NOS. 14-840, 14-841

In the
Supreme Court of the United States

FEDERAL ENERGY REGULATORY COMMISSION,
PETITIONER,

v.

ELECTRIC POWER SUPPLY ASSOCIATION, ET AL.,
RESPONDENTS.

ENERNOC, INC., ET AL.,
PETITIONERS,

v.

ELECTRIC POWER SUPPLY ASSOCIATION, ET AL.,
RESPONDENTS.

On Writs of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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RULE 29.6 STATEMENT

The Rule 29.6 statement included in the brief in opposition was amended on June 22, 2015, but otherwise remains current. This brief on the merits is joined by the following respondents:

The ***Electric Power Supply Association ("EPSA")*** is a national trade association that represents the competitive power industry. EPSA's members include 14 companies, along with numerous supporting members, and state and regional partners representing the competitive power industry in their respective regions. EPSA's members have significant financial investments in electric generation and electricity marketing operations across the country.

The ***American Public Power Association ("APPA")*** is the national service organization representing the interests of not-for-profit, publicly owned electric utilities throughout the United States. More than 2,000 public power systems provide over 15 percent of all kilowatt-hour sales to ultimate customers, and APPA members do business in every State except Hawaii. Many APPA members sponsor or participate in "demand response" programs in the course of providing retail electric utility services.

The ***National Rural Electric Cooperative Association ("NRECA")*** serves more than 900 not-for-profit rural electric cooperatives and public power districts providing retail electric service to more than 42 million customers in 47 States. NRECA's members include consumer-owned local distribution systems and 66 generation and transmission

cooperatives that supply wholesale power to their distribution cooperative owner-members.

Old Dominion Electric Cooperative ("ODEC") is a regional, consumer-owned power supplier that was formed in 1948 to provide power to a consortium of electric distribution cooperatives. In 2014, ODEC's 11 members served over 560,000 retail consumers in Virginia, Maryland, and Delaware, representing approximately 1.4 million member-owners.

The ***Edison Electric Institute ("EEI")*** is the trade association of the U.S. shareholder-owned electric companies. EEI members serve 95 percent of the ultimate customers in the shareholder-owned segment of the industry, and they represent approximately 70 percent of the U.S. electric power industry. EEI's diverse membership includes utilities operating in all regions of the U.S.

The ***PJM Power Providers Group ("P3")*** is a non-profit composed of suppliers of energy, capacity, and other services within the PJM Interconnection, L.L.C. ("PJM") power market. P3 supports the development of properly designed, well-functioning markets in the PJM region, which includes 13 States and the District of Columbia. P3's members own over 88,000 megawatts of power and over 51,000 miles of transmission lines, serve nearly 12.2 million customers, and employ over 55,000 people.

PPL Electric Utilities Corporation is a subsidiary of PPL Corporation. The shares of PPL Corporation are publicly traded. No other publicly held company has a 10% or greater ownership interest in PPL Electric Utilities Corporation.

Talen Energy Marketing, LLC (f/k/a PPL EnergyPlus, LLC), ***Brunner Island, LLC*** (f/k/a PPL Brunner Island, LLC), ***Holtwood, LLC*** (f/k/a PPL Holtwood, LLC), ***Martins Creek, LLC*** (f/k/a PPL Martins Creek, LLC), ***Talen Maine, LLC*** (f/k/a PPL Maine, LLC), ***Montour, LLC*** (f/k/a PPL Montour, LLC), ***Susquehanna Nuclear, LLC*** (f/k/a PPL Susquehanna, LLC), and ***Lower Mount Bethel Energy, LLC*** are indirect subsidiaries of Talen Energy Corporation. The shares of Talen Energy Corporation are publicly traded. No other publicly held company has a 10% or greater ownership interest in any of the Talen entities joining this brief.

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INTRODUCTION

This case is not nearly as complicated as the Federal Energy Regulatory Commission ("FERC") and its supporters would make it out to be. There is no dispute that the Federal Power Act ("FPA") divides jurisdiction over electricity sales between the States and FERC, expressly preserving the States' traditional and exclusive authority to regulate retail transactions, while granting FERC exclusive authority to regulate interstate wholesale transactions found by this Court to be outside the States' authority to regulate. There is also no dispute that the transactions FERC seeks to regulate through its "demand response" rule are retail transactions. All parties recognize that because Congress divided jurisdiction between the States and FERC, retail prices in many States do not always reflect the real-time wholesale cost of electricity. FERC identifies that disconnect between retail and wholesale rates as a "problem" and has attempted to address it by changing the effective price for retail transactions for the express purpose of altering the level of retail demand.

The "demand" FERC expects to "respond" to the payments at issue here is thus plainly retail demand. And the mechanism for eliciting that response is increasing the effective price of retail sales by offering a bounty to retail customers who reduce their retail purchases. The only real dispute is whether the fact that those bounties are paid by wholesale-market operators allows FERC to regulate retail demand and the effective price of retail transactions. It does not. The FPA leaves such

regulation with the States, where it has always resided. FERC cannot circumvent that clear congressional decision by inviting retail customers into a wholesale market and ordering wholesale-market operators to compensate them for reducing retail sales.

There is no question that States have authority over the retail markets and can introduce real-time pricing for retail sales. FERC concedes as much. But many States have declined to do so and prefer to keep retail rates stable throughout the day to avoid unexpected and unpredictable rate increases and to prevent claims of discrimination between different retail customers. One can debate the merits of the States' policy choices concerning the retail market, but Congress clearly placed the authority to make those choices with state regulators who are closer and more responsive to the people. FERC is free to make a contrary judgment about wholesale prices, and to try to persuade state regulators to adopt policies that would make retail demand more responsive to changes in wholesale rates. But FERC is not free to dictate the levels of retail price or demand. And it cannot accomplish that end by the convoluted means of ordering wholesale-market operators to compensate retail customers for reducing their retail demand.

FERC points to the presence of retail customers in the wholesale markets and asks who else can regulate the proper level of payments in the wholesale markets but FERC, the wholesale regulator. But that is question-begging in the extreme. Retail customers are participating in the

wholesale markets only because they have been lured in by payments designed to lower retail demand. The presence of retail customers in an otherwise wholesale market is not an excuse for federal regulation, but powerful evidence that FERC has overstepped its jurisdiction.

Even if FERC did possess jurisdiction to regulate retail demand, it would at least owe the regulated community the benefit of a rational regulation. FERC's stated interest has always been to "balance" supply and demand by ensuring that retail customers confront an effective retail price that mirrors the real-time wholesale price. FERC initially accomplished that goal by allowing wholesale-market operators to pay retail customers a bounty for non-consumption that reflected the difference between the wholesale price and the nominal retail rate set by the State, while recognizing that any greater payment would be an inappropriate subsidy. That formula ensured that retail customers would make purchasing decisions based on the real-time wholesale rate, rather than the nominal retail rate set by the States. The end was ultra vires, but at least the means were rational.

In its latest order, however, FERC has increased the payments not to reflect the difference between wholesale and retail rates, but to provide a bounty for non-consumption equal to the full amount of the wholesale rate, with no offset for the savings retail customers achieve by not purchasing electricity. That formula guarantees dramatic *over-compensation* of decisions to forgo electricity purchases; instead of balancing supply and demand, it distorts the markets

and inefficiently suppresses demand far below what the real-time wholesale price supports. FERC has never changed either its assessment of the problem that it believes needs to be remedied or its stated goal of balancing supply and demand so that both respond efficiently to the real-time wholesale cost of electricity. But its new compensation formula, adopted without any reasoned explanation, treats the reduction of retail demand as if it were an end in itself. That is arbitrary and capricious; it also confirms Congress' wisdom in leaving the regulation of retail prices and demand to state and local regulators.

STATEMENT

A. Statutory Background

States have long had exclusive jurisdiction to regulate retail electricity sales. Indeed, that "is one of the most important of the functions traditionally associated with the police power of the States." *Ark. Elec. Coop. Corp. v. Ark. Pub. Serv. Comm'n*, 461 U.S. 375, 377 (1983). This state authority reflects a cardinal virtue of federalism: States and localities are more responsive and accountable to local citizens than any federal regulator could be when it comes to the provision of one of modern life's basic necessities. Although FERC unquestionably has an important role in the regulation of electricity, that role is interstitial, having developed out of a need to fill a gap in the regulation of interstate wholesale electricity sales, not out of a congressional effort to supplant the States' primary authority over the retail electricity market.

States were historically the exclusive regulators of all aspects of the electricity market. In the early part of the last century, however, this Court recognized constitutional limits on the States' power to regulate electricity sales in interstate commerce. *See, e.g.*, *Pub. Utils. Comm'n of R.I. v. Attleboro Steam & Elec. Co.*, 273 U.S. 83 (1927); *see generally ONEOK, Inc. v. Learjet, Inc.*, 135 S. Ct. 1591, 1595 (2015). Although the Court did not question the plenary and exclusive power of the States to regulate retail transactions, it concluded that States could not regulate wholesale transactions in which electricity is sold from a generator in one state to a utility in another for resale to a retail customer. The Court thus "fashion[ed] a bright line dividing permissible from impermissible state regulation." *Ark. Elec.*, 461 U.S. at 377-78. States could not regulate interstate wholesale sales, but fully retained their exclusive police power to regulate the retail market. *See, e.g.*, *Attleboro*, 273 U.S. at 87-90.

Because Congress had not authorized federal regulation of the interstate transactions that this Court held to be outside the States' authority, the Court's decisions created a regulatory void known as the "*Attleboro* gap." The Court acknowledged the gap, but noted that "if such regulation is required it can only be attained by the exercise of the power vested in Congress." *Id.* at 90. Congress took this hint and enacted the FPA as "a direct result of *Attleboro*." *United States v. Pub. Utils. Comm'n of Cal.*, 345 U.S. 295, 311 (1953).

The FPA closed the "*Attleboro* gap" by providing federal authority to regulate transactions that the

States could not reach, but it did not reallocate any state authority to the federal regulator. To the contrary, the Act expressly reaffirmed the States' exclusive role over all aspects of the retail market, where there was no regulatory gap to close. The Act grants FERC jurisdiction over two specific activities in interstate commerce that were foreclosed to state regulators after *Attleboro*—namely, "the transmission of electric energy in interstate commerce" and "the sale of electric energy at wholesale in interstate commerce." 16 U.S.C. §824(b)(1). And to effectuate that jurisdiction, Congress charged FERC with reviewing "[a]ll rates and charges made, demanded, or received by any public utility for or in connection with" either the transmission or wholesale sale of electricity in interstate commerce, as well as "all rules and regulations affecting or pertaining to such rates or charges," to ensure that they are "just and reasonable." *Id*. §824d(a).

Congress made crystal clear, however, that FERC's jurisdiction extends no further. As a former Solicitor to FERC's predecessor explained, although some "had little faith in the competency of state regulation and ... pressed hard for federal regulation to the fullest extent," Congress "stood firm on the proposition that the Federal Government should take no hand in the establishment of local consumer rates, but that this field should be left entirely to state regulation." Dozier A. DeVane, *Highlights of Legislative History of the Federal Power Act of 1935 and the Natural Gas Act of 1938*, 14 Geo. Wash. L. Rev. 30, 34-35 (1945). Accordingly, the FPA and its sister statute, the Natural Gas Act, were "drawn

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. Pub. Serv. Comm'n of Ind.*, 332 U.S. 507, 517-18 (1947).

To that end, section 201(a) expressly declares that the Act's authorization of "Federal regulation" shall "extend only to those matters which are not subject to regulation by the States." 16 U.S.C. §824(a). And section 201(b) makes clear that, "except as specifically provided," there is no federal authority over "facilities used for the generation of electric energy," "facilities used in local distribution or only for the transmission of electric energy in intrastate commerce," or "facilities for the transmission of electric energy consumed wholly by the transmitter." *Id.* §824(b)(1). Section 201(b) also expressly excludes from FERC's jurisdiction "any other sale of electric energy," *id.*—that is, any sale that is not a sale in interstate commerce "for resale," *id.* §824(d). The Act thus ensures that "FERC's jurisdiction over the sale of power [is] specifically confined to the wholesale market," *New York v. FERC*, 535 U.S. 1, 17, 20 (2002), leaving regulation of retail sales where it has always been: with the States.

B. The Relationship Between Retail and Wholesale Sales

Although Congress divided jurisdiction over retail and wholesale electricity markets between the States and FERC, prices and demand in those markets have always been interrelated—as they are in virtually any market. State regulation of retail sales has always had a direct and substantial effect on the wholesale sales regulated by FERC, and vice

versa. Similarly, state decisions about generation and federal decisions about transmission directly affect rates at both the retail and wholesale levels.

In the FPA's early days, the effect of wholesale rates on retail rates was less extensive because the interstate wholesale market was relatively small. Most retail sales were made by vertically integrated utilities that generated most of the electricity they delivered and sold to their retail customers, and the entire intrastate process was pervasively regulated by the States. As the interstate wholesale market has developed, however, the retail and wholesale markets have become more interdependent. While load-serving entities used to respond to increases in retail demand primarily by generating additional electricity themselves, today they frequently do so by purchasing additional electricity at wholesale. Because electricity generally cannot be effectively stored, this results in a close relationship between the quantity of electricity sold to retail customers for consumption (in industry parlance, "load") and the quantity of electricity purchased by wholesale entities for resale. FERC Staff Report, *Energy Primer: A Handbook of Energy Market Basics* 37-38, 42 (July 2015). For example, retail customers tend to consume more electricity at certain times of day. That increase in consumption translates directly into increased "load" that public utilities and other load-serving entities must meet. An increase in retail demand therefore typically results in a corresponding increase in wholesale demand.

In an unregulated market, the inability to "warehouse" electricity would suffice to ensure a very

close correlation between retail and wholesale prices, but the electricity market remains subject to pervasive regulation. Congress made a deliberate decision, moreover, to preserve the States' exclusive authority to regulate retail rates, and the States and FERC do not always see eye-to-eye on how to set rates. Many state and local regulators directly responsive and accountable to local consumers have made a deliberate decision to favor stability in retail rates and to avoid significant disparities in the rates paid by retail customers who use electricity at different times of the day. FERC, by contrast, has favored real-time pricing of wholesale transactions, making wholesale rates more sensitive to changes in demand. As a result, while wholesale electricity rates may vary significantly throughout the day, retail rates in many States remain steady.

As one would expect in our federalist system, not every State has adopted the same approach to the competing interests in preserving retail rate stability and having retail rates reflect the wholesale cost of electricity. While many States continue to put a premium on rate stability, others have shifted away from that preference, adopting "dynamic pricing," under which retail rates may fluctuate with changes in wholesale costs. FERC Staff Report, *Assessment of Demand Response and Advanced Metering* 3-8 (Dec. 2014). Others have devised different means of incentivizing retail customers to reduce their electricity purchases when the wholesale cost of supplying electricity is high, such as offering rebates to customers who refrain from consuming electricity during "peak periods." *See id.* at 9-10, 21-24.

These various state programs reflect the basic economic reality that demand for a product is generally inversely related to its price (demand will fall when prices rise). That is so whether a State raises the nominal price of electricity (as with dynamic pricing) or the effective price (as with rebates or other payments to consume less electricity). A simple example illustrates the point. If the retail rate is $10 per unit of electricity but a State offers retail customers $5 for each unit that they agree to forgo at peak times (relative to a baseline level of demand), then the effective retail rate during peak times goes from $10 to $15—the $10 the customer pays out of pocket, plus the $5 payment the customer forgoes by continuing to purchase at peak times. The result is functionally no different from a dynamic pricing system under which the nominal rate increases to $15 at peak times. As a matter of basic economics, both policies raise the effective retail price during peak times from $10 to $15. One policy does so overtly, while the other achieves the same result by adding a $5 opportunity cost to the $10 nominal rate.

Because these state initiatives are targeted at the retail electricity market and the prices retail customers pay for electricity, no one doubts—and FERC concedes, U.S.Br.9—the States' authority to adopt them. Just as FERC is regulating the wholesale market when it adopts real-time pricing for wholesale transactions, a State is regulating the retail market when it implements real-time pricing for retail transactions. That is so whether a State does so directly (by allowing the nominal rate to fluctuate) or indirectly (by altering the effective rate

through incentive payments to consume less electricity at peak times). And a State that continues to prefer a more traditional fixed pricing model is just as plainly regulating the retail market.

In short, given the division of authority between the state and federal regulators, there will be a disconnect between retail and wholesale pricing whenever the two regulators pursue different policies. That is an inevitable byproduct of Congress' decision to preserve state authority over the retail market. But the presence of such a disconnect neither expands FERC's authority nor contracts the authority of the States, who enjoy the unquestioned and conceded authority to regulate retail prices and demand through any means, including incentive payments to retail customers to forgo consumption during peak hours.

C. FERC's "Demand Response" Initiative

While nothing requires States to follow FERC's lead and adopt dynamic pricing or comparable initiatives, FERC considers the decisions of most States not to do so a "problem." U.S.Br.43. According to FERC, these permissible state regulatory choices prevent demand at the retail level from being sufficiently "responsive to price increases" at the wholesale level. U.S.Br.43; *see also* U.S.Pet.App.23a-25a, 97a, 215a; JA924; FERC Staff Report, *A National Assessment of Demand Response Potential* 65-66 (June 2009). In other words, state policies favoring rate stability cause retail customers to make consumption decisions based on the retail price, even though that price may not reflect the full cost of supplying electricity from the wholesale

market at a particular time. *See Energy Primer*, at 41-42. In FERC's view, both the retail and wholesale markets would be more efficient if retail prices and retail demand more accurately reflected fluctuations in wholesale prices.

This "problem" posed a regulatory quandary for FERC. The most direct way to solve this "problem" would be to compel States to adopt real-time pricing. But the FPA plainly forbids that type of frontal assault on the States' exclusive power to regulate retail rates and sales. While FERC certainly may encourage States to adopt dynamic pricing models, *see, e.g.*, Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594, it cannot dictate prices in the retail market. Seeking to achieve the same end by alternative means, FERC sanctioned its own scheme for paying retail customers to consume less electricity during peak hours, in an effort to make the effective retail rate more reflective of the real-time wholesale rate. Just like state-level rebate programs, these payments alter the effective retail rate by adding an opportunity cost (in the form of a forgone payment) to the nominal retail rate of electricity at peak times. FERC dubbed its efforts to facilitate and set the amount of these payments to retail customers "wholesale demand response."

In theory, "demand response" could target the level of demand in either the retail or the wholesale markets—*i.e.*, it could be designed to change either (i) the quantity of retail customers' purchases through changes in retail prices, or (ii) the quantity of resellers' wholesale purchases through changes in wholesale prices. FERC's own definition of "demand

response," however, makes clear that FERC's efforts target only the former:

> *Demand response* means 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) (relevant emphases added). Because only retail customers "consume" electricity (wholesale customers purchase it for resale), there is no question that the demand FERC seeks to regulate through its "demand response" initiative is the demand of retail customers. Thus, although FERC confusingly proclaims that "[d]emand-response programs exist in both retail and wholesale markets," U.S.Br.9, it really just means that efforts to alter *retail* demand are being undertaken by both the States and FERC. But to be clear, the target of FERC's "demand response" initiative is retail demand—the amount of electricity consumed by end-users. No payments are being made to wholesale customers to reduce their wholesale purchases, and the effect on wholesale demand is only an indirect result of the change in retail demand. And that focus on retail demand follows directly from the "problem" FERC seeks to address—namely, the failure of States to align retail prices (and thus retail demand) with the real-time pricing in the wholesale markets.

FERC seeks to alter retail demand by incorporating "demand response" into the wholesale markets and the mechanisms that they use to set wholesale prices. Traditionally, the wholesale

markets operated by regional transmission organizations ("RTOs") and independent system operators ("ISOs") were reserved for wholesale sellers—*e.g.*, generators that sell electricity—and wholesale buyers—*e.g.*, load-serving entities that purchase electricity for resale to retail customers. In most of these wholesale markets, generators bid their electricity into an auction at their preferred price, and the wholesale-market operator then accepts those bids priced at or below a single market-clearing price determined by using what is referred to as the "locational marginal price" ("LMP") model. The load-serving entities then purchase the electricity at the same market-clearing price (LMP) and go on to resell it to retail customers. That wholesale rate represents "the least-cost of meeting an incremental megawatt-hour of demand at each location on the grid," *Sacramento Mun. Util. Dist. v. FERC*, 616 F.3d 520, 524 (D.C. Cir. 2010) (per curiam), and thus may vary depending on the time and location of the generator or the load-serving entity.

Because retail customers neither produce electricity nor purchase it for resale, they ordinarily would have no reason to participate in the wholesale markets. Retail customers instead fall within the bailiwick of state regulators. Under FERC's "demand response" program, however, retail customers can bid their commitments not to consume electricity at peak times into the wholesale auctions, either on their own or through a third-party "aggregator" acting as their agent. FERC requires wholesale-market operators to treat that non-consumption of electricity the same as generation, and to pay these retail customers (or their agents) for their commitments to consume less

electricity through the same auction mechanisms that they use to pay the generators who agree to supply it. *See* 18 C.F.R. §35.28(g)(1)(i), (iii); *Wholesale Competition in Regions With Organized Electric Markets*, 73 Fed. Reg. 64,100 (Oct. 17, 2008).

The stated goal of this "demand response" regime is to better align the effective cost of purchasing electricity at retail (the retail price) with the cost of purchasing electricity at wholesale (the wholesale price), thereby incentivizing retail customers to reduce their retail purchases when the cost of supplying electricity is relatively high. With that goal in mind, FERC initially concluded that the payments for these "demand response" commitments (or, more accurately, "reduced-retail-consumption" commitments) should mirror the difference between the prevailing retail and wholesale rates. Specifically, it allowed wholesale-market operators to compensate retail customers who agreed not to consume electricity under a formula known as "LMP-minus-G," where LMP represents the real-time wholesale price of electricity and G represents the generation component of the retail price, which typically accounts for the bulk of the retail price. By setting the reduced consumption, or "demand response," payment at what is essentially the difference between the wholesale and the retail price, FERC initially aligned the effective price faced by retail customers with the real-time wholesale price. *See PJM Indus. Customer Coal. v. PJM Interconnection LLC*, 121 FERC ¶61,315, at P26 (2007).

To take the same state-regulatory example used above, if the nominal retail rate were $10 and the wholesale price were $15, then the "demand response" payment that FERC initially allowed in the wholesale markets would be $5—that is, LMP ($15) minus G ($10). Under that scheme, if a retail customer faces a nominal retail rate of $10, but can earn $5 not to consume at peak times, then the effective retail rate during peak times is $15—the $10 the customer will pay, plus the $5 "demand response" payment the customer must forgo if it consumes electricity during peak hours.

These payments to retail customers are plainly directed at reducing demand in the retail markets and operate no differently in practice from the rebate schemes that some States have adopted. According to FERC itself, the whole point of its "demand response" initiative is to address what it perceives as an anomaly in retail pricing by forcing retail customers to account for the real-time wholesale price when deciding how much electricity to purchase at retail. As FERC explained, the "demand response" payment "provides customers under retail rates with the same economic incentive to curtail load as if they were paying the wholesale rate itself." *Id.*; *see also, e.g.*, *In re PJM Interconnection, LLC*, 99 FERC ¶61,227, 61,941 (2002) ("The purpose of a load response program is to try to duplicate what a customer reducing power would receive in an unregulated market where the customer's price reflects the LMP."). Both by design and in effect, then, FERC's effort to regulate "demand response" is an effort to regulate retail sales, countermand state

decisions concerning retail rates, and manipulate retail demand.

D. FERC's Order No. 745

Before Order No. 745, FERC took the position that "demand response" payments cannot be designed to decrease retail demand as an end in itself, but rather should be designed to decrease retail demand only to the extent that a gap between wholesale and retail prices actually supported such a decrease. As FERC explained, the LMP-minus-G compensation formula offered retail customers "the difference between the LMP and what the customer would save by not using power (the retail price it didn't have to pay)." *PJM Interconnection*, 99 FERC ¶61,227, 61,941. If retail rates already reflected wholesale rates—*i.e.*, if G equaled LMP—then the formula would provide no payment at all (LMP – LMP = 0). Offering a "demand response" payment in that situation would not further FERC's goal of balancing wholesale supply and retail demand, but instead would distort the markets by creating an unwarranted over-payment to retail customers and perverse incentives for them to forgo even economically efficient retail purchases. *PJM Indus. Customer Coal.*, 121 FERC ¶61,315, at P26. Accordingly, FERC rejected proposals to require wholesale-market operators to offer "demand response" payments higher than LMP-minus-G. *See id.* P29.[1]

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[1] FERC did authorize one wholesale-market operator to pay the full LMP under certain limited circumstances, but only on a short-term basis to "jump-start" its "demand response"

Several years after first opening wholesale markets to retail customers and their agents, however, FERC decided that there was not as much "demand response" being bid into these wholesale markets as it wanted. In 2010, FERC issued a notice of proposed rulemaking expressing its dissatisfaction that "demand response providers" were "collectively" playing only "a small role in wholesale markets," and suggesting that "inadequate compensation structures have hindered the development and use of demand response." *Demand Response Compensation in Organized Wholesale Energy Markets*, 75 Fed. Reg. 15,362, 15,365 (Mar. 18, 2010). To remedy this purported problem, FERC proposed to substantially increase the "demand response" payment—to the full LMP rate. In other words, rather than pay retail customers the difference between wholesale and retail prices to reduce their electricity consumption, FERC proposed to pay them the same amount that generators are paid to generate electricity, with no offset at all for the savings retail customers achieve by not purchasing electricity, thereby making the effective retail rate higher than the prevailing wholesale rate. *See id.* at 15,363.

To return to the example, if the retail rate is $10 but the wholesale rate during peak times is $15, then the "demand response" payment under LMP-minus-G would be $5, and a retail customer's effective retail

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program. *See PJM Interconnection*, 99 FERC ¶61,227, 61,941. Once that initial subsidy program expired, FERC expressly rejected efforts to compel the wholesale-market operator to pay the full LMP as not "necessary to produce just and reasonable rates." *PJM Indus. Customer Coal.*, 121 FERC ¶61,315, at P25.

rate (the $10 out of pocket plus the $5 forgone "demand response" payment) would equal the wholesale rate ($15). If the payment is the full $15 LMP, by contrast, the effective retail price becomes $25—the $10 retail price plus the $15 forgone "demand response" payment. Because that effective price is much higher than the cost of supplying electricity (the $15 LMP), it encourages customers to forgo consumption and reduce retail sales even when additional consumption would make sense in light of the prevailing wholesale rate. So instead of furthering FERC's professed objective of incentivizing retail customers to respond efficiently to price signals in the wholesale markets, this new payment scheme would dramatically reduce retail consumption below the levels dictated by the real-time wholesale prices.

Despite the dramatic change in the compensation formula, FERC continued to justify its regulatory scheme as needed to align retail and wholesale prices, without explaining how setting the effective retail rate well above the wholesale rate achieves that goal or why it was now ignoring the same concerns that had earlier persuaded it to reject "demand response" payments higher than LMP-minus-G. Instead, FERC just claimed that the previously rejected compensation scheme was now necessary to achieve its desired level of "demand response."

Thousands of pages of comments were filed by a broad spectrum of interests opposing FERC's attempt to assert jurisdiction over payments to reduce retail consumption and its new inefficient compensation

methodology. Without meaningfully responding to these comments, FERC issued its final rule, Order No. 745, requiring wholesale-market operators to pay retail customers the full LMP rate in return for purchasing less electricity at retail, subject to certain conditions. *See* 18 C.F.R. §35.28(g)(1)(v); U.S.Pet. App.49a-172a. On rehearing, FERC claimed jurisdiction on the theory that paying retail customers to reduce their retail purchases is a "practice ... affecting" wholesale rates within the meaning of sections 205 and 206 of the FPA. U.S.Pet.App.189a-90a. Arguing that "demand response can balance supply and demand as can generation," FERC concluded that reductions in electricity consumption by retail customers are equivalent to the production of electricity by generators. U.S.Pet.App.94a-95a. Commissioner Moeller dissented, concluding that FERC's compensation scheme is unjust and unreasonable. U.S.Pet.App.156a-72a.

E. Proceedings Below

Petitions for review were filed in the D.C. Circuit by a diverse group of wholesale-market participants, including shareholder-owned electric utilities, community-owned electric utilities, competitive power suppliers, and not-for-profit electric cooperatives. Although rarely aligned when it comes to regulation of the nation's energy markets, these parties joined together to oppose FERC on two grounds. First, they argued that FERC's attempt to dictate payments for reductions in retail electricity consumption exceeds its jurisdiction. Second, they argued that FERC's orders are unlawful because they

are unreasonable, failed to respond to serious objections, and set a compensation scheme that is not just and reasonable.

The D.C. Circuit granted the petitions and vacated Order No. 745. U.S.Pet.App.1a-2a. Judge Brown, in an opinion joined by Judge Silberman, held that FERC had "encroach[ed] on the states' exclusive jurisdiction to regulate the retail market" because demand response "involves *retail* customers, their decision whether to purchase *at retail*, and the levels of *retail* electricity consumption." U.S.Pet.App.2a, 11a. The D.C. Circuit went on to hold that, even if FERC had jurisdiction, its rule "would still fail because it was arbitrary and capricious." U.S.Pet. App.15a. As Judge Brown explained, FERC did not adequately respond to the argument, urged by Commissioner Moeller and others, that paying full LMP to retail customers for electricity not consumed has no connection to FERC's professed goal of aligning wholesale and retail rates. U.S.Pet. App.15a-17a.

In dissent, Judge Edwards advocated deference to FERC's interpretation of its jurisdiction under the FPA, and argued that FERC sufficiently explained its new compensation scheme. U.S.Pet.App.17a-48a.

SUMMARY OF ARGUMENT

Order No. 745 is a naked effort by FERC to regulate retail demand and prices that plainly exceeds its jurisdiction under the FPA. FERC concedes (as it must) that States have exclusive jurisdiction over the retail market. It concedes (as it must) that this exclusive jurisdiction includes the authority to regulate retail-level "demand response," either by changing retail prices directly or by paying retail customers to reduce their consumption. And it concedes (as it must) that it lacks the authority to regulate retail-level "demand response" by changing retail prices directly.

The only question is whether FERC may regulate retail-level "demand response" by having wholesale-market operators pay retail customers to reduce their consumption. The answer is plainly no. FERC has no more jurisdiction to regulate retail-level "demand response" through payments to retail customers than it does to raise retail prices directly. The regulation of payments to retail customers to consume less electricity at retail is fundamentally the regulation of retail sales and rates. That is so whether those payments occur in the retail or the wholesale markets, and whether they are made by state regulated utilities or wholesale-market operators. Either way, the demand FERC seeks to regulate is still retail demand, the sales it seeks to affect are still retail sales, and the prices it seeks to change are still retail prices.

FERC insists that it must have jurisdiction to regulate "demand response" payments to retail customers when they are made by wholesale-

operators in wholesale markets. FERC, after all, is the wholesale regulator. But that remarkably circular argument just begs the question what the retail customers are doing in the wholesale markets in the first place. Retail customers do not ordinarily participate in wholesale markets, and they have been lured into these wholesale markets only because FERC is dissatisfied with the States' exercise of their undoubted authority to regulate retail demand by increasing retail prices or by authorizing payments to retail customers. In short, the presence of retail customers in wholesale markets is not an excuse for FERC to regulate retail demand, but a sure sign that FERC has overstepped the FPA's jurisdictional boundaries.

FERC fares no better with its attempt to expand its interstitial jurisdiction over wholesale rates by narrowly confining the States' retail authority to setting the nominal rate of fully consummated sales. Congress enacted the FPA to fill a regulatory gap with regard to wholesale sales, not to reallocate or limit the States' historical police powers over retail markets. And that plenary power necessarily includes the power to regulate retail demand, and to determine the effective—not just the nominal—rate for retail sales.

But even if FERC had jurisdiction to regulate retail-level "demand response," it would at the very least owe the regulated community a rational regulation. Order No. 745 is anything but that. While FERC initially approved "demand response" payments under a formula (LMP-minus-G) that was designed to accomplish FERC's goal of aligning retail

and wholesale rates, Order No. 745 deviates from past practice and adopts a new formula that does not rationally accomplish that goal. Instead, the Order's full LMP formula dramatically overcompensates "demand response" providers and distorts the markets by making the effective cost of consuming electricity at peak times even higher than the cost of supplying it. Those inflated demand response payments cause retail consumers to forgo economically efficient consumption and suppress retail demand *below* the level that wholesale prices would justify. Nonetheless, while FERC's new compensation formula affirmatively misaligns retail and wholesale price signals, FERC still clings to its purported interest of "balancing" retail demand and wholesale supply. FERC has no business regulating "demand response" at all, but it certainly has no business regulating it in such an utterly irrational way.

ARGUMENT

I. The Federal Power Act Forecloses FERC's Attempt To Regulate "Demand Response."

A. FERC's "Demand Response" Rule Is a Transparent Attempt to Regulate Retail Sales.

The FPA draws a "clear and complete" jurisdictional line that cuts "sharply and cleanly between sales for resale" (wholesale sales), which are subject to FERC's jurisdiction, "and direct sales for consumptive uses" (retail sales), which are reserved to the States. *Panhandle*, 332 U.S. at 517; *see also FPC v. S. Cal. Edison Co.*, 376 U.S. 205, 215-16

(1964). Congress passed the Act not to create a comprehensive federal regulatory regime, but to fill a regulatory gap created by the absence of *any* federal regulatory regime that reached the interstate wholesale transactions that this Court held off-limits to the States. FERC thus was given an interstitial authority to address interstate wholesale transactions that the States could not regulate. But Congress could not have been clearer that the Act did not divest States of their traditional and exclusive jurisdiction over retail matters or reallocate that authority to federal regulators. The FPA grants FERC jurisdiction over "the sale of electric energy at wholesale in interstate commerce," but expressly denies FERC jurisdiction over "any other sale of electric energy," or any other "matters … subject to regulation by the States." 16 U.S.C. §824(a), (b)(1); *see also Panhandle*, 332 U.S. at 516 (noting that this "explicit prohibition" was "deliberate").

In short, although Congress tasked FERC with regulating wholesale sales and ensuring that the rates for those sales—as well as public utility "practices" affecting those rates—are just and reasonable, 16 U.S.C. §§824d, 824e(a), FERC has no plenary power to regulate all electricity, and no power at all to regulate retail sales or other transactions "subject to regulation by the States." *Id.* §824(a). FERC thus concedes, as it must, that it "lacks jurisdiction to regulate retail sales (*i.e.*, sales to users of electricity)." U.S.Br.4.

That concession should be the end of this case, as FERC's "demand response" rule is a transparent attempt to dictate the effective rate for retail sales

and reduce the level of demand by retail customers. That much is clear from FERC's definition of "demand response," which FERC omits from its brief:

> *Demand response* means 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) (relevant emphases added). These references to "consumption" necessarily refer to retail purchases of electricity by retail customers. Only retail customers "consume" electricity. Wholesale customers buy electricity for resale, not consumption. *See* 16 U.S.C. §824(d) (defining "sale of electric energy at wholesale" as "a sale of electric energy to any person for resale").

FERC's concept of "demand response" is thus exclusively focused on reducing *retail* electricity consumption by *retail* customers below an otherwise expected benchmark level of *retail* electricity consumption by *retail* customers. As noted earlier, when FERC misleadingly suggests that "[d]emand-response programs exist in both retail and wholesale markets," U.S.Br.9, it can only mean that it is possible for regulators at both the retail level (*i.e.*, States) and the wholesale level (*i.e.*, FERC) to attempt to impact retail consumption levels. While FERC certainly could implement initiatives designed to impact demand at the wholesale level—*i.e.*, reduce the level of purchases for *resale* below some pre-existing benchmark level of purchases for *resale*—that is manifestly not what this case is about. This

case is about an unabashed effort by the federal wholesale regulator to impact demand levels in retail markets by making the effective price for retail electricity sales different from the price set by state regulators.

FERC concedes that it cannot lawfully induce retail customers to reduce their consumption through the first means that its definition of "demand response" contemplates—that is, by directly imposing "an increase in the price of electricity" at retail. That plainly would intrude on the States' exclusive authority over retail sales. Nonetheless, FERC contends that it has jurisdiction to accomplish the same end by requiring "incentive payments" to retail customers that are "designed to induce lower consumption of energy"—even though it concedes that this, too, is something that States may do as part of their exclusive authority over retail sales. But there is no material difference between reducing demand by increasing retail rates and reducing demand by providing retail customers with incentive payments not to consume electricity. FERC's own definition of "demand response" acknowledges the functional equivalence of the two. And whether demand is reduced by the traditional route of increasing retail prices or via the alternative of offering incentive payments not to consume, there is no mistaking the fact that the "demand" FERC wants to "respond" to its price signals is retail demand. Either way, FERC is still dictating the effective cost to a retail customer of purchasing electricity in a retail sale.

The only difference between FERC's rule and a plainly verboten federal regulation openly setting retail prices is FERC's creative nomenclature. If the FERC-authorized and FERC-set "demand response" payments were more accurately labeled "reduced-retail-consumption" payments, their focus on the retail market and their functional equivalence to retail rate increases would be unmistakable. But the FPA turns on substance, not labels, *see S. Cal. Edison Co. v. FERC*, 603 F.3d 996, 1001 (D.C. Cir. 2010), and the substance of this scheme is plain: FERC is regulating retail demand, retail prices, and retail sales.

That is no accident. The whole point of FERC's "demand response" initiative is to address perceived deficiencies in the States' retail regulation. FERC was frustrated by many States' continued preference for providing stable retail rates regardless of changes in the wholesale cost of supply. Having encouraged real-time pricing in the wholesale markets, FERC wanted to ensure that, no matter what policy choices a State might make, its retail customers would consider the prevailing wholesale rate rather than the retail rate in deciding whether to consume electricity.[2]

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[2] FERC's LMP-minus-G compensation scheme made that intent crystal clear, by pegging the amount of "demand response" payments to the difference between wholesale rates (set at LMP) and retail rates (G in the LMP-minus-G formula). In States that had not adopted FERC's favored retail policies, retail consumers would receive bounties equal to the difference between the retail and wholesale rates, while the formula would have no effect on States that already set retail prices at LMP or above. FERC's new compensation formula still has FERC

FERC has not been bashful about its intent to supplant state-level decisions about retail rates and force retail customers to respond to wholesale price signals. FERC openly acknowledged that this payment scheme was designed to "provide[] customers under retail rates with the same economic incentive to curtail load as if they were paying the wholesale rate itself." *PJM Indus. Customer Coal.*, 121 FERC ¶61,315, at P26. That continues to be FERC's stated goal, even though its new compensation formula now provides retail customers with economically inefficient incentives to curtail load as if they were paying more than the wholesale rate. *See* Part II, *infra.* In both purpose and effect, FERC's "demand response" payments are thus an avowed effort to override state electricity policy choices, reset the effective price for retail electricity sales, and reduce the level of retail electricity consumption. FERC's scheme transgresses the boundaries established by the FPA because that was its intended purpose. *Cf. ONEOK*, 135 S. Ct. at 1599 (emphasizing "the importance of considering the *target* at which [a] state law *aims* in determining whether that law is pre-empted"); *Schneidewind v. ANR Pipeline Co.*, 485 U.S. 293, 308-09 (1988).

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setting effective retail rates, but FERC now does it in all States at a level that guarantees overcompensation and economically inefficient decisions to forgo consumption. *See* Part II, *infra.*

B. FERC Cannot Justify Its Jurisdictional Grab Through the Circular Argument that It May Regulate Anything that It Invites Into the Wholesale Markets.

FERC's efforts to justify its avowed effort to reduce retail demand by changing the effective retail rate are unavailing. FERC's principal justification is that because the "demand response" payments it has authorized are being paid by participants in the wholesale markets, then of course the wholesale regulator must have jurisdiction to regulate those "demand response" payments. But that is question-begging in the extreme. The only reason those payments are being set and made via wholesale markets is because retail customers were invited to participate in those markets. And the retail customers participate in those markets solely in their capacity as consumers of electricity. Because FERC wanted to reduce retail demand during peak hours but plainly lacks the authority to fix retail rates, it authorized retail customers to bid into a scheme administered by a wholesale-market operator.

The very fact that retail electricity customers—who clearly fall within the bailiwick of state and local regulators—are participating in federally regulated wholesale markets is a sure sign that FERC has overstepped its regulatory bounds. Retail customers (or their agents) bidding in "demand response" are neither selling nor buying electricity for resale.[3]

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[3] Because retail customers are neither wholesale purchasers nor wholesale sellers, the fact that they nonetheless receive payments from wholesale-market operators creates imbalances that FERC's new compensation formula tries to

They are participating in wholesale markets nonetheless because they were lured into the markets as part of a conscious effort to regulate retail demand. FERC cannot point to those retail customers' presence in the wholesale markets as a justification for regulating them. Like the proverbial economist who assumes the can opener, FERC cannot destroy the FPA's basic division of labor by luring retail customers into a wholesale market for the express purpose of affecting retail demand and prices, and then asserting jurisdiction over the payments to those retail customers on the assumption that those retail customers are properly present in what is otherwise a wholesale market. FERC's jurisdiction over wholesale rates does not include the power to create the circumstances that justify FERC's incursion on matters concededly "subject to regulation by the States," 16 U.S.C. §824(a). *Cf. Nat'l Fed'n of Indep. Bus. v. Sebelius*, 132 S. Ct. 2566, 2586 (2012) ("the power to 'regulate' something" does not include "the power to create it").

FERC's contrary argument confuses the mechanism for effectuating "demand response" payments (an otherwise-wholesale market) and the target of the payments (demand in the retail market). This confusion permeates FERC's unsuccessful effort to draw a distinction between "wholesale demand-response" programs and "retail

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address. *See* pp. 58-59, *infra* (discussing "net benefits" test). Even putting aside whether FERC has rationally counteracted that distortion, the very existence of those imbalances underscores the artificiality of inviting retail customers into the wholesale markets.

demand-response" programs. U.S.Br.9, 28, 41-42. As already explained, FERC is not regulating "wholesale demand-response" in a sense that would be jurisdictionally meaningful—*i.e.*, paying wholesale customers to purchase less electricity for resale. It is regulating "retail demand-response"—*i.e.*, paying retail customers to purchase less electricity at retail—and attempting to do so through the only mechanisms it has at its disposal, namely, the wholesale markets. But the fact that the tools FERC is using to regulate retail demand are generally associated with wholesale markets does not immunize FERC's avowed effort to use those tools to regulate retail demand.

That the "demand response" payment is being made by a wholesale-market operator is therefore beside the point.[4] FERC is still using those payments to regulate retail customers' decisions about how much electricity to consume, and those decisions are simply not the kind of practices that FERC's jurisdiction allows it to reach.

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[4] So, too, is the fact that some—but no means all—of those bidding "demand response" into the wholesale markets are third-party "demand response" "aggregators." First of all, it is undisputed that under FERC's orders large retail customers can (and do) bid directly into the wholesale markets. U.S.Br.10. Aggregators can provide the same service for multiple retail customers, but that does not convert the aggregators into wholesalers in any jurisdictionally relevant sense because they are not buying or selling electricity "for resale." 18 U.S.C. §824(d). Indeed, FERC itself has concluded that aggregators are not "public utilities" subject to FERC's jurisdiction. *See EnergyConnect, Inc.*, 130 FERC ¶61,031, at P30 (2010).

FERC cannot justify its avowed effort to regulate retail demand by pointing to its authority to regulate "practices affecting" wholesale rates. U.S.Br.24. FERC's "practices affecting" jurisdiction implements, rather than obliterates, the FPA's basic division of authority, which left retail regulation with the States and gave federal regulators only interstitial authority over wholesale rates. Because Congress was creating new federal authority over wholesale rates, it had to specify the metes and bounds of the new federal authority. It had no comparable need to specify the reserved police power of the States to regulate the retail market, beyond making clear that it left those reserved powers intact. *Cf.* U.S. Const. amend. X. But given the inherent relationship between the retail and wholesale markets, FERC cannot lay claim to retail regulation on the ground that excessive retail demand is affecting wholesale rates. Of course a retail customer's decision to refrain from purchasing electricity has an effect on the wholesale markets. But that effect is just a product of the basic interrelationship between retail and wholesale sales, and is no more (or less) "direct" than the effect that any retail transaction has on the wholesale markets. And yet Congress intentionally left retail regulation to the States, and did not countermand that fundamental decision by granting FERC authority over practices affecting wholesale rates. *See Whitman v. Am. Trucking Ass'ns*, 531 U.S. 457, 468 (2001) ("Congress … does not alter the fundamental details of a regulatory scheme in vague terms of ancillary provisions—it does not, one might say, hide elephants in mouseholes.").

The fact that the "demand response" payments are made by wholesale operators and incorporated into wholesale prices does not save FERC's "affecting" argument. FERC's effort to suggest that the effect of "demand response" payments on wholesale prices is especially direct suffers the same basic flaw as its effort to use the counterintuitive presence of retail customers on the wholesale markets as an excuse to regulate them. To the extent the effect is especially direct, that is only because FERC has made it so.

FERC's argument thus has no limiting principle. FERC attempts to distract from that problem by conceding that it could not regulate the price of coal or steel, even if they were offered in an auction conducted by a wholesale-market operator, and the payments for that coal were recouped from wholesale electricity purchasers. *See* U.S.Br.28. But under those circumstances the effect of coal and steel sales on wholesale electricity prices would be just as direct as the effect of "demand response" payments. FERC is correct that it cannot regulate coal and steel prices in the name of regulating wholesale electricity rates (or practices affecting those rates). But it has no more business regulating retail transactions by luring retail customers into the wholesale markets, paying them to reduce retail sales, and characterizing the reduction in retail sales as a service to the wholesale markets. Indeed, the problem with FERC reaching retail transactions is even more acute than with FERC reaching coal or steel sales because Congress deliberately reserved retail electricity sales to the States.

FERC and its supporters protest that FERC-mandated "demand response" payments "*very directly* affect" wholesale prices, PJM.Br.40, on account of the complex nature of the wholesale auctions and the "sophisticated computerized systems" they employ to set wholesale prices. U.S.Br.6-7, 24, 44; PJM.Br.1. FERC's methods for setting effective retail prices and tweaking retail demand may be the height of sophistication and elegance, *but see* Part II, *infra*, but they remain retail sales regulation. A sophisticated power grab is no more permissible than a clumsy one. *Cf. U.S. Term Limits, Inc. v. Thorton*, 514 U.S. 779, 830 (1995) ("The Constitution nullifies sophisticated as well as simple-minded modes of infringing on constitutional protections.").

C. FERC's Effort to Broaden Its Wholesale Jurisdiction at the Expense of the States' Retail Jurisdiction is Unavailing.

FERC alternatively insists that it is not intruding on the States' exclusive power over retail sales because "[a] commitment to refrain from taking electricity from the system 'does not involve a sale' at all—it is a promise *not* to make a retail purchase." U.S.Br.39. That characterization of FERC's "demand response" initiative as reaching only non-sales is both misleading and legally irrelevant. It is misleading because, as demonstrated above, the whole point of that initiative is to affect the quantity, timing, and pricing of retail sales. That FERC does so by providing compensation for retail purchases forgone or deferred does not alter that basic fact. Indeed, FERC's own definition of "demand response"

underscores the functional equivalence of raising rates directly and increasing the effective price by offering incentives not to purchase. 18 C.F.R. §35.28(b)(4). Both have the exact same effect on retail sales. Moreover, FERC and the private petitioners both recognize that the effect of at least some "demand response" payments is not to convert a sale into a non-sale, but simply to defer a sale to a non-peak time. U.S.Br.54; EnerNOC.Br.54. And that deferral is part and parcel of what FERC wants to accomplish. Such a purposeful effort to change the timing and terms of a retail sale of electricity plainly "involve[s] a sale."

But FERC's non-sale argument is in all events legally irrelevant. This Court has been rightly skeptical in other contexts of government efforts to confine the meaning of "sale" to the narrow conception of a fully consummated sale. *See, e.g.*, *Christopher v. Smithkline Beecham Corp.*, 132 S. Ct. 2156, 2171 (2012). And there are particularly good reasons to reject FERC's cramped conception here. The States' authority over retail sales has always been plenary. The FPA did not disturb that broad authority over all aspects of the retail market or somehow limit the States' pre-existing exclusive authority to the artificially narrow subject of fully consummated sales. Indeed, FERC concedes that States may regulate "demand response" at the retail level either by directly setting the prices of consummated sales or by providing payments to retail customers who reduce their consumption. U.S.Br.8. Either is an unobjectionable exercise of the States' plenary authority over the retail market. But if States' have clear authority to do both, it makes no

sense that FERC is free to regulate retail demand as long as it does not regulate a fully consummated sale. The States' authority over the retail market—and FERC's potential intrusion on that authority—is simply not limited to fully consummated sales.[5]

Indeed, not even FERC's interstitial authority over wholesale rates is artificially limited to fully consummated sales. Instead, Congress gave federal regulators authority over "[a]ll rates and charges made, demanded, or received … for or in connection with the … sale of [electric energy]" at wholesale. 16 U.S.C. §824d(a). Congress had no comparable need to specify the metes and bounds of the States' authority because it was preserving the States' pre-existing authority, not displacing it. But the States' reserved plenary authority over the retail market of course cannot be narrower than the limited and newly created federal authority over wholesale rates.

The States' jurisdiction over retail sales thus necessarily encompasses jurisdiction over, *inter alia*, "[a]ll rates and charges made, demanded, or received … for or in connection with the … sale of electric energy" at retail. *Id.* And there can be no serious dispute that FERC's "demand response" rule involves a rate or charge received in connection with a retail

[5] The utter artificiality of FERC's sale/non-sale argument is well-illustrated by the fact that if FERC's concern were that retail prices were too high and retail demand too low, wholesale operators could not offer retail customers incentive payments to make additional purchases without inducing a sale. There is no logical reason why FERC's jurisdiction to authorize incentive payments would turn on whether retail prices were too low rather than too high, but that is what FERC's sale/non-sale distinction necessarily implies.

sale. The "demand response" payment directly alters the effective price for a retail sale by permitting a retail customer to receive a bounty in connection with that sale. The amount of that payment will be determined, in part, based on a benchmark level of previously consummated retail sales and is contingent on reducing the amount of retail sales. Contending that this is not a payment received at least in connection with a retail sale blinks reality.

Indeed, FERC itself concedes that it could not order wholesale-market operators "to give a credit to any consumer who reduced its expected use of retail electricity." U.S.Pet.App.11a. If the States' authority were really limited to fully consummated sales, that concession would be unnecessary. FERC not only could directly order credits and rebates for non-sales; it could forbid sales from occurring at certain times or prices. In reality, FERC's concession is necessary because it has been clear for at least a century that the power to regulate transactions includes the power to forbid them from taking place. *See, e.g.*, *Champion v. Ames*, 188 U.S. 321 (1903). It is equally clear—and FERC concedes, U.S.Br.8—that the States' exclusive authority over retail sales extends to payments made to retail customers to forgo or defer a sale.

Both this Court and FERC have recognized as much when the shoe is on the other foot. In *Northern Natural Gas Co. v. State Corporation Commission of Kansas*, for instance, this Court concluded that state regulators would exceed their jurisdiction and "invade the federal agency's exclusive domain" if they tried to regulate the "prices or volumes of purchases"

of natural gas at wholesale by issuing orders "unmistakably and unambiguously directed at [wholesale] purchasers." 372 U.S. 84, 90-92 (1963). More recently, FERC has objected to what it viewed as state efforts to alter the effective rate of wholesale transactions even though they did not "formally upset the terms of a federal transaction," *PPL EnergyPlus, LLC v. Nazarian*, 753 F.3d 467, 477 (4th Cir. 2014) (holding preempted a state order that supplemented what generators receive in connection with federally regulated sales), *petitions for cert. filed*, Nos. 14-614, 14-623 (Nov. 25 & 26, 2014); *see also* Br. for the United States and FERC as *Amici Curiae* at 13, 17, *PPL EnergyPlus, LLC v. Solomon*, 766 F.3d 241 (3d Cir. 2014), *petitions for cert. filed*, Nos. 14-634, 14-694 (Nov. 26, Dec. 10, 2014) (arguing that a state statute is preempted where "the state-offered subsidy … is contingent on the selected generators clearing in [a wholesale] auction[s]" and therefore "directly affects (suppresses) the auction's resulting wholesale capacity rate").

Here, FERC has done the same thing in reverse. While FERC claims that it is not "literally ... changing the retail rate set by state utility commissions," U.S.Br.41, it is plainly regulating retail sales and rates by dictating what a customer will receive if it undertakes a retail transaction. FERC was not indifferent to what it viewed as state efforts to dictate the effective rate for wholesale transactions, and it has no license to dictate the effective rate of retail transactions just because it leaves the nominal terms of the retail transaction undisturbed.

FERC attempts to downplay its interference with the States' retail regulation authority by emphasizing that its rule does not "require[] wholesale-market operators to allow participation in demand-response programs … where state law prohibits that practice by retail customers." U.S.Br.43; *see* 18 C.F.R. §35.28(g)(1)(i), (iii). But this provision for explicit state override is tantamount to a concession that FERC has overstepped its regulatory boundaries. The FPA is supposed to preserve exclusive spheres of regulation. When FERC is properly exercising its exclusive jurisdiction, it does not (and could not) authorize States to opt out and thereby override its deliberate policy choices. Indeed, if FERC were right that it has jurisdiction to control "demand response" participating in the wholesale markets, it is hard to see how state action seeking to block that participation would be constitutional. *See, e.g.*, *New England Power Co. v. New Hampshire*, 455 U.S. 331, 339 (1982). FERC's authority derives from a statute designed to fill a regulatory gap caused by the States' inability to regulate interstate wholesale transactions.

The mechanism by which States would exercise this veto—a "state law [that] prohibits the practice by retail customers"—also is telling. That underscores that States' authority over the retail market is plenary and that FERC's "demand response" initiative is focused on the purchasing decisions of "retail customers" and creates an anomalous direct relationship between the wholesale markets and retail customers. FERC could hardly not recognize that States have the primary regulatory relationship with retail customers, and

thus the power to bar their participation in wholesale markets. But FERC's recognition that States have the ultimate trump card over the federal "demand response" initiative is just an implicit concession that FERC has delved deeply into the regulation of retail customers.

Finally, FERC's concession that States have the ultimate trump card hardly eliminates the intrusion into the States' exclusive regulatory authority over retail sales. In the system Congress designed, States can provide for stable rates for all customers simply by specifying retail rates. The ability of a State to recapture that policy preference by enacting an additional affirmative law precluding its customers from participating in a federal initiative designed to circumvent the State's policy preference for stable pricing (and substitute the federal preference for real-time pricing) is hardly a close substitute. While the former involves only an exercise of well-established regulatory authority, the latter requires a new affirmative act that pointedly restrains the autonomy of retail customers. FERC's opt-out thus forces state regulators into a hostile relationship with their retail customers—depriving them of an opportunity that at least some will find attractive—just to preserve their initial policy decisions.

Any student of the current political situation in Washington also can appreciate the importance of inertia. The absence of state laws affirmatively banning retail customers from bidding into federal wholesale markets reflects no overwhelming state enthusiasm for the federal interference with retail demand levels, but rather the difficulty of passing

any legislation, let alone legislation designed to reclaim authority that the FPA already reserves to the States.[6]

D. None of FERC's Remaining Arguments Can Salvage Its Ultra Vires Rule.

FERC's appeals to *Chevron* deference cannot cure the defects in its jurisdictional argument, as this case does not have any ambiguity as to which *Chevron* is relevant. There is no ambiguity about the nature of the problem or the customers to which FERC's "demand response" initiative is addressed; FERC is concerned with retail demand and hopes to regulate retail demand through payments provided to retail customers. There is likewise no ambiguity that those payments come from wholesale-market operators that FERC can regulate when wholesale transactions are involved. The only question is whether FERC can achieve its avowed effort to regulate retail demand because the payments come

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[6] It is not surprising that a handful of States that favor real-time pricing would file in support of FERC. Any State can adopt real-time retail pricing, but if it does so, it may face complaints from customers who prefer stable rates. FERC has adopted these States' favored policy choices but has obscured responsibility and accountability for that choice. And good luck to a retail customer—especially one that has no interest in bidding in a federal market—who tries to lodge a complaint with FERC. This accountability confusion underscores the problem with FERC's intrusion into the retail market. The FPA leaves retail regulation in the hands of state and local regulators precisely because they are more responsive to the people than a federal regulator. In all events, States cannot give FERC permission to exercise jurisdiction that Congress withheld. *See La. Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 374 (1986).

from wholesale-market operators. As already demonstrated, the FPA speaks directly to that question by reserving retail regulation exclusively to the States. FERC is certainly not entitled to *Chevron* deference in interpreting the scope of that reservation. Nor is it entitled to deference when it embarks on an avowed effort to render "Congress's specific grant of power to the States … virtually meaningless." *Nw. Cent. Pipeline Corp. v. State Corp. Comm'n of Kan.*, 489 U.S. 493, 515 (1989); *cf. FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 159 (2000). There is simply no rule that the tie goes to the usurper when FERC crosses the boundaries erected in the FPA.[7]

Moreover, the FPA expressly confines *all* FERC's jurisdiction—including its "affecting" jurisdiction—"to those matters which are not subject to regulation by the States," 16 U.S.C. §824(a), and FERC concedes that retail demand is a matter subject to regulation by the States. U.S.Br.9. FERC's attempt to usurp jurisdiction over that matter is therefore at war with Congress' decision to preserve spheres for exclusive jurisdiction by the States over retail and by FERC

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[7] Unlike the statute in *City of Arlington, Texas v. FCC*, 133 S. Ct. 1863 (2013), a case on which FERC relies, the FPA does not "explicitly supplan[t] state authority" over the retail market, *id.* at 1873, but rather expressly preserves it. Thus, the choice here is not between regulation "by unelected federal bureaucrats, or by unelected (and even less politically accountable) federal judges." *Id.* Instead, the choice here is whether retail regulation will remain with state and local regulators politically accountable to retail customers, or will it belong to wholesale regulators in Washington. That is a difference worthy of "a passionate States' rights debate." *Id.*

over wholesale, as opposed to concurrent jurisdiction. That radical reinterpretation of the FPA is "inconsistent with the administrative structure that Congress enacted into law." *Brown & Williamson*, 529 U.S. at 125; *cf. Michigan v. EPA*, 135 S. Ct. 2699, 2708 (2015).

Nor can FERC justify its jurisdictional incursion by adverting to the Energy Policy Act of 2005. That Act neither grants FERC jurisdiction to regulate "demand response" nor even hints that FERC already had the power to do so. The Act instead takes as its premise that "demand response" is regulated by the States, "encourag[ing] *States* to coordinate … *State* energy policies to provide reliable and affordable demand response services," and directing federal regulators to provide "technical assistance to *States* ... to assist them" with these efforts. 119 Stat. at 965-66 (emphasis added); *see also id.* at 963-67. The Act assigns FERC only an advisory role of "educating consumers on the ... benefits of advanced metering"; "working with States, utilities, other energy providers and [various] experts to identify and address barriers to the adoption of demand response programs"; and preparing a report "that assesses demand response resources, including those available from all consumer classes." *Id.*

Latching onto the language in a statement of "the policy of the United States" that "unnecessary barriers to demand response participation in energy, capacity and ancillary service markets shall be eliminated," FERC contends that Congress meant to empower FERC to use the wholesale markets to regulate retail demand. *See* U.S.Br.35. But in

context, the "barriers" to which Congress was alluding are barriers in the wholesale markets to *retail-level* demand response, which FERC and the wholesale-market operators have taken steps to eliminate. *See, e.g.*, *PJM Interconnection, LLC*, 137 FERC ¶61,204, at P2 (2011). If Congress really had envisioned FERC regulating retail-level demand response directly, section 1252's pervasive focus on encouraging States to adopt their own demand response initiatives would be inexplicable. So, too, would FERC's decision to permit the most obvious "barrier" to its efforts to regulate retail demand via the wholesale markets—the ability of States to bar their retail customers from participating in those wholesale initiatives. In short, if Congress really had intended to take the extraordinary steps of deviating from the FPA's basic division of labor and granting FERC authority to regulate payments to retail customers not to consume electricity, it presumably would have said so expressly in an operative provision, rather than ambiguously and elliptically in a statement of federal policy.

Ultimately lacking a statutory leg to stand on, FERC resorts to a parade of horribles that it claims would result were this Court to confirm that it lacks jurisdiction to regulate "demand response." These arguments are both legally misplaced and factually flawed, as leaving the regulation of retail demand in the hands of state regulators hardly creates a regulatory gap, and even a professed "need for federal regulation does not establish ... jurisdiction that Congress has not granted." *FPC v. La. Power & Light Co.*, 406 U.S. 621, 635-36 (1972).

FERC contends, for instance, that affirming the D.C. Circuit's jurisdictional holding would require the Court to "read into the [Act] an implicit prohibition on FERC regulation—or perhaps any FERC-regulated wholesale-market activity at all—that significantly affects the 'retail market.'" U.S.Br.20-21. Not so. Given the relationship between the retail and wholesale markets, there is plenty FERC can do when regulating wholesale transactions that can affect retail sales, whether "significantly" or otherwise. *See, e.g.*, *Miss. Power & Light Co. v. Miss. ex rel. Moore*, 487 U.S. 354, 371 (1988); *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953, 970 (1986); *FPC v. Conway Corp.*, 426 U.S. 271, 276 (1976). What FERC cannot do is set out to regulate retail demand and to determine the effective price of retail sales, and justify its efforts by pointing to the truism that retail consumption affects wholesale rates. Nor can it assert jurisdiction over retail demand just by offering retail customers payments in wholesale markets. Recognizing those limits on what FERC can do to affect retail demand will in no way disturb the FPA's carefully crafted federal-state balance.

FERC protests that if it cannot regulate the price of "demand response" payments in the wholesale markets, then no one can. U.S.Br.29-35. That may well be true, but that just underscores that payments to retail customers for reducing consumption are misplaced in the wholesale markets. It certainly does not mean that there will be a regulatory gap in which no regulator can regulate payments directed at reducing retail demand. It just means that state and local retail regulators will be regulating retail

demand. Many States and localities have already implemented their own demand response schemes. And because state regulators have plenary authority to regulate the retail market, they can choose from the whole array of tools to regulate retail demand, and are not artificially limited to the convoluted device of offering retail customers payments via a wholesale auction. Indeed, the private petitioners have recognized that state regulators "have traditionally been significant supporters" of demand response and that, under their authority, "demand response solutions will continue to deliver major economic benefits to consumers of electricity" even without FERC's rule. EnerNoc, Inc., Press Release (May 27, 2014), *available at* http://investor.enernoc.com/releasedetail.cfm?releaseid=850532. Of course, some States may maintain rate stability in response to consumer preferences. That is a permissible policy option, and one the FPA deliberately leaves in the hands of regulators closer to the people.

That does not mean, as FERC suggests, that the wholesale markets are precluded from utilizing any of the tools that fall under the umbrella of demand response, broadly defined. There is no jurisdictional problem, for instance, with FERC paying *wholesale* purchasers who reduce their wholesale purchases, or using other tools to incentivize them to do so. *See, e.g.*, *Town of Norwood, Mass. v. FERC*, 962 F.2d 20 (D.C. Cir. 1992). Indeed, FERC utilized that kind of true wholesale-level demand response for decades before it began asserting the additional authority to regulate payments to retail customers to reduce retail demand. *See, e.g.*, *Kentucky Utils. Co.*, 15 FERC ¶61,002, 61,003-05 (1981). FERC cannot

expand its jurisdiction by eliding the difference between retail and wholesale demand.

Nor can FERC justify its jurisdictional grab through a "curious appeal to entrenched executive error," *Rapanos v. United States*, 547 U.S. 715, 752 (2006). *See* U.S.Br.32. To be sure, Order No. 745 was not the first time FERC claimed jurisdiction to regulate retail-level "demand response" via the wholesale markets. But the full ramifications of that assertion were not apparent until FERC exercised that authority to radically overcompensate reductions in retail demand in ways that destabilize the very markets that FERC purports to be trying to balance. *See* Part II, *infra*. Respondents certainly did not waive their right to object to FERC's exercise of jurisdiction it does not have by staying their hand until the injurious effect of FERC's actions became more acute. *See, e.g.*, *Niagara Mohawk Power Corp. v. FERC*, 452 F.3d 822, 827 (D.C. Cir. 2006).

At bottom, FERC's insistence that allowing it to regulate retail sales is necessary to make wholesale markets more efficient is nothing more than a disagreement with Congress' decision to bifurcate jurisdiction over wholesale and retail electricity sales. In dividing that jurisdiction between FERC and the States, Congress surely had its reasons for structuring a regulatory regime that might, at times, sacrifice "some degree of efficiency." *Conn. Light & Power Co. v. FERC*, 324 U.S. 515, 530 (1946). But Congress' "unequivocal recognition of the vital interests of the states and their people, consumers and industry alike, in the regulation of rates and service," *Panhandle*, 332 U.S. at 521, means that

FERC may not regulate retail sales even if doing so would make its own wholesale regulations more efficient. That is the inevitable consequence of Congress' "meticulous regard for the continued exercise of state power" over retail sales. *Id.* at 517-18. It is hardly a justification for FERC to ignore the limits of its role under the FPA.

II. FERC's Rate For Compensating "Demand Response" Is Arbitrary And Capricious.

Even if FERC had jurisdiction to regulate retail demand, and even if it could exercise that jurisdiction for the express purpose of overriding state decisions to keep retail rates stable, FERC's compensation scheme would remain arbitrary and capricious. *See* U.S.Pet.App.15a-16a; 5 U.S.C. §706(2)(A). FERC has not begun to articulate a satisfactory explanation for making the effective cost of consuming electricity at peak times not just reflective of, but substantially more expensive than, the cost of wholesale supply. Nor could it, as that dramatic and unacknowledged departure from its earlier approach to compensating "demand response" is inexplicable in light of FERC's unchanged justification for regulating retail demand.

A. FERC's New Compensation Scheme Is Divorced from Its Professed Policy Goal.

FERC's stated and unchanged purpose for regulating retail demand through "demand response" payments is to balance supply and demand for electricity by effectively aligning wholesale and retail prices, such that the latter reflect the real-time pricing that governs the former. As FERC explained,

"demand response ... mov[es] [retail] prices closer to the levels that would result if all demand could respond to the marginal cost of energy" reflected in the wholesale price, thereby incentivizing retail customers to treat the wholesale rate as the retail rate when deciding whether to purchase electricity at peak times. U.S.Pet.App.99a. In short, FERC has justified—and continues to justify—its regulation of retail demand as an effort not to reduce demand in the abstract, but to "balance supply and demand" by making the cost of purchasing electricity at retail reflective of the real-time pricing in the wholesale markets. U.S.Br.9; *see also* U.S.Pet.App.216a.

Even assuming FERC has jurisdiction to regulate retail demand in the first place, and even assuming it can do so for the avowed purpose of overriding state resistance to real-time retail pricing, it still must compensate "demand response" in a manner that rationally achieves its stated policy goals. And whatever else can be said about FERC's pre-Order No. 745 efforts to regulate "demand response," the compensation formula FERC approved (LMP-minus-G) was designed to make the effective retail rate better reflect the real-time wholesale rate. By subtracting the generation component of the retail price (G) from the wholesale price (LMP) and offering retail customers the difference, FERC provided "customers … the incentive to reduce load based on the wholesale rates they confront." *PJM Indus. Customer Coal.*, 121 FERC ¶61,315, at P26. But as FERC itself initially recognized, *id.*, it would make no sense to pay consumers *more* than LMP-minus-G to forgo consumption, as the goal of "demand response" is to incentivize consumers to

reduce their consumption when the cost of supplying electricity is high relative to the retail rate, not to reduce consumption even when the effective retail rate is equal to or higher than the wholesale price. Payments greater than LMP-minus-G, FERC thus explained, would inappropriately incentivize retail customers to forgo consumption when doing so is not economically efficient. *See id.*

Yet that is precisely what Order No. 745 does. In an abrupt and unexplained reversal of course, FERC directed wholesale-market operators to pay retail customers the full LMP rate for their reductions in consumption, even though FERC previously acknowledged that doing so would raise the effective cost of retail consumption well above the wholesale rate and create overpayments that would deter economically efficient consumption. To take the earlier example, if the wholesale rate is $15 and the retail rate is $10, then FERC's new compensation formula makes the effective cost of consumption at peak times not the wholesale rate of $15, but $25. A retail customer deciding to purchase electricity at peak times must not only pay $10 out of pocket to consume the electricity, but also forgo a $15 "demand response" payment. By ignoring the reality (central to the LMP-minus-G formula) that a retail customer's effective cost of consumption includes both the actual cost of consumption ($10) and the forgone payment for non-consumption ($15), FERC's new formula systematically overcompensates non-consumption. And the distortion is particularly pronounced in a jurisdiction where the retail rate already reflects the wholesale rate, *i.e.*, where G already equals or exceeds LMP. FERC's initial

formula rationally provided no payment in such circumstances (if LMP = G, then LMP – G = 0). But FERC's new formula provides the same $15 presumptive subsidy as in other jurisdictions, causing the effective cost to double the wholesale rate.

FERC's approach thus results in what one expert called "double payment" for the forgone consumption, "encourag[ing] inefficiently large amounts of imputed demand response." JA193, 217; *see also PJM Indus. Customer Coal.*, 121 FERC ¶61,315, at P26 n.20 ("customers paying LMP-based rates would receive a financial benefit" equal to "twice the LMP," which "could lead them to curtail cost-effective production" of other products). As Commissioner Moeller explained in his dissent, rather than eliminating the disconnect between the cost of consuming electricity and the cost of producing it, FERC's final rule substitutes an inefficiently high price signal for an inefficiently low price signal. Instead of "moving prices closer to the levels that would result if all demand could respond to the marginal cost of energy," U.S.Pet.App.99a, the "rule leads to an inefficiently high amount of imputed demand response, because it dissuades consumers from consuming electricity even in cases where the cost of producing that electricity is less than the value of that electricity to consumers." JA194. The rule thus distorts both retail and wholesale markets by artificially dampening retail demand and discouraging productive economic activity.

FERC's own factory example illustrates the point. *See* U.S.Br.55-56. For FERC's hypothetical

factory, the opportunity cost of not consuming electricity is $120. It is therefore economically efficient and socially desirable for the factory to continue consuming electricity until its cost exceeds $120. Accordingly, if the wholesale cost is $125 and the retail price is $100, consumption is economically inefficient, a problem that the LMP-minus-G formula rationally addresses. If, however, as in FERC's example, LMP is $100 and G is $25, then the factory should continue to operate, and would under LMP-minus-G, which would provide a $75 bounty for non-consumption with a resulting effective retail price equal to the wholesale cost ($100). Yet under FERC's new formula, the factory's effective price for consuming electricity will be $125 (the $100 in forgone bounty and $25 to cover the actual retail rate), and it will forgo consumption even though the wholesale cost is less than the factory's opportunity cost. FERC's own example thus perfectly illustrates the problem with its new compensation formula, as it would cause an economically rational factory owner to refrain from operating even when doing so would be efficient and rational based on the wholesale cost of electricity. As the Federal Trade Commission cogently explained in its comments to FERC, "policies that give the wrong incentives may make it more profitable for demand response providers to sell power rather than consume it to produce socially desirable goods or services." JA282.[8]

[8] This example also illustrates the problem with petitioners' insistence that the subsidy may cause the retail customer to time-shift its consumption to a non-peak time. That the consumer will eventually have to pay for whatever

FERC is correct that its hypothetical factory would not submit a "demand response" bid under an LMP-minus-G approach. U.S.Br.56. But neither should it, because doing so would not advance FERC's stated goal of balancing demand by ensuring that retail customers respond to wholesale price signals. FERC's perception of the factory's decision not to reduce its consumption as a failure demonstrates that FERC's objective has shifted from ensuring that retail customers' consumption decisions reflect wholesale cost to suppressing retail demand for its own sake. But FERC has never officially embraced the goal of suppressing demand for its own sake (much less attempted to explain how that goal would be consistent with its statutory charge). To the contrary, FERC is the champion of real-time pricing and ensuring that retail consumption responds to wholesale price signals. Whatever its jurisdictional flaws, the LMP-minus-G formula achieved that goal by ensuring that the effective retail price was LMP. By paying LMP regardless of the prevailing retail price, FERC has raised the effective retail price above LMP (to LMP *plus* G) and produced inefficiencies that do not advance its stated goals. That is the very definition of an arbitrary and capricious action.

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electricity it consumes at peak or non-peak times does not alter the reality that a rational consumer will include both the cost of purchasing electricity and the value of any forgone bounty for non-consumption when calculating the effective price of consumption. If G is $25 throughout the day and LMP is $125 at peak, a rational factory with an opportunity cost of $120 will defer consumption until non-peak hours even though it will part with the same $25 to purchase electricity at non-peak hours.

B. FERC Did Not and Cannot Explain Its Decision To Adopt a Compensation Scheme that Manifestly Fails to Further Its Professed Regulatory Objectives.

As the foregoing illustrates, Order No. 745 is not just an abrupt departure from FERC's prior position that a full LMP approach was inappropriate; it is an abrupt departure that is patently inconsistent with FERC's professed rationale for regulating retail demand in the first place, which has remained unchanged. It is one thing to try to balance supply and demand by substituting the wholesale rate for the retail one, but it is quite another to raise the effective retail rate well above the wholesale rate. Yet by paying consumers the full LMP with no offset for the savings achieved by forgoing the retail purchase of electricity, that is precisely what Order No. 745 does. There is simply no rational explanation for this incoherent approach to FERC's stated goal of balancing supply and demand.

FERC's principal defense is that paying "demand response" providers the full LMP makes sense because "[a] reduction in demand … brings the same value to an organized wholesale energy market as an equivalent increase in supply." U.S.Br.52; *see also* U.S.Pet.App.219a-20a. But as FERC itself initially recognized, that is so only when that reduction in demand is economically efficient—*i.e.*, when the cost of forgoing the consumption of electricity is no more than the cost of supplying it. *PJM Indus. Customer Coal.*, 121 FERC ¶61,315, at P26. That is why "G" was subtracted in the first place—to ensure that the effective retail rate would equal, not exceed, the

wholesale rate. Yet Order No. 745 does not even acknowledge FERC's reversal of position, let alone explain it. *See FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515 (2009).

FERC alternatively contends that continuing to subtract the retail rate would not be "consistent with the treatment of generation" because FERC "generally does not examine each of the costs of production for individual [generation] resources." U.S.Pet.App.219a. But that just underscores the fundamental problem with FERC's shift from LMP-minus-G to LMP. FERC's bold foray into regulating retail demand was not based on an extravagant fiction that not purchasing electricity is the functional equivalent of producing electricity (or that the retail rate is the "demand-response" equivalent of the costs of generation). Instead, FERC simply recognized that States' failure to incorporate real-time pricing created potential inefficiencies that could be solved by offering payments for retail non-consumption that would cause retail customers to behave as if the retail price were the wholesale price. LMP-minus-G perfectly reflected that policy.

But now FERC has changed its position on the appropriate compensation formula without changing its original justification for regulating retail demand. To the extent FERC is attempting to justify its new formula by suggesting that a reduction in retail demand is equivalent to an increase in wholesale production, that submission is fanciful. Refraining from consumption, even when efficient or otherwise socially useful, is not the same as producing. And the avoided cost of consumption is a benefit to the would-

be consumer, not a cost. Equally important, the optimal subsidy for non-consumption bears no logical relationship to the cost of production, which is why FERC's new formula results in excessive subsidies. When the stated problem is the disconnect between wholesale and retail rates, the difference between those rates (LMP-minus-G) is a rational measure of the necessary subsidy to balance supply and demand and equate retail and wholesale prices. But a subsidy equal to the absolute level of wholesale prices (LMP) is not even rationally directed at the problem FERC set out to solve.[9]

Beyond that, FERC's defense of its rule just boils down to the circular assertion that paying more for "demand response" is a good idea because it produces more "demand response." *See, e.g.*, U.S.Pet.App.97a-99a. But whether more is better depends entirely on why FERC wants to suppress retail demand. And FERC has never justified its efforts to reduce retail demand by an interest in suppressing demand for its own sake. Instead, FERC's policy has always been to reduce retail demand only to the level justified by

[9] That is not to suggest that if FERC really did have jurisdiction to regulate retail-level "demand response" (which it plainly does not), LMP-minus-G is the only formula FERC could adopt to further its stated goals. If LMP-minus-G did not produce the level of "demand response" FERC desired (which, based on its stated goals, could only be the level produced by a retail rate equal to LMP), that might justify a tweak to the LMP-minus-G formula. For example, if the profits earned by aggregators left the effective rate for some retail customers less than LMP, then a modest adjustment (LMP-minus-(G-plus-X), where X is a positive adjustment for those margins) might be justified. But simply embracing the full LMP is far too blunt a tool to address any such problem.

wholesale prices. If FERC's rule leads retail customers to reduce their demand even when doing so is not efficient—which is the inevitable result of a subsidy of the full LMP—it may produce more "demand response" (*i.e.*, less retail demand), but it does not rationally advance FERC's stated goal. Instead, it just swaps one inefficiency for another.

FERC's "net benefits" test does not cure this fatal flaw. Indeed, if anything, FERC's felt need to adopt that half-measure only underscores the fatal flaws in its compensation scheme. As FERC acknowledged in adopting the test, paying retail customers to reduce consumption even when doing so is not economically efficient has the distorting effect of creating a revenue shortfall in the wholesale markets. U.S.Pet.App.92a-94a. Wholesale-market operators must pay both generators and "demand response" providers, but the "demand response" causes load-serving entities to purchase less electricity in the wholesale markets. As a result, the wholesale-market operator is making a "demand response" payment for which it receives no corresponding payment from the load-serving entities. This "difference between the amount owed by" the wholesale-market operator "to resources, including demand response providers," and the revenues the wholesale-market operator can collect from load-serving entities creates a "negative balance" in the wholesale markets. U.S.Pet. App.128a.

FERC attempted to ameliorate this distortion by requiring that retail customers "be paid LMP only when the benefits of demand response compensation

outweigh the energy market costs to consumers of paying demand response resources." U.S.Pet. App.82a. But as Commissioner Moeller explained, this "net benefits" test does nothing to solve the more fundamental problem that FERC's compensation scheme "distort[s] price signals by attracting more demand response than is economically efficient," and instead just creates the additional problem of erroneously "equating the concept of a just and reasonable rate with a lower price." U.S.Pet.App.166a. The best that can be said about the "net benefits" test is that it results in wholesale-market operators paying too much less frequently.

At bottom, FERC cannot escape the reality that its new compensation scheme is utterly divorced from the stated rationale for its regulation. What FERC does not and cannot explain is why it makes sense to incentivize "demand response" even when doing so results in the same sort of inefficient consumption that prompted its creation in the first place. Having premised its "demand response" scheme on concerns of economic efficiency—the need to align retail and wholesale rates to give retail customers the right price signal—FERC cannot justify paying retail customers to consume less electricity than the wholesale rate would dictate. This internal inconsistency forecloses any attempt to articulate a satisfactory explanation for setting LMP as the rate for "demand response" compensation. *See Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983); *Gen. Chem. Corp. v. United States*, 817 F.2d 844, 846 (D.C. Cir. 1987) (per curiam).

In sum, there are fundamental problems with using a wholesale market to regulate retail demand. It is a blatant jurisdictional overreach, as illustrated by the compensation formula that FERC previously endorsed, which systematically aligned the effective retail price with the wholesale price. It is hard to imagine a more obvious effort by federal regulators to override the decisions of state regulators as to the proper price for sales on the retail market. But if FERC can undertake this effort at all, surely it has to undertake it rationally. The proper way to equate retail and wholesale prices is not to provide a bounty for non-consumption in the full amount of the prevailing wholesale price. That compensation formula cannot help but artificially reduce retail demand below the level justified by FERC's professed reasons for its foray into regulating retail demand. FERC has no business intruding into this area of exclusive state jurisdiction, but if it enters this forbidden field at all, it at least owes the regulated community a rational regulation.

CONCLUSION

The judgment below should be affirmed.

Respectfully submitted,

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