ORAL ARGUMENT HAS NOT BEEN SCHEDULED

Nos. 11-1486, *et al.*

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

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ELECTRIC POWER SUPPLY ASSOCIATION, ET AL.,
*Petitioners,*

v.

FEDERAL ENERGY REGULATORY COMMISSION,
*Respondent.*

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# REPLY BRIEF OF PETITIONERS ELECTRIC POWER SUPPLY ASSOCIATION, AMERICAN PUBLIC POWER ASSOCIATION, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION, OLD DOMINION ELECTRIC COOPERATIVE, AND EDISON ELECTRIC INSTITUTE

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## GLOSSARY OF TERMS

| | |
|---|---|
| APPA | Petitioner American Public Power Association |
| Commission | Federal Energy Regulatory Commission |
| Demand Response | A reduction in the consumption of electric energy by retail customers from their expected consumption in response to an increase in the price of electric energy or to incentive payments designed to induce lower consumption of electric energy. 18 C.F.R. § 35.28(b)(4). |
| EEI | Petitioner Edison Electric Institute |
| EPSA | Petitioner Electric Power Supply Association |
| FERC | Federal Energy Regulatory Commission |
| ISO | Independent system operator — The operator of a regional transmission system that is independent of market participants. *See* RTO. |
| LMP | Locational marginal price — A measure of the least-cost of meeting an incremental megawatt-hour of demand at each location on the grid. At any given grid location, the LMP has three components: a generation component, a congestion component, and a losses component. |

| | |
|---|---|
| LMP-minus-G | A measure of the least-cost of meeting an incremental megawatt-hour of demand at each location on the grid, adjusted to reflect an offset accounting for saved retail generation charges ("G" represents the retail generation charge). |
| Megawatt (MW) | A measure of real power equal to a million watts. |
| Megawatt hour (MWh) | The power utilization for one hour measured in megawatts. |
| NRECA | Petitioner National Rural Electric Cooperative Association |
| ODEC | Petitioner Old Dominion Electric Cooperative |
| Order 719 | *Wholesale Competition in Regions with Organized Elec. Mkts.*, Order No. 719, FERC Stats. & Regs. ¶ 31,281 (2008) (JA__). |
| Order 745 | *Demand Response Compensation in Organized Wholesale Energy Markets*, Order No. 745, Final Rule, FERC Stats. & Regs. ¶ 31,322, Docket No. RM10-17-000 (Mar. 15, 2011) (JA __). |
| Order 745-A | *Demand Response Compensation in Organized Wholesale Energy Markets*, Order No. 745-A, Order on Rehearing and Clarification, 137 FERC ¶ 61,215, Docket No. RM10-17-001 (Dec. 15, 2011) (JA __). |
| Retail Sales | Sales of electric energy to end-use customers. Such sales are subject to state jurisdiction. |

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|---|---|
| RTO | Regional transmission organization — An entity responsible for the operation of a regional transmission network. *See* ISO. |
| Tariff | A Commission-approved document stating the rate or rates to be charged by a particular company or utility. |
| Transmission Owner | A transmission-owning utility. The term is used to refer to a transmission-owning utility that has transferred functional control over its transmission facilities to an RTO or ISO and, therefore, is no longer a provider of transmission services. |
| Wholesale Sales | Sales of electric energy to load-serving entities for resale to end-use customers. Such sales are subject to federal jurisdiction. |

## SUMMARY OF ARGUMENT

Petitioners' opening brief identified three overarching flaws in the Commission's orders: ***First***, the orders exceed the Commission's jurisdiction because they regulate retail sales — an area of traditional, exclusive state concern — by requiring that independent system operators ("ISOs") and regional transmission organizations ("RTOs") pay retail customers for not purchasing energy at retail. *See* Pet. Br. 27-44. ***Second***, the orders violate the Federal Power Act and are arbitrary and capricious because they result in unjust and unreasonable wholesale rates, depart from precedent without explanation, fail to respond to substantial objections, and irrationally treat non-consumption of energy at retail the same as the generation of energy at wholesale. *See id*. at 45-61. ***Third***, the orders improperly require changes to rates already in effect without making the requisite statutory finding that those rates are no longer just and reasonable. *See id*. at 61-65.

In response, the Commission contends that its authority to regulate practices "affecting" wholesale rates empowers it to promulgate rules that draw retail customers into the wholesale markets, compensate them for reducing their purchases of energy at retail, and thereby effectively reset the level of charges paid for retail service. This position cannot be reconciled

with the bright jurisdictional line Congress drew between wholesale and retail sales. *See* 16 U.S.C. §§ 824, 824(a). The Commission asserts that "demand response" is a "wholesale service," but this label should not obscure the substance: The Commission is attempting to regulate retail rates directly by paying retail customers not to consume energy. However broad the Commission's "affecting" jurisdiction may be, it does not extend to the direct regulation of retail service. (*See* Section I, below.)

The Commission is unable to point to anything in its orders that provides a reasoned explanation for its decision to compensate retail non-consumption the same as wholesale production, even though retail customers already avoid the retail charge for generation when they forgo consumption. The Commission repeatedly invokes the principle that its orders are entitled to deference, but that principle applies only where (unlike here) an agency explains its departures from precedent, takes account of contrary record evidence, and answers serious objections to its approach. Although the Commission has previously found that paying retail customers the full locational marginal price ("LMP") would result in an improper subsidy, its orders neither acknowledge this precedent nor explain why its earlier finding is now incorrect. Similarly, although the

Commission has recited the many objections to its approach, its orders (and its brief) never answer those objections. The Commission has not addressed concerns that its final rule will incentivize too much "demand response." Nor has it substantively responded to concerns raised that the Commission's approach will overcompensate "demand response" providers, distort the Nation's energy markets, and harm consumers. Indeed, while rejecting "textbook economic analysis" and disavowing any obligation to identify "empirical proof" supporting its approach, the Commission offers nothing to replace these reliable guideposts for reasoned decision-making. The Commission's facile, unexplained position that more "demand response" is always better is both unjustified and inconsistent with its statutory obligations. (*See* Section II, below.)

Finally, the Commission has not shown that its orders make any of the findings required under the Federal Power Act to support its determination that existing rates were unjust, unreasonable, or unduly discriminatory. The Commission contends that its orders were needed to eliminate barriers to "demand response," but its orders do not support that assertion with reasoned analysis or adequate record evidence. (*See* Section III, below.)

## ARGUMENT

### I. The Commission's Orders Exceed Its Statutory Authority.

The Commission's orders exceed its statutory authority because they regulate matters within the exclusive jurisdiction of the States by requiring that certain retail customers receive payments for reducing retail consumption. In its response brief, the Commission first seeks to avoid the merits and then asserts that it is merely exercising authority to regulate the wholesale markets. None of its arguments withstands scrutiny.

#### A. The Court Should Not Allow The Many Distractions In The Commission's Brief To Obscure The Jurisdictional Issues.

The Commission's brief is littered with distractions — cursory suggestions that appear designed to obscure the merits but ultimately serve only to highlight a basic defect in the Commission's orders: They are not supported by the careful reasoning that, at a minimum, is required when a federal agency steps into a traditional area of state concern.

In this vein, the Commission attempts to diminish this case's importance by describing petitioners as "Generators" and derisively suggesting that this case is only about protecting petitioners' parochial interests as market competitors. *See* FERC Br. 5; *see also id.* at 71 (characterizing petitioners as "essentially complain[ing] about the potential

for increased competition"). In fact, petitioners represent a broad cross-section of the electric industry, including competitive power suppliers (EPSA), publicly-owned, not-for-profit utilities and cooperatives (APPA, NRECA, ODEC), and investor-owned utilities (EEI). Their interests extend far beyond competitive concerns. For example, EEI's, APPA's, and NRECA's members collectively serve the bulk of the Nation's retail load and have been actively engaged in developing and implementing "demand response" programs at the local level in their respective service territories. Petitioners are deeply concerned that the Commission's orders will interfere with these efforts, inject instability and inefficiency into the Nation's energy markets, and ultimately cause significant harms to retail consumers. *See* Pet. Br. 55-56.

The Commission repeatedly observes that the States are not petitioners, *see* FERC Br. 5, 20, 26, 29, as if their absence somehow puts the Commission's position on firmer jurisdictional footing. In fact, as the Commission's orders acknowledge, many States do not support the Commission's position, for "several state commissions" registered their concern that the Commission's orders improperly interfere with retail ratemaking. Order 745, at PP103-104 (JA __); *see also* R.105 at 4 (MISO

States) (JA __); R.79 at 2 (Delaware) (JA __); R.10 at 10-11 (Illinois) (JA __); R.91 at 9-10 (California) (JA __). Moreover, although the States have not filed their own petitions, "jurisdiction cannot arise from the absence of objection, or even from affirmative agreement." *Columbia Gas Transmission Corp. v. FERC*, 404 F.3d 459, 463 (D.C. Cir. 2005) (citation omitted). The division of authority under the Federal Power Act, no less than the division of authority embodied in the Constitution, exists to protect individual citizens, not simply for the benefit of state governments. *See Bond v. United States*, 131 S. Ct. 2355, 2364 (2011). The "interests of public officials" often do not coincide with the "intergovernmental allocation of authority," *New York v. United States*, 505 U.S. 144, 181, 183 (1992) ("State sovereignty is not just an end in itself"), and individuals have an indisputable right to "assert injury from governmental action taken in excess of" properly delegated authority. *Bond*, 131 S. Ct. at 2363-64; *see also Detroit Edison Co. v. FERC*, 334 F.3d 48 (D.C. Cir. 2003) (ruling that Commission actions infringed on state retail jurisdiction based on a challenge by a utility).

The Commission likewise complains that its asserted authority to regulate retail consumption decisions was not previously challenged in the context of earlier orders addressing "demand response." FERC Br. 26-27

(citing *Wholesale Competition in Regions with Organized Elec. Mkts.*, Order No. 719, FERC Stats. & Regs. ¶31,281 (2008) (JA__)); *see also* Interv.-Resp. Br. 2-4, 9. But its earlier orders had far less practical effect: They were more limited in scope and required only that "demand response" providers receive "comparable" (not preferential) treatment. Order 719, at P3 (JA__). A party need not challenge a principle adopted by the Commission "if it is satisfied with the practical impact of the order," and its decision to forgo an appeal "does not foreclose its ability to challenge the principle as beyond the agency's statutory authority when the agency later utilizes it to cause substantial injury." *Niagara Mohawk Power Corp. v. FERC*, 452 F.3d 822, 827 (D.C. Cir. 2006). Because the orders below inflict substantial harms on petitioners and threaten to destabilize the energy markets, *see* Pet. Br. 45-50, 53-61, there is no bar to considering petitioners' arguments.

Finally, the Commission suggests that its "assertion of jurisdiction" is entitled to deference under *Chevron U.S.A., Inc. v. Natural Resources Defense Council*, 467 U.S. 837 (1984). FERC Br. 23. But *Chevron* deference plainly does not apply. The Commission has not cited any relevant textual ambiguity in the Federal Power Act and, as petitioners' opening brief explains, courts have consistently held that the statute draws a "bright line"

between wholesale and retail transactions that unambiguously deprives the agency of power to regulate activities subject to regulation by the States. *See* Pet. Br. 6-9, 27-28. Where, as here, the courts have held a statute is unambiguous, there is no room for agency discretion. *National Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 982-83 (2005); *cf. City of Arlington Tex. v. FCC*, No. 11-1545 et al. (U.S. Oct. 5, 2012) (granting certiorari to consider whether *Chevron* deference applies when an agency is determining its own jurisdiction).

### B. The Commission Has No Authority To Regulate Retail Transactions.

In response to petitioners' basic jurisdictional objection, the Commission advances three arguments: (1) a retail customer's decision not to purchase energy at retail is purportedly a wholesale service; (2) the Commission's authority to regulate practices "affecting" wholesale sales permits it to regulate retail purchase decisions; and (3) the Commission's orders are supported by precedent. Each of these arguments collapses on examination.

### 1. The Commission Cannot Regulate Retail Transactions By Re-Characterizing Them As Wholesale Services.

The Commission does not and cannot dispute that the States have exclusive authority over the regulation of retail sales, which includes the authority to set the level of charges paid for retail consumption (*i.e.*, demand). *See* FERC Br. 34; *see also Niagara Mohawk*, 452 F.3d at 824 ("States retain jurisdiction over retail sales …."). The Commission instead asserts that its orders do "not regulate retail transactions of any kind," FERC Br. 34, because there are purportedly "two types of demand response: one occurs at the retail level and the second occurs at the wholesale level." FERC Br. 20. According to the Commission, its orders apply only when retail customers "choose to participate" in the "Commission-jurisdictional wholesale markets" by agreeing to reduce retail consumption. *Id.*

These assertions beg the question whether the Commission has any authority in the first place to draw retail customers into the wholesale markets by paying them not to engage in retail sales. The Commission cannot transform a retail transaction into a wholesale transaction simply by characterizing it as a "wholesale" service. *Cf. National Fed'n of Indep. Business v. Sebelius*, 132 S. Ct. 2566, 2586 (2012) (the power to "regulate" something

does not include "the power to create it"); *Atlantic City Elec. Co. v. FERC*, 295 F.3d 1, 5 (D.C. Cir. 2002) ("if there is no statute conferring jurisdiction, [the Commission] has none"). As this Court has made clear, "[u]nless a transaction falls within" the Commission's "wholesale or transmission authority, it doesn't matter how [the Commission] characterizes it." *Southern Cal. Edison Co. v. FERC*, 603 F.3d 996, 1001 (D.C. Cir. 2010); *cf. Oklahoma Nat'l Gas Co. v. FERC*, 906 F.2d 708, 713 (D.C. Cir. 1990) (Commission may not assert jurisdiction by "plac[ing] a premium on the form rather than the substance of the transaction").

While the Commission asserts that there is an important distinction between wholesale and retail "demand response," its orders do not define the difference. Nor has the Commission responded to petitioners' key point: No matter what label the Commission might apply, the only "service" provided by "demand response" providers under the Commission's orders is a commitment by retail customers to purchase and consume less energy at retail. The Commission is not proposing to regulate demand at the wholesale level by, for example, paying wholesale customers to reduce their purchases of energy at wholesale for resale to retail customers. That type of regulation would fall within the Commission's statutory authority. Instead,

the Commission's orders seek to regulate retail transactions directly by paying retail customers to reduce retail consumption.

The Commission's regulations belie any suggestion that its orders are merely regulating a wholesale service. *Panhandle E. Pipe Line Co. v. FERC*, 613 F.2d 1120, 1135 (D.C. Cir. 1979) ("axiomatic that an agency is bound by its own regulations"). The regulations have only one definition for "demand response": a "reduction in the ***consumption*** of electric energy by customers from their expected consumption in response to an increase in the price of electric energy or to incentive payments designed to induce lower consumption of electric energy." 18 C.F.R. § 35.28(b)(4) (emphasis added); *see also* Order 745 at n.2 (JA __).

Regulating "consumption" by retail electricity customers necessarily means regulating retail, not wholesale, sales. *See* 16 U.S.C. § 824(d) (defining "sale of electric energy at wholesale" to "mean[] a sale of electric energy to any person for resale"); Black's Law Dictionary 1055 (7th ed. 2000) (retail: "The sale of goods or commodities to ultimate consumers, as opposed to the sale for further distribution or processing.... Cf. Wholesale"); *id.* at 253 (consumer: "[a] person who buys good or services … with no intention of resale"); *id.* at 254 (consumption: "… the use of thing in a way that thereby

exhausts it"). And that is the giant fly in the Commission's ointment: Retail sales of electricity are within the traditional and "exclusive jurisdiction of the States." *Duke Energy Trading & Mktg., LLC v. Davis*, 267 F.3d 1042, 1056 (9th Cir. 2001). Regardless of how they might be characterized, or what they might be called, the Commission has no authority to regulate them. *Cf. Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, 487 U.S. 354, 377 (1988) (Scalia, J., concurring) (noting "common ground" that where Commission "has jurisdiction over a subject, the States cannot have jurisdiction over the same subject").

**2. The Commission's Authority Over Practices "Affecting" Wholesale Rates Does Not Allow It To Regulate Retail Sales.**

The Commission contends that its authority to regulate practices "affecting" wholesale rates includes authority to regulate retail consumption. FERC Br. 30-34; 16 U.S.C. §§ 824d, 824e. This argument ignores the "red lines that cabin" the Commission's jurisdiction. *EME Homer City Generation, L.P. v. EPA*, __ F.3d __, 2012 WL 3570721, at *9 (D.C. Cir. Aug. 21, 2012). Although there is undeniably a link between wholesale rates and retail sales, *see* Pet. Br. 11-14, Congress excluded from the Commission's jurisdiction any matters "subject to regulation by the States" — which

includes the States' unquestioned authority to set the level of charges paid by retail customers for purchasing electricity at retail. 16 U.S.C. § 824(a); *see also* 16 U.S.C. § 824(b)(1) (authority to regulate transmission and sales at wholesale "shall not apply to any other sale of electric energy"); *Public Utils. Comm'n v. FERC*, 900 F.2d 269, 276 (D.C. Cir. 1990) (noting that, under similarly worded provisions of the Natural Gas Act, the "states had unquestioned authority over retail sales").

The Commission has no response to petitioners' basic statutory argument that, no matter how broad the Commission's "affecting" jurisdiction might extend, it cannot be interpreted as a "blank check," *EME Homer City*, 2012 WL 3570721, at *10, authorizing the Commission to regulate retail services. *See* Pet. Br. 30-38. By requiring that certain retail customers receive payment for reducing retail consumption, the Commission is modifying the dollar amount paid by retail customers for each unit of electricity they purchase, thereby setting the level of charges paid by retail customers for the electricity they consume. This has more than an "incidental effect" on the retail rate; it directly changes it.

Nor can the Commission point to anything in the Federal Power Act granting it authority over retail demand or any other aspect of retail

consumption. *Cf. Gregory v. Ashcroft*, 501 U.S. 452, 460 (1991) (plain statement required when Congress intends to interfere with an area of traditional state concern); *see also Gonzales v. Oregon*, 546 U.S. 243, 274-75 (2006). To the contrary, the statute reflects "a constant purpose to protect … [the] authority of the [S]tates," *Connecticut Light & Power Co. v. FERC*, 324 U.S. 515, 525 (1945), and was drafted "with meticulous regard for the continued exercise of state power, not to handicap or dilute it in any way." *Panhandle E. Pipe Line Co. v. Public Serv. Comm'n of Ind.*, 332 U.S. 507, 517-18 (1947) (statute cuts "sharply and cleanly" between retail and wholesale transactions); *cf. Bonneville Power Admin. v. FERC*, 422 F.3d 908, 920 (9th Cir. 2005) (the Commission's general authority over wholesale rates does not trump provisions limiting its authority).

The Commission's approach would render meaningless the limits on its jurisdiction imposed by Congress and obliterate the "bright line" between federal and state jurisdiction over power sales. *See* Pet. Br. 33. That is because the level of retail rates, and the design of those rates, will ***always*** affect the overall demand for electric services and the prices that prevail in the wholesale market. For example, if a state commission imposes surcharges on certain retail customers or chooses to subsidize activities of

those customers, those surcharges or subsidies will inevitably affect consumption and thereby the wholesale market and wholesale rates. That relationship between wholesale and retail consumption is true of any product. As petitioners' opening brief explains, the Commission's interpretative approach would allow the Commission to regulate any entity that supplies an input that in turn influences the cost of generating or transmitting energy. Pet. Br. 33.

The Commission contends that these types of entities are not (yet) "'direct participants' in Commission-jurisdictional wholesale energy markets." FERC Br. 37. But that is not a meaningful distinction: As the Commission appears to recognize, retail customers did not participate in the wholesale markets until the Commission brought them into the markets by paying them to reduce retail purchases. *See id.* at 37-38. The Commission provides no reason why, under its proposed statutory construction, it also could not claim authority to pay entities to produce more or less of any input that influences the costs of generating and transmitting energy.

With no response on the merits, the Commission resorts to diversionary tactics, pointing to petitioners' past statements that they "'fully support' demand response participation in wholesale energy markets."

FERC Br. 38. In fact, in the same paragraph from which the Commission has extracted this quotation, petitioners cautioned that the agency "must do more than pay lip service to the 'confines of [its] statutory authority,'" and argued, in particular, that the Commission's rule would involve "setting rates for non-jurisdictional, retail non-purchases that fall well outside the Commission's delegated authority." R.232 at 2-3 (EPSA, APPA, et al. Reh'g Req.) (JA __).

To be clear, petitioners continue to support appropriate federal and state "demand response" initiatives, provided that those initiatives respect jurisdictional boundaries and are consistent with sound economic principles. That position is in accord with Congress's intent in the Energy Policy Act of 2005 to promote "demand response," while recognizing that it was a matter of state concern and assigning the Commission the purely advisory role of preparing a report. Pet. Br. 36. Congress did not grant the Commission any authority to regulate retail demand. If anything, the 2005 statement of policy recognizes that this authority resides outside the Commission's proper jurisdiction. *See Comcast Corp. v. FCC*, 600 F.3d 642, 654 (D.C. Cir. 2010) ("[p]olicy statements … are not delegations of regulatory authority").

### 3. The Cases Cited By The Commission Do Not Support Its Position.

Perhaps recognizing that there is no evidence that Congress intended the Commission to regulate the charges associated with retail-purchase decisions, the Commission attempts to defend its power grab by citing other cases where this Court has declined to strike down Commission orders on jurisdictional grounds. When examined, however, these cases only confirm that the Commission's attempt to exercise jurisdiction here is unauthorized.

The Commission first points to *Indiana Utility Regulatory Commission v. FERC*, 668 F.3d 735 (D.C. Cir. 2012), suggesting that the decision accepted that there are "different types of demand response." FERC Br. 4, 13-14, 34. But the Court in that case was not asked to examine whether agreeing to reduce retail consumption is, in fact, reasonably characterized as a wholesale service. The Court did not even make a drive-by jurisdictional ruling. *Cf. Steel Co. v. Citizens for a Better Env't*, 523 U.S. 83, 91 (1998). To the contrary, the Court specifically declined to address whether "the Commission encroached upon the state's jurisdiction" because the jurisdictional issue was not properly preserved. *Indiana Util. Regulatory Comm'n*, 668 F.3d at 740; *see also* FERC Br. 14 (conceding this point).

The Commission also points to *New York v. FERC*, 535 U.S. 1 (2002), as "particularly instructive," because that case upheld the Commission's "assertion of jurisdiction ... on interstate transmission lines — even those directly serving retail customers." FERC Br. 31. But that holding hinged on the fact that "[t]here is no language in the statute limiting [the Commission's] ***transmission*** jurisdiction to the wholesale market, although the statute does limit [the Commission's] ***sale*** jurisdiction to that at wholesale." 535 U.S. at 17 (emphasis in original). If anything, *New York* underscores the weakness of the agency's position in this case. Unlike in *New York*, the Commission here is claiming authority to regulate retail transactions in a manner that directly transgresses the statutory limits on its authority.

Finally, the Commission continues to hang its hat on cases in which the Commission was allowed to regulate matters because the effects on state regulation or non-jurisdictional entities were "indirect and incidental." *S. Cal. Edison*, 603 F.3d at 1001; *see also* Pet. Br. 38-40 (distinguishing *Sacramento Mun. Util. Dist. v. FERC*, 616 F.3d 520 (D.C. Cir. 2010), *Connecticut Dep't of Pub. Util. Control v. FERC*, 569 F.3d 477 (D.C. Cir. 2009), and *United Distrib. Cos. v. FERC*, 88 F.3d 1105 (D.C. Cir. 1996)). The Commission argues that

these cases establish that the Commission has authority to set rules for the wholesale markets and to regulate any parties that "directly participate" in those markets. FERC Br. 39-40. But none of these cases dealt with a situation where, as here, the Commission has sought to annex into the wholesale markets a practice that falls within the exclusive province of the States. *See* Pet. Br. 38-40. Because the Commission does not have authority to regulate retail sales, it cannot overcome that jurisdictional constraint by requiring ISOs and RTOs to pay certain retail customers not to consume electricity at retail and then claiming that it is merely regulating the way in which the ISOs and RTOs run the wholesale markets.

### C. The Commission Has Failed To Justify Its Interference With State "Demand Response" Initiatives.

Even if Congress had not expressly denied the Commission jurisdiction to regulate retail sales, the Commission's orders would remain unlawful because they unreasonably interfere with what the Commission concedes is an area of traditional state concern and fail to explain adequately the Commission's exercise of jurisdiction. In particular, the orders provide no meaningful response to objections that federal regulation will interfere

with state policies regarding the appropriate type and level of retail-demand programs. *See* Pet. Br. 41-44.

The Commission argues that the Court should not consider this issue because petitioners purportedly did not raise it on rehearing, *see* FERC Br. 3, 29, but that is manifestly wrong. In a section of its rehearing request entitled "Paying Demand Resources Full LMP Undermines Retail Programs and Imposes Additional Costs on Non-Participating Retail Consumers," EEI specifically and expressly argued that changes in retail consumption in response to the Commission's rule "could undermine the effectiveness of [state] retail programs and have other unintended consequences that the Commission did not appear to even consider." R.239 at 17-19 (EEI Reh'g Req.) (JA __). Similarly, EPSA argued on rehearing that the final rule "may hinder efforts to overcome barriers to [demand response] entry at the retail level by interfering with the development and implementation of" retail programs. R.240 at 38 (EPSA Reh'g Req.) (JA __); *see also* Order 745-A, at P71 (JA __).

Stripped of its unsupported claim of waiver, the Commission has no meaningful response on the merits. The Commission offers only the conclusory assertion that an "incidental effect" on state programs is

"insufficient to deprive the Commission" of either its obligation "to ensure that FERC-jurisdictional rates are reasonable and not discriminatory" or its "exclusive jurisdiction to regulate market rules for organized wholesale energy markets." FERC Br. 30. Because the Commission never considered the effect its orders will have on "demand response" programs at the state level, however, it cannot claim to know that its orders will have only an "incidental effect."

In fact, the Commission's orders will necessarily interfere with state regulation. In particular, by requiring that certain retail customers receive compensation for reducing retail purchases, the Commission's orders directly interfere with the States' decisions regarding the price that retail customers should pay for the retail electricity they purchase. It makes no sense for States to set the price that retail customers pay for power when they consume electricity, but not the price they pay (or are paid) when they consume less of it. Dividing a retail transaction into different components for demand increases (consuming more energy) and demand decreases (consuming less energy) seeks to separate the inseparable and to pretend that the net charge is anything other than a rate for retail sales.

## II. The Commission's Orders Requiring Payment Of Full LMP For Retail Non-Consumption Violate The Federal Power Act And Are Arbitrary And Capricious.

The Commission's orders violate both the Federal Power Act and the requirements of reasoned decision-making because they bestow an undue preference on "demand response" providers while unduly discriminating against power suppliers, distort the market, and result in artificially suppressed prices. *See* Pet. Br. 45-61. In response, the Commission repeatedly pleads that its ratemaking decisions are entitled to deference. *See* FERC Br. 22, 25, 48, 54-64; *see also* Resp.-Intervs. Br. 22-39; Resp.-Amici. Br. 17-27. But the Commission is not entitled to deference unless it complies with statutory requirements, explains departures from precedent, and responds meaningfully to serious objections to its approach. *See, e.g.*, *Fox v. Clinton*, 684 F.3d 67, 75 (D.C. Cir. 2012) (citing cases). It has not satisfied those obligations.

### A. The Commission's Orders Depart From Precedent Without A Reasoned Explanation.

In *PJM Industrial Customer Coalition v. PJM Interconnection, LLC*, 121 FERC ¶ 61,315 (2007), the Commission previously determined that paying retail customers to provide "demand response" at the full LMP results in an improper "subsidy" because the retail customers not only receive the full

LMP but also avoid the associated retail generation charge. *Id*. at P26. As petitioners' opening brief explains, the Commission's orders are arbitrary and capricious because they do not even acknowledge their departure from that precedent, much less explain why the Commission's earlier determination is no longer valid. Pet.Br.5; *see FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515 (2009).

The Commission's response asserts that it explained its change in position in paragraph 10 of its notice of proposed rulemaking, where it expressed concern that compensation for "demand response" was inadequate, *see* FERC Br. 67 (citing R.2 at P10, 75 Fed. Reg. 15,362 (Mar. 29, 2010) (JA __)), and in paragraphs 40 and 58 of its rehearing order, where it purportedly addressed petitioners' "'subsidy' argument." *Id*. at 68 (citing Order 745-A, at P58 (JA __)). But nowhere in any of the cited paragraphs, or anywhere else in its orders, did the Commission acknowledge its previous characterization of full LMP as an improper "subsidy" or explain why that determination was no longer valid. This failure "to come to grips with conflicting precedent" is arbitrary and capricious. *Jicarilla Apache Nation v. U.S. Dep't of Interior*, 613 F.3d 1112, 1120 (D.C. Cir. 2010) (citations omitted).

### B. The Commission's Orders Are Unexplained And Do Not Respond To Substantial Objections.

Even had the Commission acknowledged its departure from precedent, its orders would still be invalid because they fail to respond to serious objections. In particular, the Commission (1) never justified its conclusion that more "demand response" will achieve just and reasonable rates, and (2) never responded to concerns that paying full LMP will distort the market.

The Commission argues that its orders are reasonable because it determined that "existing demand response programs … are inadequate," FERC Br. 46, that "demand response participation remains relatively low," *id*. at 49, and that its orders are "vital" to eliminating "numerous, continuous barriers" to "demand response" participation in the wholesale markets. *Id*. at 45, 49. But these bare observations about the levels of "demand response" participation do nothing to establish that the Commission's approach will result in "just and reasonable" rates, as the Federal Power Act requires. *See* 16 U.S.C. § 824d(a). Nor do they establish that, in seeking to lower rates by increasing "demand response," the Commission has fulfilled its obligation to protect the interests not only of consumers but also of suppliers.

Pet. Br. 57 (*citing FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944)). In fact, as petitioners' opening brief explains, numerous experts testified that the Commission's orders will produce too much "demand response," distort the market, and harm both consumers and suppliers. *See* Pet. Br. 47-48, 53-56; *see also* Amicus Brief of R. Borlick, et. al. [Doc. 1378605].

Tellingly, the Commission identifies nothing in its orders that responds to petitioners' concerns that the Commission's rule will result in ***too much*** "demand response" being offered into the markets, which will upset the delicate balance struck between under-mitigation and over-mitigation of market power under the existing rules approved by the Commission. Pet. Br. 53-61. It is not enough for the Commission to assert that it "balanc[ed] the competing interests at stake." FERC Br. 55. That assurance is backed up by no substantive analysis. And it rings especially hollow given the Commission's acknowledgment that "market power mitigation [was] not the subject of [the] rulemaking" *id.* at 71, meaning it never considered the possibility of over-mitigation at all.

Although the Commission's orders do not grapple with the merits of expert testimony raising substantial concerns about the problems of paying full LMP for "demand response," *see* Amicus Brief of R. Borlick, et. al. [Doc.

1378605],* the Commission credits itself with "[d]escribing in detail the dispute among experts" regarding "the appropriate compensation level for demand response" and resolving that dispute. FERC Br. 18. But this does not free the Commission from the requirements of reasoned decision-making. *See Schurz Commcn's, Inc. v. FCC*, 982 F.2d 1043, 1050 (7th Cir. 1992) ("unprincipled compromises … among contending interest groups" are not reasonable). The Commission must do more than merely describe objections to its approach; it must respond to them in a meaningful fashion. *See PSEG Energy Res. & Trade LLC v. FERC*, 665 F.3d 203, 210 (D.C. Cir. 2011) (to "characterize objections … is not to answer them"). An agency's decision "must take into account whatever in the record fairly detracts" from its decision, *Universal Camera Corp. v. NLRB*, 340 U.S. 474, 488 (1951), and must "explain why it rejected evidence that is contrary to its findings." *Carpenters & Millwrights v. NLRB*, 481 F.3d 804, 809 (D.C. Cir. 2007).

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* Respondent-intervenors opposed the *amicus* brief filed by the 21 economists in support of petitioners on grounds that accepting the brief would "leave the door open" for other "expert witnesses and consultants" to file their own *amicus* briefs. *See* Interv.-Resp. Opp. to Mot. 8 (June 22, 2012) [Doc. 1380314]. The door was open, but no one walked through it: No economist or any other expert has appeared in support of the Commission.

The Commission appears to suggest that it can ignore the criticisms raised by expert economists objecting to full-LMP compensation, arguing that "markets are not perfect" and that it therefore has no obligation to ground its decision-making in either "textbook economic analysis" or "empirical proof." FERC Br. 47, 58. But the Commission's orders never explain why that is a reasonable approach (especially because textbook economics do not assume that markets are perfect). Instead, they appear to be based on the raw *ipse dixit* that additional "demand response" is always better and can be achieved only by paying retail customers the full LMP (in addition to the foregone retail rate).

That is hardly a basis for ignoring rudimentary economics and failing to respond to expert objections. Although the Commission argues that "demand response" providers and generators are both "capable of providing the same service to the market, balancing supply and demand," FERC Br. 63, it cannot reasonably claim that retail customers are similarly situated to electricity generators. *See* Pet. Br. 49 (*citing Alabama Elec. Coop., Inc. v. FERC*, 684 F.2d 20, 27-28 (D.C. Cir. 1982)); *see also General Motors Corp. v. Tracy*, 519 U.S. 278, 298-99 (1997) ("any notion of discrimination assumes a comparison of substantially similar entities" and poses the "threshold

question whether the companies are indeed similarly situated"). Indeed, as experts explained, "demand response" providers do not have any relevant costs of production and, in fact, realize additional savings when they do not consume energy at retail. *See* Pet. Br. 47-50.

The Commission contends that it does not inquire "into resources' costs of ***production.***" FERC Br. 64 (emphasis added). But the whole point of the economic analysis on which the Commission previously relied but which it now eschews is that "demand response" providers do not ***have*** any relevant costs of production because they "do not create electricity." *Id.* at 63. According to the Commission, the retail rate "reflects a demand response provider's cost of production." *Id.* at 66. Nonsense: By definition, providing "demand response" requires a retail customer not to purchase (and not to be charged for) electricity. That is why, as petitioners' opening brief explains, if a commitment to consume less energy than expected constitutes a "service," the avoided retail rate is similarly a form of "compensation" that must be taken into account to ensure efficient price signals and to avoid over-incentivizing retail customers to forgo retail consumption. Pet. Br. 49-56. Although the Commission asserts that "the costs or benefits of production are not relevant" to whether a resource can

help balance supply and demand, FERC Br. 64, its statutory obligation is not to "balance" the markets but to prevent undue discrimination and to ensure just and reasonable wholesale rates. *See* 16 U.S.C. § 824d. The Commission never explains why these goals are achieved by overcompensating retail non-consumption. Indeed, as noted above, the Commission previously (and correctly) found that paying retail customers the full LMP is an improper subsidy. *See* Pet. Br. 50-53.

### C. The Commission's New "Net Benefits" Test Cannot Salvage The Commission's Orders.

Effectively recognizing that paying full LMP will overcompensate "demand response" providers, the Commission suggests that this concern is irrelevant because the LMP payment is "conditioned upon satisfaction of the balancing capability and net benefits test." FERC Br. 68. The problem with this response is obvious: The conditions to which the Commission refers do not prevent undue discrimination; they only limit ***when*** an unlawful subsidy will be paid. *See* Amicus Brief of R. Borlick, et. al. at 27-30 (describing flaws in the net-benefits test) [Doc. 1378605]. The Commission cannot try to justify unduly preferential rates for "demand response" providers by claiming that it has imposed conditions "limiting the period during which," FERC Br. 61,

they will be overpaid. While this may be better than paying unjustified subsidies all the time, the Federal Power Act "does not say 'a little unlawfulness is permitted.'" *FPC v. Texaco, Inc.*, 417 U.S. 380, 399 (1974).

## III. The Commission Did Not Satisfy Its Statutory Obligations Before Ordering Changes To Existing Rates.

In response to petitioners' argument that the Commission failed to make the necessary findings that existing rates were "unjust, unreasonable, unduly discriminatory or preferential," 16 U.S.C. § 824e, the Commission points to conclusory assertions in its orders that existing compensation schemes were "inadequate." FERC Br. 46 (citing orders). But these assertions are not supported by reasoned analysis and do not carry the burden that Congress imposed on the Commission.

The Commission contends that it was appropriate for it to move toward a more "uniform" approach. *Id.* at 73. But the Commission's desire for uniformity cannot overcome its obligation to find that existing rates were unjust and unreasonable before ordering them changed. It is therefore dispositive that the Commission never reviewed, nor made any findings regarding, the different ISO and RTO rules governing compensation for "demand response." Pet. Br. 63.

The Commission nonetheless asserts that "substantial record evidence" supports its conclusions. FERC Br. 48-54. There is a vital difference, however, between making the required statutory findings and merely pointing to the fact that certain parties supported the Commission's position. That aggregators and large industrial consumers unsurprisingly lobbied for increased compensation for "demand response" does not constitute a "find[ing]" establishing that existing rates were "unjust, unreasonable, unduly discriminatory or preferential," which is the statutory predicate for the Commission's fixing of new rates. 16 U.S.C. § 824e(a). Nor does it provide any basis for assuming that the full-LMP compensation ordered by the Commission was just and reasonable.

* * * *

At bottom, the Commission's orders rest on a professed desire to eliminate "barriers" to "demand response." But it has not adequately explained its position and cannot overcome the fact that eliminating "barriers" by ***overcompensating*** "demand response" providers will distort the markets and harm consumers. And, in any event, those barriers are not for the Commission to remove. They are an inevitable consequence of the

wall that ***Congress*** erected between the retail and wholesale energy markets. That wall should be respected.

## CONCLUSION

The Court should grant the petitions for review, reverse the Commission, and vacate the orders below.

Respectfully submitted,

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Dated: October 11, 2012

## CERTIFICATE OF COMPLIANCE

Pursuant to Rule 32(a) of the Federal Rules of Appellate Procedure and Circuit Rule 32(a)(2), I hereby certify that the textual portion of the foregoing brief (exclusive of the disclosure statement, tables of content and authorities, certificates of service and compliance, but including footnotes) contains 6,201 words as determined by the word-counting feature of Microsoft Word 2000.

/s/ Ashley C. Parrish
Ashley C. Parrish

**CERTIFICATE OF SERVICE**

Pursuant to Rule 25 of the Federal Rules of Appellate Procedure, I hereby certify that I have this 11th day of October 2012, served a copy of the foregoing documents electronically through the Court's CM/ECF system. All participants in the case are registered CM/ECF users and will be served by the appellate CM/ECF system.

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