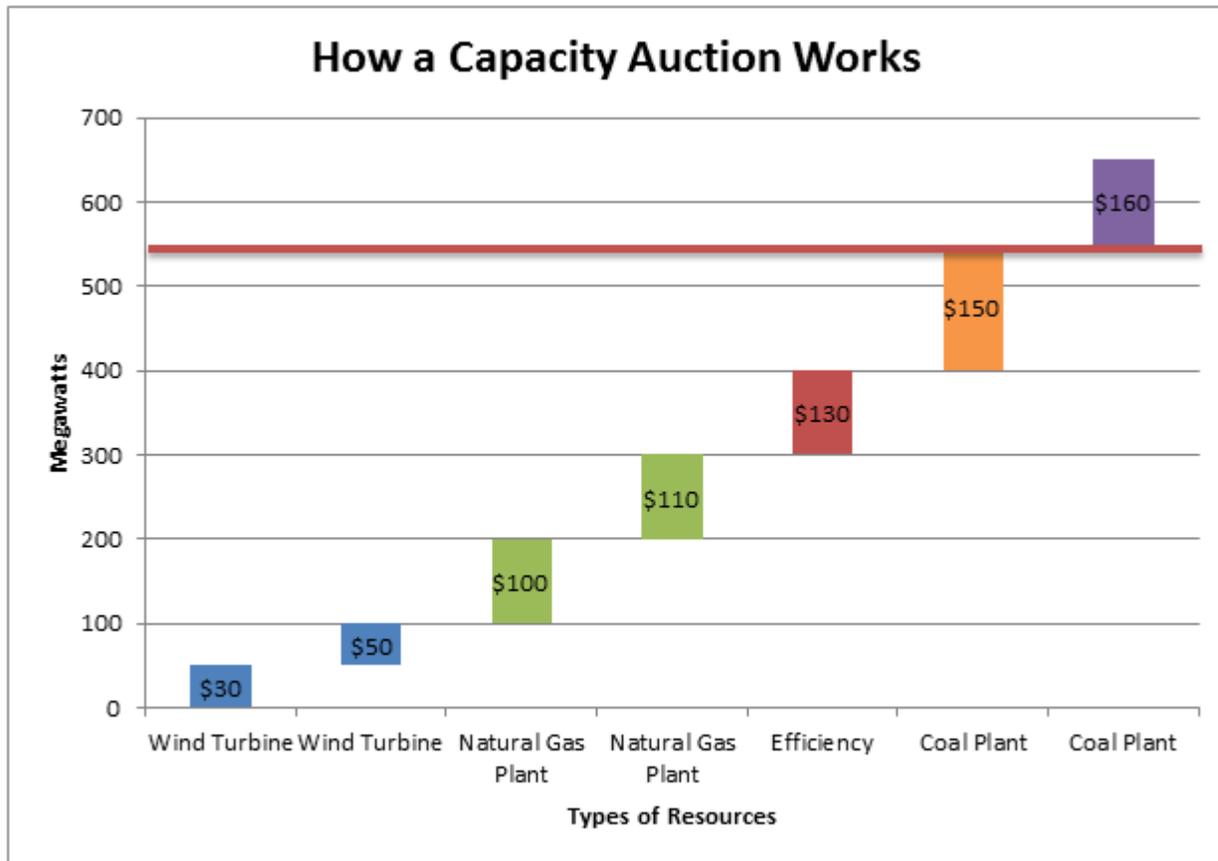
## Background on the Wholesale Energy Markets

In [many regions of the country](#), the Federal Energy Regulatory Commission (FERC) oversees markets administered by entities known as Regional Transmission Organizations (RTOs), or Independent System Operators (ISOs). Maryland is located in a large RTO called the [PJM Interconnection](#), which stretches across all or parts of 13 states from Illinois to North Carolina.

PJM operates wholesale markets for electricity, where buyers (usually the utilities that then sell that power at retail to customers for use in our homes and businesses) purchase energy through an auction to meet electricity demand a [day ahead](#) of when it is used and in [real time](#) (i.e. immediately before it is needed and used). PJM also operates a market for “capacity,” where power plant (or demand response or energy efficiency) owners promise three years ahead of time to be available if called upon to meet demand by PJM, and are paid at the time they make that future commitment. This forward-looking market design intends to send price signals that incent resource owners to maintain existing resources or develop new ones to ensure system reliability and reduce the risk of blackouts in the future.

Technically, buyers and sellers participating in this auction don’t actually sell the electricity and capacity to one another. Instead, sellers transfer the energy to PJM as the market operator, and buyers procure it from PJM. PJM determines the amount of demand that each auction is held to satisfy, and accepts bids from sellers to meet that demand. It accepts bids beginning with the lowest price per unit proposed by a seller and then increasing. Regardless of the amount they bid, PJM pays each owner a single per unit “clearing price” equal to the highest accepted bid. This incentivizes the sellers to bid their true costs of meeting demand for electricity.

In the simplified example below from the [Energy Collective](#), all of the resources bidding into the auction would receive \$150 per MW, because that was the highest price proposed by the last bidder whose resources were necessary to meet demand:



## Energy Collective

Separate and apart from these organized markets, sellers and buyers can engage in *inilateral* transactions for electricity and capacity. Contracts governing these transactions, often called “Power Purchase Agreements” or “PPAs” when they include sales of electricity, can cover long time horizons (e.g. 20 years). These long-term contracts give buyers more certainty regarding their long-term costs, and can form the basis on which developers obtain financing to build energy resources by providing some assurance of future revenue. When a buyer purchases electricity or capacity through one of these separately-negotiated contracts, the buyer then bids those resources into PJM’s organized markets at the appropriate time.

## Maryland’s Program

In 2011, based on concerns with in-state electric grid reliability issues, the Maryland Public Service Commission decided to incent new power plant construction in its State. It solicited construction proposals from power plant developers, chose a winning bidder, and issued an order requiring the State's large retail utilities to enter into contracts with that winner, a company called [Competitive Power Ventures](#) (CPV).

The contracts were similar to traditional bilateral contracts for electricity and capacity, but they differed in one critical respect. Like PPAs, the contracts guaranteed the seller (in this case CPV) revenues across a long period. But unlike with PPAs, the utilities didn't actually buy electricity or capacity from CPV. Instead, they called for CPV to retain ownership of the electricity and capacity and bid them into the PJM markets. The contracts stated that across their 20-year term, so long as CPV's bids cleared in PJM's markets, the utilities would effectively guarantee CPV fixed revenues by paying CPV the difference between the revenue CPV received in those markets and a guaranteed price set by the contracts. If the market revenues were higher than the contract price, then CPV would be required to pay the utilities the difference. The arrangement that each distribution company entered into with CPV is generically known as a "contracts for differences."

## The Challenge to Maryland's Program

As we discussed [here](#), CPV's competitors challenged the Maryland Public Service Commission's order in federal court, arguing that by effectively adjusting PJM's wholesale market prices, Maryland impermissibly infringed on FERC's authority to regulate rates for interstate wholesale sales of electricity under the Federal Power Act. Both the [district court](#) and the [Court of Appeals for the Fourth Circuit](#) agreed, holding that the Public Service Commission's order was invalid (or, in legal terms "preempted").

In striking down the program, the Fourth Circuit was careful to state that its ruling was “narrow and focused upon the program before us.” But some advocates raised questions regarding what it meant for various renewables programs. When the Supreme Court took the case, this offered the potential to clear up any misconceptions caused by the Fourth Circuit’s decision. But it also elevated the stakes considerably. The American Wind Energy Association (AWEA) argued in an amicus brief that if the Court were to affirm the Fourth Circuit decision without “emphasiz[ing] that the preemption decision is limited to the specific circumstances of the Maryland program, it could stifle the states’ ability to encourage new generation of clean energy.”

## The Supreme Court’s Decision

In reading Justice Ginsburg’s unanimous opinion in *Hughes*, we breathed a sigh of relief, because the holding is limited in exactly the manner requested by AWEA. The opinion rules that Maryland’s program “invades FERC’s regulatory turf.” But critically, the Court repeatedly emphasized that the reason for its holding was not a general concern that the program could potentially influence market prices, but rather because of a feature unique to Maryland’s “contract for differences” requirement that is not present in state PPA requirements or other mechanisms to incentivize renewable energy.

Specifically, the Court “reject[ed] Maryland’s program *only* because it disregards an interstate wholesale rate required by FERC.” (emphasis added). This conclusion followed from prior decisions holding that a State may not “second-guess the reasonableness of interstate wholesale sales.”

But here’s the important part: Maryland’s program crossed the line into unacceptably replacing FERC’s rates only because under FERC’s rules, the clearing prices in

organized wholesale markets for sales of electricity and capacity are *per se* just and reasonable. In other words, in carrying out its responsibility to oversee rates for wholesale electricity sales, FERC has determined that PJM's market prices, as arrived at through the operation of FERC-approved market rules, are fair. By requiring its utilities to enter into contracts that directly modified the FERC-approved PJM clearing prices, Maryland disregarded FERC's approved rates in favor of its own.

This defeating characteristic of the Maryland program is not present with bilateral contracts such as PPAs. A bilateral contract does not modify the FERC-approved price for a sale of electricity or capacity to PJM because it involves an entirely separate transaction between the two parties themselves, rather than a sale to PJM. Only afterwards does the buyer bid the electricity and capacity into the PJM markets. Thus, while the economic incentives delivered by PPA are similar to those provided by a CfD arrangement—such contracts also guarantee the buyers and sellers fixed prices—the payment between the parties does not depend on, or directly override the PJM market prices. Significantly, while FERC has approved the price for sales to PJM, its rules do not say that bilateral contracts for electricity or capacity need to be set at this same rate. Indeed, FERC routinely approves contracts between parties that provide for rates that are different from PJM's clearing prices.

When a state located in an RTO requires its utilities to enter into PPAs to procure renewables, even though the rates provided for in such a contract will inevitably be different from the clearing prices in the RTO, they do not similarly “disregard an interstate wholesale rate required by FERC.” Justice Ginsburg's opinion specifically highlighted this key distinction between contracts for differences and other bilateral contracts. As she put it, “the contract for differences does not transfer ownership of capacity from one party to another outside of the auction.” Instead of governing an

entirely separate sale between the contracting parties, it works by adjusting the FERC-approved rate for the sale *to PJM*.

Put differently elsewhere in the opinion, the “fatal defect” of Maryland’s program was that it conditioned payment of funds on CPV’s bids clearing in PJM’s capacity market. By doing so, it required payment “in connection with interstate wholesale sales to PJM,” and thereby modified the FERC-approved rate for such sales in a manner that a traditional bilateral contract such as a PPA would not have done.

## Impact on States Going Forward

The Court’s opinion is directly relevant to numerous ongoing state efforts to spur clean energy development. By striking down Maryland’s program in such a narrow manner, the Court ensured that its opinion does not obstruct many of these efforts.

For example, in New York, Governor Cuomo recently [laid out](#) a bold new [Clean Energy Standard](#) to require New York to get 50% of its electricity from renewable sources by 2030. As part of that effort, New York is considering requiring its electric distribution companies to enter into PPAs to procure renewables. New York conducted a rigorous [cost study](#) examining the Clean Energy Standard (discussed [here](#)). Among its conclusions, the study found that under scenarios in which New York requires its distribution companies to enter into PPAs, costs will be significantly lower, and accordingly net benefits will be significantly higher, than if New York relies on a more traditional renewable portfolio standard structure that relies only on renewable energy credits. The study projects that by 2023, a structure mandating 50% of the renewable energy be procured through PPAs delivers \$787 million in net benefits, compared to only \$65 million in net benefits under a renewable energy credit-only structure.

These benefits are a big reason why we and other environmental organizations in New York [strongly support](#) the State adopting such a requirement to supplement its renewable energy credits mandate. It's also one reason why we are thrilled that the Court's opinion carefully distinguished these requirements from the program Maryland used to incentivize the construction of a natural gas plant. Going forward, states like New York should continue to utilize all of the tools at their disposal, including PPA requirements, to spur clean energy development in a cost-effective manner.

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