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Who Flips The Switch?

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The energy sector faces significant change, driven by factors ranging from shifting sources of electricity generation, to commercialization of emerging technologies and the experimentation with new market models. In response, both the federal government and various states have sought to insert themselves in these evolving industry dynamics and to assert their jurisdiction in these areas.

In many cases, however, there's no clear policy as to what's the province of the federal government and what's the province of the states. That will mean uncertainty for companies operating in these markets — it will also mean litigation.

Both the conflicts and attendant uncertainties have perhaps most starkly arisen from the need for a rapid and large-scale build-out of gas-fired, renewable and, increasingly, distributed generation, as well as the infrastructure required to support such a build-out. They will be exacerbated by the retirement of an aging generation fleet, spurred by the U.S. Environmental Protection Agency's proposed Clean Power Plan developed under Section 111(d) of the Clean Air Act, U.S. shale-gas boom, which has made natural gas abundant and affordable, and reduced costs of what had been thought of as "uneconomic" technologies, particularly clean technologies with reduced carbon costs.

The industry also is on the cusp of significant developments affecting electric markets, driven by the increasing importance of demand response and energy efficiency, storage, distributed generation, regional transmission expansion, resource adequacy and adherence to reliability requirements.

Moreover, even while the federal government and states have their own regulatory spheres, even where these spheres are well-defined, what one does affects the other. As a consequence, the two will have to learn to work together. But as they do, it will mean a year of adjustments — sometimes dramatic — for companies in the energy industry.

Planning for Cleaner Power

The EPA's proposed rules for regulating greenhouse gas emissions from existing power plants will be finalized in 2015. Those rules most surely will be challenged in the courts.

In fact, 15 to 20 states already have sued the EPA. We'll also see litigation from various industries and industry groups. At first that litigation will center on Washington. Initially, the major issues will concern the EPA's authority to regulate CO2 emissions under the Clean Air Act given that the Clean Power Plan could be viewed as extending federal oversight to the entire electric grid, including the portion that falls under state control. Then, as each state implements its own plan under EPA's guidance, litigation almost certainly will arise in most cases.

Eventually, the litigation is likely to wind its way up to the U.S. Supreme Court. Overall, the new EPA rules probably will survive, because for the most part the Supreme Court has backed the EPA's interpretation of the Clean Air Act. But how the Supreme Court rules ultimately could shape the evolution of electricity production and consumption in the U.S., and industry's ability to adapt to these new models.

The EPA regulation will drive the replacement of coal-fired power plants with natural gas and renewable sources, as well as the build-out of infrastructure such as natural gas pipelines and electric transmission lines. That will require coordination among the EPA, Federal Energy Regulatory Commission, North American Electricity Reliability Corp., regional transmission organizations, public utility commissions and state environmental regulators. These organizations do not have an unblemished track record of cooperation.

Demand Response and State Prerogatives Over Generation

Another key energy issue this year will concern the continued vitality of demand response (i.e., incentivizing customers to reduce their electricity usage during peak demand). FERC had required regional markets to compensate a demand-response provider for the power avoided (i.e., saved) at the same rate as a generator received for the power it sold. In other words, if the market price for electricity is $100, any consumer reducing its energy use by that amount would be paid $100.

However, in large part, the federal courts have nixed that approach. In Electric Power Supply Association v. FERC, the D.C. Circuit said that FERC's demand-response incentive was essentially a pricing mechanism for distribution and retail operations — making it a matter for state, rather than federal, oversight. This creates a jurisdictional quagmire for markets that span multiple states. It's unclear how state decisions about demand response will be integrated into FERC's regional markets. Ultimately this, too, likely will be resolved by the Supreme Court.

So, too, will many questions as to state prerogatives to incentivize the development of new generation. Increasingly, states have grown dissatisfied with the failure of the FERC-regulated markets to incentivize new generation sited in-state or nearby. States are trying to establish programs to provide out-of-market revenues to ensure construction of the resources they prefer. And even though the states, and not FERC, have exclusive authority over generation, states have run into challenges and been rebuffed by federal courts.

For example, Maryland and New Jersey awarded long-term contracts to new gas-fired generators. But the contracts were judicially invalidated on the grounds that the states unlawfully sought to preempt FERC's authority to regulate wholesale markets. Some believe those decisions to be so broad as to preclude any state-mandated renewable energy program in a FERC-organized market.

However, regardless of who turns out to be right here, until the issues are resolved definitively, state-supported infrastructure developers in the organized markets might not even be able to reply on fallback positions. For example, if a contract were to provide that should the contract be found to be unenforceable, some other pricing mechanism would apply, it's at least uncertain as to whether even the fallback would avoid challenges.

These are by no means the only issues where FERC and states are at cross-purposes. For example, similar to the issues concerning how, if at all, states might facilitate the construction of new generation, in regions where natural gas infrastructure requires significant investment, such as the Northeast, some states assert that the revenues available under FERC-regulated tariffs simply aren't sufficient to induce generators to commit to the firm delivery services needed to fund new pipelines and, as a consequence, are questioning what they might do to help alleviate this situation.

Power Potpourri

Numerous other regulatory issues will emerge over the next year. On distributed generation, the line between federal and state regulation likewise is unclear. Even where it's governed by states, distributed generation will affect and be affected by FERC's regulation of grid reliability.

On the construction of new electricity transmission, utilities are implementing FERC's new regional planning and cost allocation rules, in part established to reduce the likelihood of states litigating with the commission over pricing rules that allocate costs over many states. In that same rule, FERC ordered that federal tariffs no longer could include rules preventing competition for the right to construct transmission projects. However, the states are still able to prevent such competition when exercising their authority to site and approve the construction of those projects.

Dueling jurisdictional arguments will impede the ability of the states and federal government to pursue policies and market rules for an integrated grid. As a consequence, many in the industry are wondering how important decisions driving tomorrow's grid architecture will get made. For example, there are unanswered questions regarding who makes decisions on the integration of retail and distribution resources, and how such resources are priced on the wholesale market. But no matter who has the authority, the states will demand to be involved to create practical approaches to pricing, reliability and sustainability.

Certainly, federal and state court litigation isn't making the industry's efforts to develop and modernize the grid any easier. In California, lawsuits challenging emissions are an ongoing impediment to new generation development and grid improvement projects. Current litigation includes a Ninth Circuit case addressing the permitting and ongoing operation of a gas-fired plant and another challenging the building of a biomass plant that would rely on renewable fuel sources. In California and other places, if you are developing or repowering a plant that will create any emissions at all, you're likely to trigger some sort of legal action. One way or the other, this likely will be a year of significant regulatory and litigation uncertainty.

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