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Constrained Regulatory Exit in Energy Law

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CONSTRAINED REGULATORY EXIT IN ENERGY LAW

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ABSTRACT

In recent years, the federal government's efforts to open up competitive electricity markets have transformed how we think about the regulation of energy. In many respects, the Federal Energy Regulatory Commission's (FERC) broad "deregulatory" efforts, which commenced in the 1990s, might appear to be a case of paradigmatic regulatory exit as defined by J.B. Ruhl and Jim Salzman. But our case study of FERC's restructuring of wholesale electricity markets reveals some important institutional features that make exit in federalism contexts, and under federal statutory duties, a rich and difficult problem. In the context of energy, exit from one regulatory sphere can create regulatory gaps. This has led FERC, which largely exited the regulation of wholesale electricity rates, to increase regulation in other spheres. It has also invited forms of intergovernmental exchange, as states have emulated or otherwise responded to FERC's regulatory modifications in the areas in which states have jurisdiction. In this sense, the transition to competitive energy supply markets has involved constrained exit characterized by a hydraulic back-and-forth between regulators and institutions in an effort to ensure that statutory duties are fulfilled and other public needs are met.

This assessment of regulatory exchange has a prescriptive implication: a federal regulator seeking to exit specific forms of conventional regulation needs to proactively develop strategies to facilitate regulatory exchange, while simultaneously preserving its authority over important substantive values related to its regulatory mission. Attention to "offsetting" regulations is often necessary to ensure that problematic regulatory gaps will not arise. In the energy context, these strategies might also include the use of mechanisms that give other institutions a voice in implementing exit strategies, as well as better ex ante regulatory planning for market enforcement that will

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continue after partial exit. We argue that it is not only a good strategy for federal regulators to recognize this hydraulic feature of exit, but that cooperative federalism statutes such as the Federal Power Act often require them to do so.

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INTRODUCTION

A vast body of administrative law scholarship assumes that regulations are relatively sticky. Agency officials and staff members cling to the issues deemed to be highest priority and zealously guard their regulatory turf and the scarce resources associated with it.[1] A growing subset of the literature focuses on regulatory adaptation and dynamism, recognizing that too often there is not enough flexibility for the regulatory modifications needed to address changing issues over time or to experiment with new regulatory approaches.[2] These literatures reveal the classic tension between entrenchment and

1. *See, e.g.*, Bradley C. Karkkainen, *Bottlenecks and Baselines: Tackling Information Deficits in Environmental Regulation*, 86 TEX. L. REV. 1409, 1441 (2008) ("Once established, bureaucracies do not surrender power lightly."); Roberta Romano, *Regulating in the Dark and a Postscript Assessment of the Iron Law of Financial Regulation*, 43 HOFSTRA L. REV. 25, 47 (2014) (noting "an agency's inherent bias in interpreting the independent experts' analysis in support of the regulatory status quo or its agenda").

2. *See, e.g.*, Robin Kundis Craig & J.B. Ruhl, *Designing Administrative Law for Adaptive Management*, 67 VAND. L. REV. 1, 1 (2014); Donald T. Hornstein, *Complexity Theory, Adaptation, and Administrative Law*, 54 DUKE L.J. 913, 945 (2005) (noting adaptive management scholars' belief that "agencies . . . can reap the benefits of structured learning over time through a systematic program of active experimentation").

certainty on the one hand, and the need for flexibility on the other.

Professors J.B. Ruhl and James Salzman have identified a powerful form of regulatory transition that threatens to upset the balance between certainty and flexibility—a transition that they define as "exit," meaning an agency's reduction or elimination of regulation in a particular sphere.[3] Their typology of various forms of exit offers useful strategies for many regulatory settings.[4] Dramatic political shifts provide an especially stark reminder of the tension between regulatory certainty and flexibility. For example, in the environmental context, President Trump quickly announced an intent to withdraw from the international Paris Agreement on climate[5] and appointed a director of the Environmental Protection Agency with an avowed distaste for many environmental regulations.[6] Although similar sudden reforms have occurred in the past,[7] recent events such as these remind us of the need for better analytical tools to help regulators strike a balance between entrenchment and flexibility during times of political and policy disruption.

Few industries in the United States have experienced as much disruption over the past 50 years as the electric power sector. It should thus not be surprising that one of Ruhl and Salzman's many illustrations of exit comes from energy law; they describe the movement to competitive energy markets as a form of "adaptive exit."[8] This Article accepts the framework of their typology. But it also argues that the example of "exit" in energy requires further examination before it can produce useful lessons for regulatory exit generally.[9]

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3. *See* J.B. Ruhl & James Salzman, *Regulatory Exit*, 68 VAND. L. REV. 1295, 1302 (2015) (defining exit as "the intentional, significant reduction in governmental intervention initiated at a particular time under specified processes and conditions" (emphasis omitted)).

4. *Id.* at 1316–23.

5. *Statement by President Trump on the Paris Climate Accord*, WHITEHOUSE.GOV (June 1, 2017), https://www.whitehouse.gov/briefings-statement/statement-president-trump-paris-climate-accord [https://perma.cc/276E-D79M].

6. Coral Davenport, *Senate Confirms Scott Pruitt as E.P.A. Head*, N.Y. TIMES (Feb. 17, 2017), https://www.nytimes.com/2017/02/17/us/politics/scott-pruitt-environmental-protection-agency.html [https://perma.cc./XH45-BFVY].

7. *See, e.g.*, Abner J. Mikva, *Deregulating Through the Back Door: The Hard Way to Fight a Revolution*, 57 U. CHI. L. REV. 521 *passim* (1990) (describing President Reagan's broad deregulatory efforts, which began immediately upon Reagan assuming office).

8. Ruhl & Salzman, *supra* note 3, at 1321–22.

9. Consider that, where there is potential for either state or federal regulation, pure exit requires *both* state and federal regulators to exit (*quadrant 1*, below). Outside of this possibility, if the federal government retains regulatory power but the states fully exit, there would seem to be a strong possibility for unitary regulation, as may occur through federal preemption (*quadrant*

Lessons from the energy sector suggest that often, "regulatory exit" is better characterized as a form of constrained exit that we call "hydraulic regulatory exchange." This exchange is a regulatory or policy change at a federal, state, or other governmental level in response to partial deregulation or other modifications of the regulatory status quo. We identify two distinct forms of exchange: first, *intra-agency exchange*, in which an agency augments certain deregulatory efforts with regulations aimed at other activities in order to meet its statutory duties, and second, *intergovernmental exchange*, in which governments at other levels respond to federal exit with regulations that emulate the federal exit response but sometimes differ from it, or that compete with the federal approach. Importantly, within this exchange of regulations or institutions, "exit" is rarely the reduction or elimination of regulation in a regulatory area. Rather, it involves a federal agency, state, or other institution changing its regulatory approach or opting out of one type of regulation, while simultaneously increasing regulation elsewhere in order to achieve a policy goal.

These types of exchange—in which only partial deregulation or even a net expansion of regulation occurs—result from two factors that constrain the classic exit case defined by Ruhl and Salzman. Federal statutes tend to create duties that agencies may not abandon through exit, thus sometimes requiring offsetting protective regulation. Additionally, these statutes sometimes divide authority in a particular regulatory area between federal and sub-federal institutions, thus making intergovernmental regulatory exchange likely. The Federal Power Act (FPA)—the enabling statute of the Federal Energy

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2, below). Where states remain but the federal government exits, there is state regulation (*quadrant 3*, below). This Article argues that the Federal Power Act (FPA) largely operates in *quadrant 4*, containing those situations in which the federal and state governments both retain some regulatory authority—a relationship we generally describe as "cooperative federalism." This Article's use of cooperative federalism is distinct from the more narrowly defined use of the term, which refers to states implementing federal mandates under acts such as the Clean Air Act. This Article aims to provide an account of the dynamic interaction that occurs as the federal government moves toward exit in the cooperative federalism context—as a way of mediating exchange between the state and federal spheres, rather than forcing federal or state regulators to move into other quadrants.

Table 1.

	Feds Full Exit	Feds Remain
States Fully Exit	(1) Pure Exit	(2) Unitary Preemption
States Remain	(3) State Regulation	(4) **Cooperative Federalism**

Regulatory Commission (FERC)—provides a classic example of both of these factors. FERC's primary duty under the FPA is to ensure that rates are "just and reasonable,"[10] thus facilitating intra-agency regulatory exchange and making full exit unlikely. Further, the FPA increases the likelihood of intergovernmental exchange if any federal exit occurs; it tasks FERC with regulating wholesale sales (power sales between two different utilities or between generators and utilities) and the transmission of wholesale electricity,[11] while it specifically reserves to the states authority over generation and retail electricity (sales from utilities directly to customers).[12] FERC's efforts under the FPA to better serve consumers by enhancing competition in the electricity sector powerfully demonstrate both forms of exchange.

Beginning in the 1990s, FERC initiated a broad project to undo conventional delivery of electric power by vertically integrated utilities that operated as franchises free from competition and subject to regulated rates.[13] The "exit" that occurred in this case was exit from a particular *type* of regulation (traditional rate regulation). FERC decided that its duty of ensuring just and reasonable rates would be better achieved by encouraging competition in electricity generation, thus exiting the regulation of wholesale rates.[14] At the same time,

10. 16 U.S.C. § 824d(a) (2012). The phrase "just and reasonable" refers to both protecting consumers from excessive rates but also protecting utilities from exceedingly low rates that would prevent utilities from recovering the costs they incur in fulfilling obligations to customers. *See* Fed. Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944) (noting that to be just and reasonable, utility rates must involve "balancing of the investor and the consumer interests"); Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Va., 262 U.S. 679, 693 (1923) (noting that under the "just and reasonable" standard, the financial return to the utility under the rates it is allowed to charge "should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties").

11. *See* 16 U.S.C. § 824(b) (indicating that "[t]he provisions of this subchapter shall apply to the transmission of electric energy in interstate commerce and to the sale of electric energy at wholesale in interstate commerce").

12. *See id.* (providing that the commission "shall not have jurisdiction . . . over facilities used for the generation of electric energy or over facilities used in local distribution or only for the transmission of electric energy in intrastate commerce," as well as certain other transmission).

13. *See* FERC Order No. 888, Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, 61 Fed. Reg. 21,540, 21,541 (May 10, 1996) (codified at 18 C.F.R. pts. 35, 385) [*hereinafter* Order No. 888] ("Today the Commission issues three final, interrelated rules designed to remove impediments to competition in the wholesale bulk power marketplace and to bring more efficient, lower cost power to the Nation's electricity consumers.").

14. *See infra* notes 15–16.

FERC enhanced regulation in the transmission area, forcing the opening up of transmission lines, which often served as bottlenecks preventing access to cheap wholesale generators.[15]

FERC's new approach removed the commission from detailed oversight of power supply investment decisions, enhanced the commission's role in regulating transmission, and created a competitive interstate energy market.[16] During this transition, intergovernmental regulatory exchange also occurred, in part because FERC pressured states—which share authority with FERC under the FPA and regulate retail electricity markets—to deregulate or open up portions of these markets.[17] When this regulatory restructuring took off in earnest, a significant number of states whose customers were saddled with high-cost and obsolete power generation assets followed FERC's restructuring lead.[18] But the state regulatory response tended to entrench distinct regulatory approaches—some of which emulated FERC's lead, and others of which differed substantially from it. In an example of a state emulating partial federal exit,[19] California required utilities to acquire all of their power through a competitive marketplace but failed to implement adequate protections against

15. *See* Order No. 888, *supra* note 13, at 21,543 (concluding that its rule requiring enhanced access to transmission lines and associated approval of more competitive wholesale rates for generators that could show a lack of market power would "remedy undue discrimination in transmission services in interstate commerce and provide an orderly and fair transition to competitive bulk power markets").

16. *See* FERC Order No. 816, Refinements to Policies and Procedures for Market-Based Rates for Wholesale Sales of Electric Energy, Capacity and Ancillary Services by Public Utilities, 80 Fed. Reg. 67,056, 67,057 (Oct. 30, 2015) (codified at 18 C.F.R. pt. 35) [*hereinafter* Order No. 816] (describing the Commission's history of approving market-based rates in lieu of regulated cost-of-service rates).

17. Much of the pressure from FERC involved encouraging utilities within states—which tend to generate and transmit both wholesale and retail electric power—to hand over operational control of their transmission lines to regional entities called independent system operators or regional transmission organizations. These regional entities, once formed would run competitive wholesale markets for the electricity flowing through the lines and would generally allow both retail and wholesale electricity customers to access more generators because these generators would have broader geographic options for transmission and selling electricity. *See, e.g.*, FERC Order No. 2000, Regional Transmission Organizations, 65 Fed. Reg. 810, 831 (Jan. 6, 2000) (codified at 18 C.F.R. pt. 35) [*hereinafter* Order No. 2000] (encouraging the formation of regional transmission organizations); Order No. 888, *supra* note 13, at 21,542 (encouraging the formation of independent system operators).

18. *See, e.g.*, ENERGY INFO. ADMIN., STATUS OF STATE ELECTRIC INDUSTRY RESTRUCTURING ACTIVITY AS OF FEBRUARY 2003, at 1–2 (2003), https://www.eia.gov/electricity/policies/legislation/california/pdf/restructure.pdf [https://perma.cc/CR4B-Q5SB].

19. Ruhl & Salzman, *supra* note 3, at 1321–22 (describing pricing problems in the California marketplace).

gaming of the system, leading to unusually high wholesale (and retail) electricity prices.[20]

Additionally, as FERC has partially exited the sphere of electricity regulation, stakeholders have looked to regional, state, and local institutions to address important consumer protection, reliability, and environmental goals.[21] In this sense, the shifting demand for new forms of regulation expands and contracts as regulatory exit at the federal level changes. This has forced federal and state regulators to engage in an ongoing exchange of jurisdictional control, with FERC acknowledging state control of activities related to retail electricity sales and other activities while zealously protecting its jurisdictional authority over other areas. For example, with wholesale electricity competition already underway, FERC attempted to further encourage competition by permitting the "non-use" of electricity to be bid into markets in lieu of expensive generation during times of peak electricity demand;[22] in doing so, FERC allowed states to opt out or "veto" this federally created market by prohibiting retail users of electricity users from bidding their non-use into federal markets. Additionally, some states have maintained traditional regulation of their retail electricity sectors to control retail prices and prevent large fluctuations, in part out of a concern that problems similar to those seen in California could arise.[23] This kind of exchange has been enabled by a statutory framework that was designed to fill regulatory gaps, and that expressly preserves a role for states.[24]

The fact that exit is constrained by statutes and often causes regulatory responses at the federal level or at other levels of government—particularly under statutes colored by federalism undertones—calls for a broader understanding of even more

20. *See* Pub. Util. Dist. No. 1 of Snohomish Cty. v. Dynegy Power Mktg., 384 F.3d 756, 759 (9th Cir. 2004) (noting that "[i]n the markets the PX [Power Exchange] and ISO [Independent System Operator] managed, rates for wholesale electricity rose dramatically during 2000 and 2001," and noting alleged gaming of the markets).

21. *See, e.g.*, Vill. of Old Mill Creek v. Star, Nos. 17 CV 1163 & 17 CV 1164, 2017 WL 3008289, at *1 (N.D. Ill. July 14, 2017) (addressing the zero-emission credit program in Illinois).

22. FERC Order 719, Wholesale Competition in Regions with Organized Electric Markets, 73 Fed. Reg. 64,100, 64,119 (Oct. 28, 2008) (codified at 18 C.F.R. pt. 35).

23. Johannes P. Pfeifenberger, The Brattle Group, Electricity Market Restructuring: Where Are We Now? Presentation to the National Conference of State Legislatures Energy Policy Forum (Dec. 6, 2016), http://www.ncsl.org/Portals/1/Documents/energy/Energy_Pfeifenberger_Johannes_present.pdf [https://perma.cc/8HVB-WHBE] (noting that "[o]nly 15 states fully restructured their retail electricity markets").

24. *See infra* Part II.

complicated exit strategies than Ruhl and Salzman anticipated in their initial analysis of exit. A close look at the examples from the exit literature's typology reveals that pure regulatory exit may be more of a theory than a reality, and that what this Article describes as constrained exit in the form of regulatory exchange is a far more common and potentially feasible approach, at least in the energy sector. This Article argues that regulatory exit strategies need to anticipate and facilitate the two forms of hydraulic regulatory exchange we identify. Specifically, in planning for exit a federal agency needs to map out a vision for the future and also needs to ensure that it is able to preserve statutory obligations (typically through intra-agency regulatory exchange) and navigate complex, often unpredictable responses from other levels of government in the form of intergovernmental exchange. Proactive planning for hydraulic regulatory exchange is important to create more effective responses to regulatory gaps, to mediate conflicts among agencies with overlapping responsibilities in the regulatory area, and to ensure that agencies maintain statutory responsibilities when exiting a regulatory area.

Hydraulic regulatory exchange not only responds to private stakeholders, who bargain between regulators, but can provide various forms of insurance against future regulatory change as well. As law and psychology would suggest, individual officials have an incentive to preserve at least part of their role even when pursuing certain forms of exit,[25] and where there is greater potential for jurisdictional overlap, we would expect regulators to hold on to the option to reverse exit. Regulated industries, too, will want to preserve options to undo exit where there is a threat of undetermined forms of new regulation in the future.[26] It is therefore important that exit strategies incorporate and facilitate exchange, with an aim toward striking a balance between certainty and flexibility.

In arguing for a nuanced definition of exit that includes regulatory exchange and proposing ways to better navigate this exchange, this Article highlights two aspects of exit that are sometimes absent from

25. *See* Karkkainen, *supra* note 1, at 1441; *see also, e.g.*, Mark Seidenfeld, *Why Agencies Act: A Reassessment of the Ossification Critique of Judicial Review*, 70 OHIO ST. L.J. 251, 259–67 (2009) (describing agency staff members' and agency heads' incentives).

26. *Cf.* E. Donald Elliott, Bruce A. Ackerman & John C. Millian, *Toward a Theory of Statutory Evolution: The Federalization of Environmental Law*, 1 J.L. ECON. & ORG. 313, 326 (1985) (noting that although industry groups would have preferred no regulation in certain areas, they pushed for federal environmental law as an alternative to somewhat unpredictable, varied, and strict state laws).

"pure exit" conversations: that regulators are nearly always constrained by statutes when exiting, and that other regulatory entities often fill spaces created by partial exit or make similar or conflicting regulatory changes within their own jurisdictional spheres.

Part I introduces conventional regulation of interstate energy markets. In Part II, the Article describes FERC's efforts to exit portions of the field of wholesale electricity regulation through restructuring and the constraints on exit created by the FPA—constraints that lead to intra-agency and intergovernmental exchange rather than classic exit. Part III then explores how competitive energy markets have opened up hydraulic forms of regulatory exchange as states work to address changing public needs, such as demands to address climate change. It analyzes FERC's allowance for state veto as one form of managing and proactively planning for hydraulic exchange. Part III also discusses the ongoing ambiguity surrounding state exit from interstate energy markets—a form of reactive exit that must be monitored to ensure that it does not entrench new forms of market power.

Part IV highlights how the need for regulatory exit strategies to address and facilitate exchange will increase with greater overlap of the missions of different regulatory institutions. This may produce greater demand for approaches to exit that manage hydraulic regulatory exchange, including efforts to give more of a voice to states or other institutions. However, we warn, these efforts must be approached carefully to avoid the creation of new dysfunctions.

I. TRADITIONAL REGULATION OF INTERSTATE ENERGY MARKETS

Upon first glance, FERC's regulatory and deregulatory strategies to expand competition in the electricity sector ("electricity restructuring") over the past three decades are a classic "exit" story, in that the commission in many respects attempted to extricate itself from regulatory intervention to encourage competition in the provision of electricity. FERC in many senses did not exit the regulatory sphere, however. Indeed, FERC had to issue new regulations to ensure that markets would, in fact, be competitive. Thus, the energy law story differs from the types of exit described within Professors Ruhl and Salzman's pathbreaking work on regulatory exit,[27] and, we argue, is

27. Ruhl & Salzman, *supra* note 3, at 1302 (defining exit in terms of reduced governmental intervention).

better categorized as regulatory exchange. The energy regulatory exchange story is also notable because Congress did not appear to intend for any form of exit in the energy enabling statutes, thus creating complications for FERC's exit strategies.

Congress enacted the FPA—the statute that creates broad federal authority over electricity generation and transmission—in response to concerns about a regulatory gap created by the Supreme Court in the *Public Utilities Commission v. Attleboro Steam Company* case.[28] In holding that states could not regulate wholesale rates charged by a utility in another state, the Court in *Attleboro* created a space that could not legally be filled through state action and that the federal government had not yet addressed.[29] Thus, Congress enacted the FPA to occupy this previously "unregulated" area. The FPA contains broad jurisdictional language mandating federal involvement in interstate electricity transactions. In its declaration of policy, Congress emphasized that federal regulation of interstate wholesale electricity sales was "necessary in the public interest."[30] And the substantive portions of the FPA extended federal authority to both the transmission and wholesale sale of interstate electricity.[31] At the same time, Congress expanded federal involvement in this area through other statutes in an effort to further protect the public from anticompetitive activity in the area of wholesale electricity. For example, the Public Utility Holding Company Act of 1935 (PUHCA) required many utilities to register with the Securities and Exchange Commission (SEC) and obtain SEC approval before issuing securities or acquiring other generators and power companies, among other measures.[32]

In carrying out its FPA duties, FERC came to be heavily involved in the regulation of wholesale electricity sales and transmission. Any

28. Pub. Utils. Comm'n of R.I. v. Attleboro Steam & Elec. Co., 273 U.S. 83, 90 (1927).

29. New York v. FERC, 535 U.S. 1, 20 (2002) (noting that "[i]t is clear that the enactment of the FPA in 1935 closed the '*Attleboro* gap' by authorizing federal regulation of interstate, wholesale sales of electricity" but emphasizing that the FPA was more than a gap-filling statute because it also extended federal jurisdiction into areas previously regulated by states and provided for federal jurisdiction over areas not at issue in *Attleboro*, including electricity transmission); *Attleboro*, 273 U.S. at 90 (holding that states could not regulate rates charged for the sale of wholesale electricity from a utility in one state to a utility in another state).

30. 16 U.S.C. § 824(a) (2012).

31. *Id.* § 824(b).

32. Public Utility Holding Company Act of 1935, Pub. L. No. 74-333, §§ 5, 6, 9, 49 Stat. 803, 812–15, 817–18 (repealed and replaced by the Public Utility Holding Company Act of 2005 as part of the Energy Policy Act of 2005, Pub. L. 109-58, 119 Stat. 974).

electric utility proposing to sell electricity wholesale had to first obtain FERC approval of the rate to be charged. For most of the twentieth century, this endeavor required a lengthy "cost-of-service" rate-making proceeding in which FERC assessed the capital and operating costs for each utility (including the utility's need to provide returns to shareholders), establishing a just and reasonable rate based on this detailed information.[33] Similarly, each owner and operator of an electric transmission line over which FERC had jurisdiction had to obtain FERC approval of the rates to be charged for other utilities' use of the line and approval of the terms of service that would be offered to these utilities.[34] Users of those transmission lines had to grapple with numerous rates if they sent electricity over lines owned by different utilities.[35] And under PUHCA, the SEC had to give the green light to most utility stock offerings and mergers, among other transactions.[36]

Over time, it became increasingly apparent to Congress and FERC that guarding the "public interest"—that is, protecting electricity consumers from unreasonable rates and anticompetitive practices, and also preserving reasonable profits for utilities[37]—would require more than the oversight of rates and business transactions and might necessitate certain forms of exit to allow positive market forces to prevail.[38] Utilities continued to exercise monopolistic power over electricity markets by favoring incumbent power plants over new entrants jealously guarding use of their own transmission lines—thus

33. *See* Ari Peskoe, *Easing Jurisdictional Tensions by Integrating Public Policy in Wholesale Electricity Markets*, 38 ENERGY L.J. 1, 3 (2017).

34. *See, e.g.*, Robert J. Michaels, *The Governance of Transmission Operators*, 20 ENERGY L.J. 233, 235 (1999) (noting that "[t]hrough the 1970s" transmission was "supplied largely at the discretion of its owners at cost-recovering rates").

35. David B. Spence, *Can Law Manage Competitive Energy Markets?*, 93 CORNELL L. REV. 765, 773 n.43 (2008) ("[E]ach of many owners [of the transmission grid] demanded a separate rate from customers for the transmission of electricity along each segment of the grid (so-called 'pancaking' of rates).").

36. *See* James W. Moeller, *Toward an SEC-FERC Memorandum of Understanding*, 15 ENERGY L.J. 31, 46 (1994) (noting, prior to the repeal of PUHCA, that "it [was] unlawful under section 9(a)(1) [of PUHCA] for registered public utility holding companies and their public utility (or non-utility) subsidiaries to acquire the securities or assets of another electric public utility without SEC approval").

37. *See supra* note 10 and accompanying text.

38. *See* Order No. 888, *supra* note 13, at 21,540–46 (noting rising prices of electricity produced under the old, fully-regulated system, in which FERC approved rates designed to allow utilities to recover the costs of investments such as expensive nuclear power plants, and noting the need to move to a more competitive model); *id.* at 21,550 (noting the agency's "traditional obligation to ensure that utilities have a fair opportunity to recover prudently incurred costs and that they maintain power supply reliability").

preventing competitors from accessing these utilities' wholesale customers—and refusing to build new transmission lines that would facilitate more competitor access.[39] In response to these and other practices, which were challenged by wholesale buyers, the Supreme Court made clear that electric utilities are not immune from antitrust law and from the competitive pressures associated with this law.[40]

Congress, too, began to shift its focus from FPA-style regulatory intervention to statutes designed to protect consumers through enhanced competition in wholesale electricity. For example, Congress exempted certain utilities from PUHCA if these utilities could show that they were wholly in the business of generating electricity;[41] this had the effect of encouraging independent, competitive generators to enter the market, thus helping to lower prices. Congress also encouraged small generators to enter the market by requiring that utilities purchase power from these generators and pay them a particular rate for the power.[42] And Congress gave FERC the power to order a utility to grant competing utilities access to the utility's transmission lines in order to sell to a third-party buyer—a practice called wheeling.[43] Thus, although governmental involvement in the energy sphere continued, its aim was to enhance the power of markets and reduce the need for direct regulation of electricity rates.

FERC also began to expand its efforts to weaken utilities' anticompetitive powers. At first, FERC engaged in case-by-case efforts to encourage competition. For example, it accepted and increasingly granted applications for wholesale electricity sellers to sell power at market-based rates,[44] meaning that FERC would no longer cap the

39. *See id.* at 21,547 (concluding that previous efforts to open up transmission were inadequate to address remaining "undue discrimination" in terms of transmission pricing and access and noting "the problem of the disparity in transmission service that utilities provided to third parties in comparison to their own uses of the transmission system"); *id.* at 21,546 (noting that "[t]he most likely route to market power in today's electric utility industry lies through ownership or control of transmission facilities").

40. Otter Tail Power Co. v. United States, 410 U.S. 366, 372 (1973) (subjecting a refusal to deal allegation related to transmission lines to antitrust law scrutiny).

41. *See* Order No. 888, *supra* note 13, at 21,546–47 (describing the creation of exempt wholesale generators (EWGs) through the Energy Policy Act of 1992 and the purposes behind it).

42. *Id.* at 21,545 (describing the Public Utility Regulatory Policies Act and its intent of promoting competition).

43. *Id.* at 21,547 (noting the Energy Policy Act's amendment to the FPA to allow FERC to issue individualized wheeling orders, and noting FERC's use of this authority).

44. *See* FERC Order No. 697, Market-Based Rates for Wholesale Sales of Electric Energy, Capacity and Ancillary Services by Public Utilities, 72 Fed. Reg. 39,904, 39,907 (July 20, 2007)

price of electricity and would allow the seller to charge any price the market would bear, subject to FERC monitoring for potential market power problems.[45] FERC also used its congressionally granted power to issue individual wheeling orders.[46]

FERC quickly moved toward broad-based reform in an effort to harness competitive market powers, and this effort demonstrated how FERC's "exit" story was in fact dominated by regulatory exchange—in this case, intra-agency exchange in the form of deregulating one regulatory sphere while enhancing regulation in another. When FERC issued a broad-based policy to allow most wholesale rates to be competitive rates—primarily contained within FERC Orders 697 and 816[47]—this extricated the commission from its formal case-by-case approval of rates. But FERC had first issued a sweeping regulatory directive in 1996 called FERC Order 888 that required universal wheeling, meaning that all utilities had to offer open access to their transmission lines (within practical limits).[48] Without this enhanced federal regulatory involvement in the transmission sector, efforts to deregulate rates and allow competitive forces to protect electricity consumers would have backfired because competitive generators of electricity would have lacked access to transmission lines, which are too expensive for many generators to build and operate themselves.[49]

Despite these ambitious efforts, the following Part discusses how FERC's vision for fostering competitive markets was not fully realized, in large measure due to the fact that FERC's strategy failed to fully anticipate private anticompetitive practices that would still harm consumers—practices that emerged in restructured markets at both the federal and state levels. Further, FERC's consumer (and utility)

(codified at 18 C.F.R. pt. 35) [*hereinafter* Order No. 697] ("In 1988, the Commission began considering proposals for market-based pricing of wholesale power sales. The Commission acted on market-based rate proposals filed by various wholesale suppliers on a case-by-case basis."); ENERGY INFO. ADMIN., THE CHANGING STRUCTURE OF THE ELECTRIC POWER INDUSTRY 2000: AN UPDATE 63 (2000), https://grist.files.wordpress.com/2010/02/update2000.pdf [https://perma.cc/RX95-9V7W].

45. Sellers still must submit individual applications for market-based rate approval, but FERC approves many of these requests and has streamlined applicants' procedures for proving that they lack market power—a prerequisite to obtaining this approval. *See* Order No. 816, *supra* note 16, at 67,057; Order No. 697, *supra* note 44, at 39906.

46. ENERGY INFO. ADMIN., *supra* note 44, at 63.

47. *See infra* notes 53–56 and accompanying text.

48. Order No. 888, *supra* note 13, at 21,541.

49. *Id.* at 21,550 (noting that "[t]ransmitting utilities own the transportation system over which bulk power competition occurs and transmission service continues to be a natural monopoly").

protection mission[50] required any exit from conventional regulation to better balance these kinds of goals in its substantive regulatory approach.

II. REGULATORY EXCHANGE IN RESTRUCTURED ENERGY MARKETS

Viewed in isolation, certain aspects of FERC's electricity restructuring efforts—a combination of deregulation under Order 697 and 816, and enhanced regulation under Order 888—look like classic exit, and more specifically, "adaptive, transparent exit" which is a form that the commission did not design *ex ante* but later adopted as its strategy using clear standards.[51] But the "exit" involved here was an exit from traditionally regulated monopolistic electricity markets, not from FERC regulation. FERC's electricity restructuring was designed to facilitate a competitive electric power supply in order to reduce electricity prices for consumers while also ensuring that utilities could remain financially viable.

To accomplish this vision of competition, through Orders 697 and 816 FERC retroactively attempted to expand competition in the electricity sector and crafted standards for removing commission approval of most wholesale rates.[52] Specifically, in Order 697, FERC indicated that it would permit wholesale sellers of electricity to charge market rates after determining that these sellers lacked market power or had market power but had "mitigated it."[53] The commission also required, among other things, that the seller continue to file periodic reports so that FERC could monitor transactions over time and check for possible changes in market power, and the commission reserved the power to revoke a seller's authority to charge market-based rates.[54] Order 816 subsequently streamlined certain aspects of the

50. *See supra* note 10 and accompanying text.

51. Ruhl & Salzman, *supra* note 3, at 1322–23.

52. *See supra* notes 44 and 45.

53. Order No. 697, *supra* note 44, at 39,906. Morgan Stanley Capital Grp. v. Pub. Util. Dist. No. 1, 554 U.S. 527, 537–38 (2008) (describing FERC's ongoing authority over certain aspects of the rates, noting that before the commission authorizes market-based rates it analyzes "whether a market-based rate seller or any of its affiliates has market power in generation or transmission and, if so, whether such market power has been mitigated" and listing the analyses that FERC conducts when determining "whether market-based rates should be granted," including the question of whether the proposed "market-based rate seller or any of its affiliates has market power").

54. Order No. 697, *supra* note 44, at 39,906.

commission's analysis regarding sellers' market power.[55]

Importantly, however, FERC's deregulatory efforts with respect to wholesale rates were enabled largely by its enhanced regulatory effort under Order 888.[56] Through a form of intra-agency exchange (deregulation in one area, and enhanced regulation in another), this order required all transmission line operators under FERC's jurisdiction to file tariffs with FERC that offered use of their transmission lines on an open-access, nondiscriminatory basis—a dramatic shift from previous practice.[57] FERC believed that when more utilities and generators had access to transmission lines, buyers would, in turn, have more choices, and electricity rates would decline as a result of enhanced competition.[58]

States responded in various ways to this effort—mimicking certain aspects of rate deregulation at the state level[59] or entrenching traditional rate regulation.[60] FERC's effort to partially exit electricity regulation accordingly tells a far more nuanced story than traditional exit, and one that involves both intergovernmental and intra-agency exchange. The FPA mandates, or at minimum encourages, both types of exchange and therefore constrains what might otherwise be classic exit—an overall reduction or elimination of regulation within a regulatory field.

With respect to intergovernmental exchange, the FPA expressly reserves room for state regulation; the federal government regulates wholesale sales and transmission, and the states regulate retail transactions.[61] These seemingly clear jurisdictional dividing lines are quite blurry. Beyond the thorny nature of federalism-infused exit, FERC's electricity restructuring efforts, California's related

55. Order No. 816, *supra* note 16, at 67,059.

56. *See* Order No. 888, *supra* note 13, at 21,550 ("Non-discriminatory open access to transmission services is critical to the full development of competitive wholesale generation markets and the lower consumer prices achievable through such competition.").

57. *Id.* at 21,541.

58. *See id.* ("The continuing competitive changes in the industry and the prospect of these benefits to customers make it imperative that this Commission take the necessary steps within its jurisdiction to ensure that all wholesale buyers and sellers of electric energy can obtain non-discriminatory transmission access . . . .").

59. *See infra* notes 73–76 and accompanying text.

60. *See, e.g.*, Philip S. Cross, *N.C. Defers Retail Wheeling*, 133 PUB. UTIL. FORT. 48 (1995) ("Finding the state's electric regulation in excellent condition, and noting a slowdown in the movement toward retail wheeling in other states, the North Carolina Utilities Commission (UC) has decided against ruling on the issue at this time.").

61. 16 U.S.C. § 824(b) (2012).

restructuring, and similar exit strategies also reveal another, more nuanced type of exit in the form of intra-agency exchange. Agencies wishing to exit a regulatory field in the classic sense—meaning they want to reduce or eliminate regulation within that field—often must retain or even enhance certain regulatory authority due to statutory constraints. In the case of FERC, the FPA constrains exit by requiring FERC to protect the public interest through federal regulation of wholesale electricity and transmission.[62]

This Part describes the challenges that FERC faced with its electricity restructuring initiatives, including jurisdictional disputes and ambiguity with respect to the regulatory duties that FERC was required to retain under the FPA. These duties could have more effectively protected the public from the impacts of exit within a messy federalism area, where both states and the federal government largely abandoned certain regulation of electricity markets, leaving significant gaps that invited anticompetitive pricing in energy and harmed consumers.

A. The Challenges of Navigating Intergovernmental Exchange

Despite FERC's combined efforts to accomplish effective and efficient electricity restructuring, the commission failed to establish a comprehensive model for exit from federal regulation of the power supply; in endorsing a competitive power supply market, FERC failed to fully anticipate anticompetitive private behaviors. FERC's orders also did not fully address the potential for ongoing federalism tensions or define clearly how FERC would continue to exercise its federally mandated duties to prevent or respond to problems that arose as a result of exit, such as the exorbitant wholesale prices that emerged when California deregulated its generation market.[63]

FERC was aware of the potential for these tensions and made some efforts to address them. For example, recognizing that states—which have jurisdiction over retail utilities and the construction of transmission lines—would likely block the development of a truly regional transmission grid that would enable better competition, Order 888 encouraged the formation of regional transmission organizations

62. *Id.*

63. *See* Morgan Stanley Capital Grp. v. Pub. Util. Dist. No. 1, 554 U.S. 527, 541 (2008) (discussing the exorbitant rates that emerged in California and noting that "[t]he contracts between the parties included rates that were very high by historical standards").

as a way of coordinating the transmission grid in competitive markets.[64] Through this system, utilities could opt into regional, organized power supply markets.[65] Importantly, many parts of the country still lack these regional organizations.[66] Subsequent FERC orders have mandated regional planning for transmission lines,[67] but it is not clear how much this planning will in fact open up transmission lines to enable truly regional, competitive electricity markets. Further, FERC's electricity restructuring initiative did not—and likely could not—address all of the difficulties that would subsequently arise in interpreting the line between permissible deregulation and FERC's ongoing regulatory duties.

In many respects, FERC's restructuring initiative was successful. Competition in generation flourished,[68] and electricity rates did decline in areas of the country where they had been the highest, in part due to the enhanced competition promoted by the order.[69] But several countervailing forces substantially tempered this success. A primary hurdle in the effort to protect consumers through the restructuring initiative was the strong yet rather vague dual federalist structure preserved by the FPA. Although Congress in the FPA carved out a relatively broad area of federal authority, it also definitively preserved

64. Order No. 888, *supra* note 13, at 21,667. FERC further encouraged the formation of these entities in Order No. 2000. Order No. 2000, *supra* note 17, at 831.

65. *See* Charles H. Koch, Jr., *Control and Governance of Transmission Organizations in the Restructured Electricity Industry*, 27 FLA. ST. U. L. REV. 569, 586–87 (2000) (noting "the FERC's consultation with the states that unsurprisingly revealed substantial opposition to RTOs [Regional Transmission Organizations]"); *Regional Transmission Organizations (RTO)/ Independent Systems Operators (ISO)*, FED. ENERGY REG. COMMISSION (Dec. 21, 2017), https://www.ferc.gov/industries/electric/indus-act/rto.asp [https://perma.cc/TPG7-DAKN] (discussing the history of independent system operators and regional transmission organizations).

66. For example, most of the southeastern United States operates outside of organized regional markets, as does most of the western United States, except California, which has its own transmission operator. *Regional Transmission Organizations*, FED. ENERGY REG. COMM'N. (Nov. 2015), https://www.ferc.gov/industries/electric/indus-act/rto/elec-ovr-rto-map.pdf [https://perma.cc/ZQ59-SGAY] (showing geographic locations of RTOs); *see also* Shelley Welton, *Non-Transmission Alternatives*, 39 HARV. ENVTL. L. REV. 457, 477 (2015) (noting that "RTOs serve approximately two-thirds of electricity customers, although their geographic coverage is more limited").

67. FERC Order No. 1000, Transmission Planning and Cost Allocation by Transmission Owning and Operating Public Utilities, 76 Fed. Reg. 49,842, 49,845 (Aug. 11, 2011) (codified at 18 C.F.R. pt. 35) [*hereinafter* Order No. 1000].

68. *See* Order No. 2000, *supra* note 17, at 813 (discussing the expansion of independent generation).

69. U.S. DEP'T OF ENERGY, NATIONAL TRANSMISSION GRID STUDY xi (2002) (concluding that the "U.S. transmission system facilitates wholesale electricity markets that lower consumers' electricity bills by nearly $13 billion annually").

state authority within the energy arena. Specifically, Congress deemed federal regulation to protect the public interest a necessity, but in granting FERC authority over interstate transmission and wholesale sales of electricity Congress also provided that this authority "shall not apply to any other sale of electric energy."[70] This and other portions of the FPA created a complex federalist scheme, preserving certain authority previously held by states but encroaching upon some of their regulatory turf. The regulatory regime that emerged impeded FERC's market-based goals and in some cases left substantial regulatory gaps that were supposed to have been filled by the FPA.

Due to the authority reserved to states under the FPA—namely, the power to regulate retail sales[71]—some states effectively blocked federal efforts to make electricity generation and transmission truly competitive, thus occupying an area that FERC, through its rate and transmission-based orders, intended to leave open for competition. For example, because states maintained jurisdiction over the siting of power plants, the determination of whether a power plant should be built, and the retail rates that the plant could charge, states sometimes blocked the construction of new competitive generation that would have supplied both wholesale and retail customers.[72] The exit intended by FERC therefore became, against FERC's wishes, only partial exit, creating a market substantially influenced by state forces, many of which impeded competition.

Even in states that embraced competition, problems emerged in the form of regulatory gaps. As Ruhl and Salzman note, California—following FERC's lead—decided to open up the electricity market for both retail and wholesale generation by requiring monopolistic utilities to divest their generation infrastructure.[73] All generation subsequently had to be purchased and sold through a competitive power exchange (PX).[74] All wholesale power sales occurred through the competitive PX market, but as Ruhl and Salzman further observe, utilities purchasing

70. 16 U.S.C. § 824(b) (2012).

71. The FPA explicitly reserves to states the authority to regulate "any other sale" of energy (apart from wholesale sales). *Id.*

72. *See, e.g.*, Tampa Elec. Co. v. Garcia, 767 So. 2d 428, 435 (Fla. 2000) (finding that the Florida Public Service Commission lacked the authority to approve the construction of a power plant for which most power was not "committed" to Florida customers, thus allowing Florida to block the construction the type of power plant encouraged by the federal government).

73. Ruhl & Salzman, *supra* note 3, at 1321–22; *see also* Morgan Stanley Capital Grp. v. Pub. Util. Dist. No. 1 of Snohomish Cty., 554 U.S. 527, 539 (2008) (describing California's requirements).

74. *Morgan Stanley*, 554 U.S. at 539; Ruhl & Salzman, *supra* note 3, at 1321.

market-based wholesale power still had to sell retail power at a rate capped by the state.[75] So when wholesale sellers (now largely unregulated by FERC and allowed to charge market rates) manipulated PX by, for example, creating artificial power scarcity and inducing high wholesale prices, utilities had to purchase expensive power and sell it at a low rate. When these utilities attempted to remedy the economic harm through lawsuits alleging improper market manipulation under state antitrust law, they found themselves trapped between a rock and a hard place. Federal courts noted that FERC still technically regulated wholesale electricity prices by issuing a permit for utilities to sell at market-based rates.[76] Thus, although the rates were determined by market forces, they were officially approved by a federal agency and could not be collaterally challenged through the courts.[77] Under this rule, called the "filed rate" doctrine,[78] the only remedy was to engage in FERC proceedings,[79] which took years to complete and did not allow for full recovery of losses. Ultimately, during the disruptive crisis in the California electric power sector, FERC failed in its statutory duties to protect the public interest—particularly in its duty to protect the public from unreasonable electricity rates.

FERC's electricity restructuring initiative demonstrates both the promise and peril of an exit strategy and the failures associated with a regulatory exchange approach that lacks a model allowing for checks on the inevitable failures that accompany exit. It sheds light on the particular federalism challenges that arise when exit occurs within a shared regulatory space, and it makes clear that rarely, if ever, will full exit occur given agencies' ongoing statutory duties. The limits of electricity restructuring also highlight the need for a proactive strategy aimed at anticipating and facilitating hydraulic regulatory exchange—specifically, the need to foresee how states might fill in openings created by federal regulatory transitions, or how the federal government might reenter a regulatory space if it identifies market

75. Ruhl & Salzman, *supra* note 3, at 1322.

76. Pub. Util. Dist. No. 1 of Grays Harbor Cty. v. IDACORP, Inc., 379 F.3d 641, 649–51 (9th Cir. 2004) (describing FERC's market-based rates).

77. Pub. Util. Dist. No. 1 of Snohomish Cty. v. Dynegy Power Mktg., Inc., 384 F.3d 756, 761 (9th Cir. 2004) ("This court has rejected Snohomish's argument that the preemption-related doctrines at issue do not apply when market-based rates are involved.").

78. *Id.*

79. California ex rel. Lockyer v. Dynegy, Inc., 375 F.3d 831, 837–39 (9th Cir. 2004) (finding that the claims were governed by ISO tariffs).

problems or other challenges. And having anticipated these reactions, discrete "offramp" strategies are likely needed.[80] These would include carefully designed ex ante plans for exit that incorporate ongoing regulatory protections against market failure and new regulatory gaps, and that also anticipate increased demand for additional regulation by the commission, states, or other governments. Such strategies would better ensure that exit does not compromise an agency's statutory responsibilities, as discussed in the following Section.

B. Difficulties Fulfilling Statutory Duties in the Transition to Markets

The limitations of FERC's electricity restructuring efforts suggest that, if FERC is to avoid creating new regulatory gaps, it needs a clearer, more proactive strategy in approaching its exit from traditional energy regulation. Given the FPA's continued requirement for an assurance of "just and reasonable" rates (previously met through cost-of-service regulation),[81] FERC's modern market approach must ensure that, in pursuing competitive markets through market-based rates, it does not fall short of its responsibilities to ratepayers. It is likely impossible for an agency to fully predict the pitfalls it will encounter when exiting a particular form of regulation (in this case, conventional rate regulation) and the specific backup authority it must retain to prevent and respond to those pitfalls. These predictive difficulties necessitate a sort of "bottom-up" approach that relies on checks and balances at other levels of government as well as intra-agency exchange to serve as backup insurance in the case of failure. But as this Part discusses, certain problems can be addressed up front to balance exit strategies with statutory duties, and under FERC's electricity restructuring initiative, FERC did not plan for these contingencies as much as it could have.

One of the clearest examples of the challenges of balancing exit and ongoing regulatory duties arose in the context of wholesale contracts for electricity, as addressed by the Supreme Court in *Morgan*

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80. The roadmaps that we propose later in this Article are different from the mapped exit strategies defined by Ruhl and Salzman, in which the government identifies particular thresholds at which parties will or will not be subject to regulation. Ruhl & Salzman, *supra* note 3, at 1316–19. We envision a more comprehensive plan that would define the ongoing role of regulatory agencies at several levels of government and incorporate clearer consideration of federal agencies' oversight responsibilities under federal statutes—responsibilities from which exit is not an option.

81. 16 U.S.C. § 824d(a) (2012). *See supra* note 10 for a description of the meaning of "just and reasonable" rates.

Stanley Capital Group v. Public Utility District No. 1 of Snohomish County.[82] When FERC attempted to enhance competition in generation prices by abandoning cost-of-service ratemaking for most wholesale sales, the commission retained certain protective strategies. For example, FERC still required each power marketer or generator to obtain FERC approval to charge market-based rates,[83] thus ensuring ex ante review of potential anticompetitive problems. But for entities that entered into private long-term contracts to sell power—contracts called power purchase agreements (PPAs)—FERC's role was minimal. A longstanding doctrine developed by the Supreme Court required that FERC presume that these "freely negotiated" rates were just and reasonable under the FPA.[84] Challengers of wholesale rates contained within these contracts could only overcome the presumption by proving to FERC "that the contract seriously harm[ed] the public interest."[85]

Some PPAs negotiated during the California restructuring crisis contained unusually high rates—largely because the alternative rates available through the power exchange were even higher.[86] These PPAs locked power purchasers into these rates for long periods, and the purchasers challenged the rates as unjust and unreasonable, arguing that the presumption should not apply to these PPAs.[87] FERC disagreed and refused to allow contract modification, but the Ninth Circuit agreed with the purchasers, finding that the presumption should not apply because FERC was unable to review the PPAs just after they had been agreed to, and accordingly had lacked the opportunity to determine that the prices in the contracts were not just and reasonable due to "market dysfunctions."[88] Further, the lower court concluded that even if the presumption did apply, when purchasers—as opposed to sellers—of electricity challenge the prices, the presumption of just and reasonable rates is easier to overcome.[89] The Supreme Court disagreed with this reasoning but granted the

82. Morgan Stanley Capital Grp. v. Pub. Util. Dist. No. 1 of Snohomish Cty., 554 U.S. 527 (2008).

83. 16 U.S.C. § 824(b).

84. This is known as the "Mobile-Sierra" doctrine. *Morgan Stanley*, 554 U.S. at 530 (referencing *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956)).

85. *Id.*

86. *Id.* at 539–41 (addressing problems in the spot market).

87. *Id.* at 541.

88. *Id.* at 543–44.

89. *Id.*

purchasers relief on other grounds; in reviewing the contracts' impact on the public interest, FERC had looked only to whether the prices imposed an excessive burden *at the time they went into effect*, as opposed to "down the line"—later time periods during which the contract prices, as compared to other prices, looked excessive.[90] The Court concluded that FERC should have considered "the disparity between the contract rate and the rates consumers would have paid (but for the contracts) further down the line, when the open market was no longer dysfunctional."[91] Further, the Court reasoned that if generators and power marketers were able to lock in a high contract rate for wholesale power as a result of unlawful activity—that is, if there was a direct causal connection between unlawful activity such as market manipulation and the price—then the presumption is inapplicable to that contract.[92]

FERC's failure to address these sorts of problems ex ante, and its initial denial of power purchasers' requests for relief in *Morgan Stanley*, demonstrates the problems that arose due to the commission's lack of clearly defined strategies for preserving statutorily mandated consumer protections while exiting markets. Although FERC's effort to increase competition in markets was laudable, the commission certainly knew that market manipulation was still a threat—as evidenced by FERC's ongoing requirement that it would individually review each power marketer's and generator's proposal to operate under a market-based tariff (in other words, to charge purchasers whatever the market would bear).[93] But FERC lacked an adequately detailed ex ante plan to address unjust and unreasonable rates that arose from manipulation of competitive markets and the inevitable spillover of these rates into privately negotiated long-term contracts. To date, the U.S. Supreme Court has still not ruled that FERC's market-based rates are consistent with its mandate under the FPA, raising a continuing concern that compliance with the commission's statutory mandate will require it to be vigilant about these kinds of consumer protection concerns.

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90. *Id.* at 552.

91. *Id.* at 553.

92. *Id.* at 554–55.

93. *Id.* at 537 (describing FERC's requirement of an "initial authorization of a market-based tariff" and the accompanying reporting requirements).

III. COMPETITIVE MARKETS, PUBLIC GOODS, AND REGULATORY EXCHANGE

FERC's efforts to exit conventional rate regulation while also hewing to the commission's ongoing statutory duties produced many legal tensions, as explored in Part II. More recently, as states have addressed issues such as energy reliability and climate change, a new series of conflicts between FERC and the states have emerged. Even where FERC has embraced competitive wholesale energy markets, these private markets often fail to fully address important public goods, such as energy reliability and environmental protections.[94] Stakeholders, including power suppliers, have increasingly sought state assistance to advance these public goods.[95] In this back-and-forth between FERC and the states, regulatory exit is more commonly intergovernmental exchange, and it is a complicated game with multiple players. FERC's market initiatives might, at times, seem to cede some authority to the states, allowing states to fill in potential holes that remain in federal restructuring efforts. Yet sometimes, FERC asserts or reasserts ongoing federal authority through the courts, in the form of federal preemption, in an attempt to better manage intergovernmental exchange. To date, this kind of exchange has been reactive, leading to legal conflict and ad hoc, unprincipled resolution, typically by courts. However, if federal regulators were proactively attentive to hydraulic regulatory exchange in addressing monopoly power in modern energy markets, they would be better positioned to strike a balance between adaptation and flexibility in their exit strategies.[96]

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94. *But see generally* Jody Freeman, *The Uncomfortable Convergence of Energy and Environmental Law*, 41 HARV. ENVTL. L. REV. 339 (2017) (explaining how even in instances when FERC has not listed environmental goals in describing its initiatives, some initiatives have nonetheless had positive environmental results).

95. For a discussion of how FERC has sought to address reliability, see generally *Hughes v. Talen Energy Mktg., LLC*, 136 S. Ct. 1288 (2016). Against the backdrop of federal inaction on climate change, states have focused on their own climate change initiatives. *See, e.g.*, *Renewable Portfolio Standard Policies*, DATABASE STATE INCENTIVES FOR RENEWABLES & EFFICIENCY (Feb. 2017), http://ncsolarccn-prod.s3.amazonaws.com/wp-content/uploads/2017/03/ Renewable-Portfolio-Standards.pdf [https://perma.cc/V5X4-58RD] (showing state policies requiring renewable energy—policies that are often linked to goals associated with reducing carbon emissions).

96. We do not mean to suggest here that FERC was wholly inattentive to the likelihood that its regulatory approach would sometimes bump up against the states or to argue that FERC

Two recent U.S. Supreme Court cases demonstrate how federal regulators' ad hoc, unprincipled approach to regulatory exchange has produced conflicts due to new forms of state regulation, despite FERC's efforts to exit conventional energy rate regulation. These disputes show how full exit is not something that FERC can easily accomplish, especially where Congress has required that other institutional concerns be balanced, as it did in its effort to close the *Attleboro* gap in the FPA.[97]

These recent disputes also illustrate how the option of FERC creating a wholesale power market that fully preempts state power supply choices has failed on its own terms and is plagued by both legal and policy difficulties. As regulatory approaches to energy markets evolve, FERC and federal courts cannot merely assume that the *Attleboro* gap will be closed by energy markets, as Order 888's initial power market vision may have hoped. FERC's role as an interstate market regulator provides important guidance to state regulators. FERC can better promote market clarity and meet its statutory goal of mitigating monopolistic abuses in energy markets by defining offramps for states to exit competitive wholesale power market spheres—proactively articulating when, and under what conditions, states may pursue their own regulatory objectives outside of the wholesale power market. In this sense, the most difficult issues with modern energy market exit are not about FERC itself exiting competitive markets, as much as they are about FERC allowing states and other institutions to make decisions about power supply outside of energy markets. We argue that this kind of exit by other institutions is best approached and anticipated as a form of hydraulic intergovernmental regulatory exchange—a reactive form of exit by others that federal regulators must facilitate and manage to ensure that it does not produce new forms of market power.

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should have predicted the many conflicts that might arise as it asserted or retracted from certain regulatory authority. But we think that greater ex ante attention to some of the most likely conflicts—such as states' desire to regulate generation (including wholesale generation) for environmental purposes could have eased some of the conflict that emerged in the courts. For a discussion of FERC's tendency to avoid close consideration of the environmental impacts (or justifications) for its policies—including in its policies relating to competitive wholesale rates and open access transmission, see Freeman, *supra* note 94, at 366–71.

97. *See supra* note 29 and accompanying text.

A. *The Significance of Providing States and Other Institutions Exit Options*

FERC's experience with demand response illustrates how a proactive approach to exit strategies is necessary to avoid new regulatory conflicts. Demand response is a practice through which consumers of electricity reduce electricity use in response to higher electricity prices or other signals, such as a request from a utility to reduce demand during periods of peak generation.[98] This type of management of electricity use can substantially reduce electricity prices; for example, if, a utility can structure rates so as to reduce customer energy usage during peak times, it may not be as necessary to draw on expensive new peak generation to satisfy demand for electricity, and demand response provides an energy consumer compensation if it can guarantee this type of valuable service.[99]

In another approach that expands (rather than contracts) certain types of federal regulation, FERC has attempted to further enhance competition in wholesale electricity markets—beyond encouraging independent generation through the opening up of transmission lines—by incentivizing entities to bid demand response resources into wholesale electricity markets. For example, companies called "aggregators" can approach numerous electricity consumers and persuade them to agree to reduce their electricity use when called upon to do so; an aggregator can bid this demand response resource into wholesale electricity markets, creating value by reducing the need for certain expensive peak generation within these markets.[100] FERC incentivized this type of practice through several orders, including Order 719, which mandated utilities' acceptance of demand response bids from aggregators, and Order 745, which ensured that demand response bidders would be compensated for the valuable services they were providing.[101] Both orders, however, allowed for a sort of state "veto" by permitting states to block consumers from selling demand

98. *See* Joel B. Eisen, *Demand Response's Three Generations: Market Pathways and Challenges in the Modern Electric Grid*, 18 N.C. J.L. & TECH. 351, 351 (2017).

99. *See, e.g.*, FERC v. Elec. Power Supply Ass'n (*EPSA*), 136 S. Ct. 760, 771–72 (2016) (describing the net benefits test in FERC Order 745 and how it ensures that only demand response resources that are cheaper than generation are accepted in energy markets).

100. *See, e.g.*, Michael Gallagher, *Demand Response Aggregators and the MISO Wholesale Markets: A Survey of State Laws*, 47 ENVTL. L. REP. NEWS & ANALYSIS 11065, 11071–72 (2017) (noting that "aggregators organize consumers as a group and bid into RTO wholesale markets").

101. *EPSA*, 136 S. Ct. 760, 770–72 (2016) (describing the orders).

response resources in FERC-enabled wholesale markets.[102]

In 2016, the Supreme Court addressed and reversed a D.C. Circuit opinion that vacated Order 745.[103] Among other reasons for reversal, the court of appeals had determined that FERC's federal jurisdiction under the FPA did not extend to demand response resources, which are essential *retail* resources subject to state jurisdiction.[104] The Supreme Court disagreed in *FERC v. Electric Power Supply Ass'n (EPSA)*,[105] concluding that FERC's jurisdiction over "all rules and regulations affecting or pertaining to [wholesale] rates or charges"—an authority called "affecting" jurisdiction—covered demand response resources.[106] The Court observed that through Order 745, FERC was simply regulating "what takes place on the wholesale market"—allowing consumers to sell a cost-competitive electricity resource within these markets.[107] Further, the Court emphasized that the markets into which demand response resources are bid are run entirely by "[w]holesale market operators," and that the express aim of FERC's demand response program was to "improve[] the wholesale market," encouraging more competition in lower prices.[108] Thus, although FERC's order happened to affect state-regulated retail rates, this did not serve as a bar to federal regulation of how demand response resources are priced in the wholesale power market.[109]

Another central aspect of the Court's reasoning in *EPSA* was the FPA's initial purpose of filling the *Attleboro* gap in which neither state nor federal regulators regulated wholesale rates. In recognizing FERC's jurisdiction over demand response, the Court noted that states alone would not be permitted by the FPA to regulate demand response bids within wholesale markets.[110] By contrast, if the Court had followed the reasoning of those opposed to Order 745, it would have invalidated *federal* control over these bids, thus creating the very sort of gap that the FPA was intended to avoid.[111]

A practical consequence of *EPSA*'s focus on this statutory

102. *Id.* at 779–80.
103. *Id.* at 772–73 (reversing *Elec. Power Supply Ass'n v. FERC*, 753 F.3d 216 (2014)).
104. *Id.* at 772.
105. *Id.* at 760.
106. *Id.* at 773–75.
107. *Id.* at 776.
108. *Id.* at 776–77.
109. *Id.* at 776.
110. *Id.* at 780.
111. *Id.*

purpose of closing regulatory gaps in the regulation of market power is the creation of a relatively flexible regulatory space that recognizes a significant sphere of concurrent federal *and* state authority. In affirming FERC's authority to regulate demand response prices in the wholesale market, while also recognizing states' authority over retail aspects of demand response, the Court validated a regime that allows the federal government to engage in constrained exit. The Court's decision allowed for considerable reliance on competitive power markets, while also acknowledging the need to regulate the markets in which this competition occurs; moreover, the Court recognized how federal law leaves states considerable leeway to experiment with competitive resources like demand response as they make their own power supply choices.[112]

B. Managing Hydraulic Exchange with State Regulators

Simply providing states the option to exit the federal system for purposes of experimentation—a common trope of federalism—does not fully capture the complexities of modern regulation, especially in the electric power sector. With cooperative or dynamic federalism emerging as a new norm in energy regulation,[113] in which concurrent spheres of regulation are common, it is important for federal regulators to manage forms of state exit in order to ensure that federal energy market strategies accommodate state policies aimed at ensuring reliable and environmentally responsible approaches to power supply and to reduce (and ideally eliminate) dysfunctional conflict.

One novel strategy FERC has used to help grease the wheels of regulatory exchange without entirely relinquishing its authority over basic substantive policy issues is the state opt out or policy veto. In recognizing FERC's demand response approach as a "program of cooperative federalism," the Court noted that FERC's rules "allow[] any State regulator to prohibit its consumers from making demand response bids in the wholesale market," thus giving states "the means to block whatever 'effective' increases in retail rates demand response

112. Jim Rossi, *The Brave New Path of Energy Federalism*, 95 TEX. L. REV. 399, 436–37 (2016).

113. As noted above, we use "cooperative" federalism in a loose sense here. *See supra* note 9. Within the more traditional form of cooperative federalism, such as under the Clean Air Act, California is allowed to regulate motor vehicle emissions more stringently than federal standards if it receives a "waiver" from the EPA. *See* Ann E. Carlson, *Iterative Federalism and Climate Change*, 103 NW. U. L. REV. 1097, 1109 (2009) (discussing the waiver and other aspects of the Clean Air Act).

programs might be thought to produce."[114] This "opt out" or "veto" option would appear to envision FERC setting basic expectations for demand response resources in wholesale markets while still allowing state regulators an opportunity to experiment with a wide range of complementary approaches to power supply that promote energy conservation and also protect retail customers. Because states retain authority over retail rates, which are fundamental to retail customer demand response, states have been able to pursue a diverse range of policy experiments with energy conservation and efficiency. This "bottom-up" approach has allowed demand response resources to develop while also enabling markets and regulators (both federal and state) to learn about the viability of various retail customer demand response initiatives. The Court did not reason that the state veto option (providing each state its own "offramp" from federal market policies) is *required* by the FPA or *necessary* to support any federal regulation of state barriers to demand response as a practice affecting wholesale markets. Still, the Court considered the state veto option an important component of FERC's demand response rules that helped to soften the impact of an expansion of federal regulatory authority over demand response pricing while also recognizing a continued state role over power supply.

We think that the notion of a state veto over energy resource participation in federal power markets is a powerful tool for federal regulators in approaching other issues where states are experimenting with policies regarding power supply decisions. By permitting retail customers, who are subject to state jurisdiction, to essentially circumvent state jurisdiction and opt for participation in competitive wholesale markets instead—unless a state has prohibited this outright—FERC empowered customers themselves to make the decision to exit traditional forms of state regulation and to participate in new demand response markets. The kind of veto option helped mitigate market power and supported state buy-in by allowing states to prohibit retail customers from participating in these federally run demand response markets, thus choosing to exit FERC's market policies.

Much of the regulatory veto literature tends to cast a wary eye on vetoes as creating holdout problems, and indeed, the veto has some important limitations, which are flagged below. However, partial exit from a regulatory task—here requiring participation in demand

114. *EPSA*, 136 S. Ct. at 779–80.

response markets—can allow other institutions (such as states) some meaningful input in policies that help to mitigate market power. The state veto option over demand response appears to have been a key proactive measure taken in FERC's effort to partially exit regulated wholesale markets and further encourage competition in these markets. States are often considered to be laboratories of democracy,[115] but federal regulators themselves can learn from the diversity of different states' approaches.[116] As important, having some buy-in from states as partners can also help federal regulators mediate the hydraulics of regulatory exchange in a manner that avoids outright preemption and also minimizes the risk of regulatory backlash from states.

This is not the first time that FERC has given states options about how they wish to participate in interstate energy markets as a way of getting more buy-in from them and learning from their experiments. Through an earlier series of orders, FERC incentivized utilities to hand over control of their transmission lines to regional organizations,[117] and most recently, FERC required states and the utilities regulated by states to engage in regional planning to address the need for new electricity transmission lines.[118] In a field like energy law, in which the federal government and states operate within a shared, sometimes ambiguous, and often contested[119] jurisdictional space, incorporating these kinds of vetoes into exit from certain forms of regulation can serve as the type of compromise that allows for effective partial exit with continued, limited federal oversight and state buy-in.

This veto option powerfully demonstrates the importance of FERC's anticipation of concurrent state regulation in its market initiatives. But the FPA's federalism balance also presents complicated new issues not fully addressed by the veto option crafted by FERC—

115. *See, e.g.*, Brian Galle & Joseph Leahy, *Laboratories of Democracy? Policy Innovation in Decentralized Governments*, 58 EMORY L.J. 1333, 1351, 1335-37 (2009) (describing this common assumption found within court cases and the scholarly literature).

116. *Cf.* Hannah J. Wiseman & Dave Owen, *Federal Laboratories of Democracy*, U.C. DAVIS L. REV. (forthcoming 2018) (describing how the federal government often initiates experiments or works with states to carry out experiments and can learn from the diversity of policy approaches tried at different governmental levels).

117. Order No. 2000, *supra* note 17, at 831; Order No. 888, *supra* note 13, at 21,551.

118. Order No. 1000, *supra* note 67, at 49,845.

119. For recent cases debating federal and state authority over electricity regulations, see *FERC v. Elec. Power Supply Ass'n (EPSA)*, 136 S. Ct. 760 (2016), and *Hughes v. Talen Energy Mktg., LLC*, 136 S. Ct. 1288 (2016), along with the ongoing litigation about state policies discussed *infra*.

specifically, to what extent can state regulators "exit" or opt out of interstate energy markets in ways that promote new forms of monopolistic abuses or impede FERC's goal of enhancing competition in energy markets? To what extent can state exit be inconsistent with the FPA's aim of closing the *Attleboro* gap in the regulation of energy markets?

Without doubt, there are instances where reactive regulatory exchange has facilitated continued monopolization of energy supply and parochial forms of protectionism, which has likely helped to sustain higher electricity prices. For example, in the context of transmission planning, though FERC has solicited input from states, states still may choose the type of planning process involved and design this process. As some commenters have observed, this allows some states to essentially avoid regional planning and largely maintain the status quo.[120] Yet the FPA recognizes that there must be some limit on how far a state can go when it wishes to opt out of federal market policies aimed at mitigating market power. For example, it would seem that no state can outright prohibit a power supplier with market power from selling into the wholesale market, as this would encroach on FERC's jurisdiction to mitigate monopolistic abuses in the wholesale power market. Some states have come perilously close to this kind of encroachment by narrowly construing their jurisdiction over the construction of power plants that produce both retail and wholesale electricity. For example, Florida's Supreme Court has held that its siting statute, which requires a need finding prior to building a new power plant, does not allow the construction of a plant by an out-of-state developer that would have sold some of its electricity to customers in Florida but might have potentially sold additional wholesale electricity across state lines.[121] Similarly, in the approval of new electric power transmission lines, some states favor in-state or incumbent utilities in the approval process.[122] Perhaps the ultimate solution to these problems is for FERC to preempt all protectionist state initiatives that promote monopolistic discrimination in wholesale power markets.[123] However, short of a controversial (and legally

120. *See, e.g.*, Welton, *supra* note 66, at 461–62 (noting that regional and local planners are only making "vague promises" with respect to certain Order No. 1000 directives).

121. Tampa Elec. Co. v. Garcia, 767 So. 2d 428, 434 (Fla. 2000).

122. Alexandra B. Klass & Jim Rossi, *Revitalizing Dormant Commerce Clause Review for Interstate Coordination*, 100 MINN. L. REV. 129, 189–97 (2015).

123. *See supra* note 9 and accompanying text. This approach presents some important federalism tradeoffs: It would turn a cooperative federalism program into a unitary preemption

questionable) assertion of preemptive authority over all state regulation of power generation, the veto option has allowed ambitious federal policies that help open up markets to mitigate market power and reduce electricity prices without limiting state experimentation. Veto likely will offer similar promise in emerging areas of energy law such as energy storage, where jurisdictional space is once again quite uncertain.[124]

Even if states do not exit federal regulatory market power mitigation approaches outright, as FERC has transitioned to competitive interstate markets, energy industry stakeholders increasingly are looking to states and other institutions to provide for important public goods that these markets leave unaddressed. At some level, these new forms of state intervention may interfere with pricing signals in competitive markets, and some calls for preemption of states' reactive exit have focused on whether the incentives or subsidies interfere with or impact a wholesale rate.[125] However, these state initiatives can also help to produce undersupplied public goods and can mitigate market power by removing barriers to entry and promoting new forms of power supply. In this sense, we think that an understanding of exit aimed at mitigating market power in electric power supply can help to elucidate why it is important for courts and FERC to give states considerable leeway to adopt their own reactive forms of exit, rather than preempt them outright,

The Supreme Court's 2016 decision in *Hughes v. Talen Energy Marketing*[126] demonstrates the delicate balance that must be struck as stakeholders seek new forms of state regulation as a type of hydraulic

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program, moving the federalism approach of the FPA from quadrant 4 to quadrant 2.

124. For discussion of regulatory uncertainty in the area of energy storage, see Amy L. Stein, *Reconsidering Regulatory Uncertainty: Making a Case for Energy Storage*, 41 FLA. ST. U. L. REV. 697 (2014). FERC recently adopted a new rule designed to incorporate the participation of energy storage in wholesale power markets. FERC Order No. 841, Electric Storage Participation in Markets Operated by Regional Transmission Organizations and Independent System Operators, 83 Fed. Reg. 9580 (Mar. 6, 2018) (to be codified at 18 C.F.R. pt. 35). However, as with demand response, energy storage policies and incentives will depend heavily on state regulators. *See* Peter Maloney, *The Flip Side of FERC's Landmark Storage Order: A Call for States to Take Action*, UTIL. DIVE (Mar. 6, 2018), https://www.utilitydive.com/news/the-flip-side-of-fercs-landmark-storage-order-a-call-for-states-to-take-a/518497/ [https://perma.cc/AK8N-JSYT].

125. *See, e.g.*, Hughes v. Talen Energy Mktg., LLC, 136 S. Ct. 1288, 1299 (2016) (indicating that a previous case makes "clear that States [impermissibly] interfere with FERC's authority by disregarding interstate wholesale rates FERC has deemed just and reasonable").

126. Hughes v. Talen Energy Mktg., LLC, 136 S. Ct. 1288 (2016). New Jersey attempted a similar approach, which the Third Circuit invalidated in *PPL Energyplus, LLC v. Solomon*, 766 F.3d 241 (3d Cir. 2014).

relief (or exit) from FERC-regulated competitive energy markets. *Hughes* held that a Maryland scheme to compensate the construction of new natural gas plants to improve customer reliability is preempted under the FPA.[127] Perceiving the regional market incentives in PJM (a regional market in which Maryland utilities voluntarily participate) as insufficient to incentivize new construction within its borders, Maryland enacted a scheme whereby gas power plant owners would be compensated with a fixed revenue stream for capacity that cleared the relevant market.[128] In other words, compensation was designed to provide more revenue for the plant's owners than they would have received in PJM's capacity market, which FERC had approved.[129]

Because Maryland's auction for new in-state generation interfered with FERC's exclusive jurisdiction over interstate wholesale sales of energy under the FPA, in *Hughes* the Court upheld a lower court determination that the Supremacy Clause of the U.S. Constitution preempts the Maryland scheme.[130] Under the FPA, "FERC has approved" the regional "capacity auction as the sole [rate setting] mechanism for sales of capacity" in order to mitigate market power in the region, and, pursuant to PJM's auction, FERC "has deemed the clearing price *per se* just and reasonable."[131] Given this comprehensive measure to mitigate market power in the capacity market, Maryland was thus preempted from adopting a plan for new power generation that provided subsidies that, in effect, set a different wholesale price by guaranteeing a select power generator a rate through a 20 year-contract with the state's incumbent utilities.[132] This kind of arrangement interfered with FERC's effort to address market power through the capacity market, particularly given that Maryland had authorized its utilities to participate in a FERC-approved wholesale energy supply market and to price and compensate capacity on this basis, rather than in some other manner.

The Court's *Hughes* decision has left many regulators, lawyers, and industry stakeholders puzzled.[133] At the extreme, litigants

127. *Hughes*, 136 S. Ct. at 1290.

128. *Id.* at 1293.

129. *Id.* Maryland is one of thirteen states that have authorized their utilities to operate in PJM—a regional transmission organization that operates the largest organized wholesale power market in the United States.

130. *Id.* at 1299.

131. *Id.* at 1297.

132. *Id.*

133. *E.g.*, Emily Hammond, Response, Hughes v. Talen Energy Marketing, LLC: *Energy*

challenging state initiatives have read *Hughes* as grounding preemption of state initiatives on whether they target or interfere with wholesale prices. *Hughes* may support an expansive view of preemption, insofar as the Court noted that states may not tether revenues to wholesale market participation or condition payments on capacity clearing the relevant capacity market auction.[134] However, since the Court expressly emphasized the narrowness of its holding,[135] *Hughes'* reach also appears to be limited by its facts. The Court was particularly careful not to endorse blanket preemption by FERC of all state incentives and subsidies based on an idealized competitive wholesale power market. It fell short of concluding that every state subsidy or incentive for power supply is preempted because it impacts or undermines a wholesale energy price. The decision expressly left open "the permissibility of various other measures States might employ to encourage development of new or clean generation, including tax incentives, land grants, direct subsidies, construction of state-owned generation facilities, or re-regulation of the energy sector."[136]

At its most fundamental level, *Hughes* would seem to prohibit state regulators from adopting investment incentives for power supply that directly target federal wholesale power market participation in ways that enable an incumbent utility or energy resource to expand its market power despite federal mitigation efforts through wholesale markets, as the Maryland capacity incentives arguably may have.[137] New state incentives or subsidies for power supply that create market power might invite states to bolster incumbent firms or give favorable treatment to local resources with market power over out-of-state sources. This can lead to distortions in energy price signals. However, we do not believe that it is simple distortion of wholesale markets that creates a preemption problem under *Hughes*. Rather, it is state intervention that risks undue discrimination associated with monopoly power by incumbent power suppliers without any regulatory oversight. Consistent with this reading of *Hughes*, FERC's initial response to the decision indicated some hostility toward state-supported cost recovery

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Law's Jurisdictional Boundaries—Take Three, GEO. WASH. L. REV. DOCKET (Apr. 22, 2016), http://www.gwlr.org/hughes-v-talen-energy-marketing-llc-energy-laws-jurisdictional-boundaries-take-three/ [https://perma.cc/ZG5J-HFHG].

134. *Hughes*, 136 S. Ct. at 1299.

135. *Id.* ("Our holding is limited: We reject Maryland's program only because it disregards an interstate wholesale rate required by FERC.").

136. *Id.*

137. *See id.*

for legacy coal or nuclear plants that are no longer competitive in regional wholesale power markets operating under rules similar to those of PJM in Maryland.[138]

The emphasis on whether someone—the federal government or the state—is mitigating market power seems important in the *Hughes* context, as states can still opt to not participate in regional energy markets and to address market power issues themselves through conventional rate regulation. In this sense, states continue to hold a stealth exit option of their own—one that allows them to pursue reliability goals, like Maryland's, and other values that wholesale markets do not sufficiently price, such as enhancing reliance on low-carbon power. Traditionally regulated states such as Georgia and South Carolina offer significant subsidies for new nuclear and carbon capture projects, without running into any preemption challenge under federal law; these incentives are not likely to be invalidated on preemption grounds because states in the southeastern United States do not operate within competitive wholesale markets like PJM, nor have they restructured at the retail level.[139] Unlike Maryland, therefore, these states have retained their full authority to decide what values to pursue and compensate, while also continuing to protect consumers. Although wholesale costs must be carried forward into state rate-making proceedings,[140] these states still retain the authority to set each utility's return on investment. Moreover, the wholesale costs in these states are not derived from competitive auctions, but rather from bilateral contracts.[141] In these states, therefore, providing compensation for the costs of power project construction does not "second-guess" or "disregard[] [an] interstate wholesale rate[] FERC has deemed just and reasonable" for purposes of mitigating market power.[142] Thus, in contrast to the regional capacity market governing Maryland utilities that FERC had approved, retail reliability (and the need for new power supply capacity) in many other parts of the country

138. *See* John Funk, *FERC Rejects PUCO-Approved FirstEnergy, AEP Power Deals*, PLAIN DEALER (Apr. 28, 2016), http://www.cleveland.com/business/index.ssf/2016/04/ferc_rejects_puco_approval_of.html [https://perma.cc/6AYW-6AYR] (describing FERC's rejection of monthly surcharges aimed at protecting existing coal and nuclear plants from competitive markets).

139. Emily Hammond & David B. Spence, *The Regulatory Contract in the Marketplace*, 69 VAND. L. REV. 141, 209 (2016).

140. Nantahala Power & Light Co. v. Thornburg, 476 U.S. 953, 961 (1986).

141. *See* Hammond & Spence, *supra* note 139, at 154.

142. *Hughes*, 136 S. Ct. at 1298–99.

remains solidly within the wheelhouse of state regulators and is not priced in the interstate wholesale market.[143] Too broad of a reading of *Hughes* could thus create hydraulic incentives for states to re-regulate as they address the social project of grid decarbonization.

For the remaining two-thirds of the United States, wholesale electricity sales occur within organized competitive markets such as PJM, which are more comprehensively regulated through FERC's approval and oversight of regional market tariffs.[144] In these areas, we believe that the application of *Hughes* to state incentives and policies must be approached with attention to the purpose behind the state intervention, as well as its impact on market power. Absent any effective market price on carbon such as a national carbon tax, regional initiatives, including PJM's capacity market, fail entirely to price the carbon attributes of various sources of energy.[145] As Justice Ginsburg wrote for the *Hughes* majority, "We reject Maryland's program only because it disregards an interstate wholesale rate required by FERC."[146] This would appear to leave states—even those in organized regional markets—considerable flexibility to adopt power supply incentives and subsidies that advance other values beyond what is reflected in FERC-approved market prices.[147] Even if FERC-approved regional energy markets envision wholesale prices being set in a certain manner, state regulatory measures that aim to promote clean forms of power generation—especially those with fewer carbon emissions—may therefore be able to coexist with FERC's regulation of wholesale power markets, as long as they do not enhance market power. The basic preemption concern of *Hughes* should only really come into to

143. Even where, as in PJM, capacity markets provide some reliability pricing in the wholesale market, it is not clear that they provide a perfect market valuation of reliability values associated with different energy resources. The American Public Power Association, for example, has highlighted how long-term contracts provide a superior way of promoting reliability in comparison to capacity markets, and how capacity markets can result in different reliability pricing based on how a state chooses to address its retail market. *See* Randy Elliott, *Staying Power of a Bad Idea: Capacity Markets' Reliability Pricing Mechanism*, AM. PUB. POWER ASS'N (Sept. 8, 2015), http://blog.publicpower.org/sme/?p=761 [https://perma.cc/XM2L-E7LF].

144. *See Overview*, FED. ENERGY REG. COMM'N, https://www.ferc.gov/market-oversight/mkt-electric/overview.asp [https://perma.cc/26RU-8RU8] (noting that two-thirds of the nation's electricity load is served by organized regional markets).

145. Hammond & Spence, *supra* note 139, at 174, 212.

146. *Hughes*, 136 S. Ct. at 1299.

147. *Id.* Justice Sotomayor's concurrence also underscored "the importance of protecting the States' ability to contribute, within their regulatory domain, to the Federal Power Act's goal of ensuring a sustainable supply of efficient and price-effective energy." *Id.* at 1300 (Sotomayor, J., concurring).

play where the state incentives or subsidies are presenting a market power problem that facilitate discrimination in bulk power pricing, which is within the scope of FERC's authority to regulate just and reasonable pricing.[148]

Such a reading of *Hughes* leaves states considerable space to fill in public good gaps that FERC-regulated interstate power markets do not address, so long as states do not themselves produce new wholesale market power problems. As *Hughes* reminds us, such efforts cannot be motivated by or target a FERC-approved pricing scheme designed to mitigate market power in wholesale energy sales, such as the capacity market operated by PJM. But to the extent that state regulators adopt incentives or subsidies that take aim at legitimate regulatory objectives, such as reliability or environmental protection, without targeting federal pricing efforts aimed at mitigating market power, state regulators are exercising legitimate control over power generation policies. It is thus consistent with *Hughes*'s preemption analysis for states to compensate energy resources differently, even through subsidies.

Consistent with this approach, to date federal courts have recognized that states retain considerable leeway to pursue their own regulatory policies so long as their subsidies do not aim directly at wholesale prices. One post-*Hughes* challenge targeted the N.Y. Public Service Commission (NYPSC) Clean Energy Standard, which, among other things, compensates upstate merchant nuclear power plants for the social cost of carbon that their electricity generation avoids.[149] This Zero Emission Credit approach provides nuclear plant operators payments equivalent to the social cost of carbon (with small adjustments) for the first two-year period of the Credit.[150] To the extent

148. *See supra* note 10 and accompanying text.

149. N.Y. PUB. SERV. COMM'N, ORDER ADOPTING A CLEAN ENERGY STANDARD 1 (2016), http://documents.dps.ny.gov/public/Common/ViewDoc.aspx?DocRefId={44C5D5B8-14C3-4F32-8399-F5487D6D8FE8} [https://perma.cc/JPH2-RKLF]. In adopting this approach, New York regulators rejected earlier proposals that were much more closely tied with wholesale revenues. *See* Joel B. Eisen, *Dual Electricity Federalism Is Dead, But How Dead, and What Replaces It?*, 8 GEO. WASH. J. ENERGY & ENVTL. L. 3, 15–16 (2017) [hereinafter Eisen, *Dual Electricity Federalism*].

150. N.Y. PUB. SERV. COMM'N, *supra* note 149, at 51. This is a "Zero Emission Credit" approach because nuclear power plants do not emit carbon (aside from lifecycle emissions associated with mining for and transporting uranium, among other parts of the fuel cycle). *See* NATL. RENEWABLE ENERGY LAB., LIFE CYCLE GREENHOUSE GAS EMISSIONS FROM ELECTRICITY GENERATION 2 (2013), https://www.nrel.gov/docs/fy13osti/57187.pdf (describing relatively low life-cycle carbon emissions from nuclear energy). By paying these plants for the social cost of carbon the state supports the plants monetarily and helps them to stay in business

that this approach does not limit wholesale market participation or calculate incentives based on the wholesale price of energy, it would appear to fall on the "safe" side of *Hughes*. The NYPSC was careful to note that it was not setting a price floor for nuclear power, and that any adjustments to prices are for purposes of consumer protection.[151] In later years, though, there are some price adjustments for wholesale energy and capacity market revenues[152] that would seem to face uncertainty under an expansive reading of *Hughes*'s preemption analysis.[153] Despite these legal concerns, a federal district court rejected a preemption challenge to the New York Zero Emission Credit, noting that the challengers failed to distinguish the program from renewable energy credits that FERC had approved under the FPA.[154] A challenge to a similar Illinois program providing for zero emission credits based on carbon price (featuring discounts based on wholesale prices to protect consumers) was also rejected on the grounds that it is not inconsistent with any existing FERC policy.[155]

The ultimate outcome of these disputes surrounding state subsidies remains uncertain as the issue is appealed, but we believe that evaluating them with respect to their impacts on wholesale market power mitigation would leave states considerable, but not unlimited, leeway to address grid decarbonization, even in FERC-regulated, organized markets. States can exit regional markets entirely to the extent that they refuse to participate in coordinated markets and continue to set retail rates, though they still must pass through reasonable wholesale power purchase costs. Even when a state's utilities participate in FERC-regulated regional markets, under the recent readings of *Hughes*, states could also opt to provide public goods that FERC has not priced in its general market policies or in market

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despite their high costs relative to alternatives such as natural gas and renewable energy sources. *See* U.S. ENERGY INFO. ADMIN., LEVELIZED COST AND LEVELIZED AVOIDED COST OF NEW GENERATION RESOURCES IN THE ANNUAL ENERGY OUTLOOK 2018 5, https://www.eia.gov/outlooks/aeo/pdf/electricity_generation.pdf [http://perma.cc/FUA6-95BK] (showing relatively high costs of nuclear energy).

151. N.Y. PUB. SERV. COMM'N, *supra* note 149, at 139.

152. *Id.* at 51.

153. For further analysis, see Eisen, *Dual Electricity Federalism*, *supra* note 149, at 9.

154. Coal. for Competitive Energy, Dynegy Inc. v. Zibelman, No. 16-CV-8164 (VEC), 2017 WL 3172866, at *16 (S.D.N.Y. July 25, 2017) (rejecting challenge to New York's zero emission credit program on the grounds that challengers had failed to distinguish the program from renewable energy credits, which FERC had approved under the FPA).

155. *See* Vill. of Old Mill Creek v. Star, Nos. 17 CV 1163 & 17 CV 1164, 2017 WL 3008289, at *14 (N.D. Ill. July 14, 2017) (rejecting preemption clause challenge to Illinois zero emission credits for nuclear plants on the grounds that there is no conflict with any existing FERC policy).

tariffs that it has approved, so long as they do not undermine a FERC's market power mitigation efforts. On this view, it would be permissible for these state subsidies to influence wholesale prices to some degree (as does every form of state regulation), so long as states neither condition the subsidies on a supplier's participation in wholesale power markets, nor base the subsidies solely on a competitive wholesale price aimed at mitigating market power. The key inquiry is not whether a subsidy merely interferes with a market price in the wholesale market; rather, it is whether the subsidy promotes market power in a manner that conflicts with federal initiatives to mitigate market power through interstate power markets. Ultimately, answering this kind of question to favor preemption of a state initiative aimed at power supply would require FERC to make a finding that discrimination exists in wholesale markets, which will depend on the characteristics of different energy resources as well as regional markets.

With ongoing litigation, there remains uncertainty for states wishing to pursue particular policies, including incentives and subsidies to promote clean energy. Courts may never be able to eliminate all of this uncertainty, as no jurisdictional test can resolve every fact scenario.[156] Nevertheless, FERC can help to reduce some of the uncertainty with its own policies by clarifying which FERC approvals are aimed at mitigating market power and also clarifying when the commission intends for states to continue to adopt their own initiatives to address discrimination in power supply markets. For example, FERC could adopt guidelines that identify forms of states' existing market power mitigation approaches or those that, as a policy matter, FERC considers most desirable. By providing greater clarity, FERC could better anticipate and manage the pressures for regulatory exchange as states pursue their own market power mitigation and grid decarbonization initiatives through reactive forms of exit from wholesale markets.

FERC could encourage hydraulic regulatory exchange by clarifying that wholesale market prices are not the exclusive gauge by which state initiatives will be judged. The recent federal district court decision rejecting a preemption challenge to Illinois's incentives for zero emission energy resources reasoned that there was no conflict with existing FERC policies, even though these might impact wholesale prices.[157] FERC's promotion of wholesale markets was

156. For criticism of court-led preemption approaches, see Rossi, *supra* note 112.

157. *Vill. of Old Mill Creek*, 2017 WL 3008289 at *14.

designed to mitigate market power in power supply, but because it also leaves both power supply decisions and retail rates to states, it is important to recognize how the regulatory gaps (first identified in *Attleboro*) that motivated adoption of the FPA abound in modern wholesale markets. As with demand response, FERC would appear to have a range of options that allows for sharing lanes with state regulators as they find new ways to incentivize clean energy resources: Namely, it can recognize acceptable forms of state hydraulic exchange—perhaps through the option of a policy statement identifying permissible forms of state subsidies—while also encouraging states to participate in wholesale markets as partners in mitigating market power. Absent some proactive approach by FERC, however, it would appear that states seeking to address problems not priced into wholesale power markets such as climate change continue to retain some significant "exit" options of their own—that is, the ability to opt out of fully competitive markets envisioned by FERC. For example, states substantially influence the types of new generation built through renewable portfolio standards (RPS), which require a certain percentage or amount of retail electricity to come from renewable sources. This sort of mandate for retail generation can impact the types of generation built to serve both wholesale and retail customers and is unlikely to present any market power problem at all.[158]

At least in the energy context, exit is not a one-way strategy that federal regulators monopolize. Framing state responses as examples of hydraulic exchange is important if regulators are to be attentive to the potential for regulatory gaps in mitigating market power in wholesale power supply markets. Because of the cooperative federalism design of the FPA, states and market participants have exit options too, and federal regulators need to design their own exit strategies with this possibility in mind.

CONCLUSION

Our case study of FERC's effort to exit traditionally regulated energy markets shows that, at some level, there are both legal and

158. RPS affect utility decisions in terms of which type of generation to build in part because compliance with RPS is achieved through the generation of a "renewable energy credit" (REC). *See* Felix Mormann, *Clean Energy Federalism*, 67 FLA. L. REV. 1621, 1631 (2015) (noting that "[i]ndependent power producers can sell their RECs to utilities to earn a premium on top of their income from power sales in the wholesale electricity market").

political economy limits on how far federal regulators can go in exiting conventional energy regulation aimed at addressing market power. At some basic level, the law requires continued regulatory vigilance over pricing arrangements or other initiatives that promote market power, so pure exit typically is not a strategy available to federal regulators, and intra-agency exchange—in which deregulation in one sphere accompanies enhanced regulation in another—is often the norm. Moreover, given the complex federalism backdrop of utility regulation, which creates another constraint on pure exit, the forms of exit that occur in energy law look much more like regulatory exchange, adding further nuance to adaptive exit. Federal regulators operating in such a context generally cannot exit conventional regulation without expecting hydraulic reactions by other institutions that can step in with their own substitute initiatives to provide the public goods formerly provided through federal regulation. The FPA would appear to allow states substantial leeway where FERC is not already regulating an activity, but FERC also needs to monitor these reactions to ensure that they do not create new forms of market power.

Unlike the Endangered Species Act—the rich point of departure for Ruhl & Salzman's insightful assessment of regulatory exit—not all federal statutes allow agencies leeway to fully exit their traditional regulatory missions.[159] Cooperative federalism[160] statutes such as the FPA—which recognize institutions with overlapping regulatory authority—may be poor candidates for pure exit, though they may allow constrained forms of exit for some regulatory tasks. Study of the transition to competitive energy markets as a form of exit also underscores the significance of paying attention to hydraulic regulatory exchange during regulatory transitions, including efforts to exit conventional regulation. As the potential for regulatory overlap expands, one agency's exit strategies will create new pressures for other institutions, such as states and regional transmission organizations, to intervene. Regulators operating under statutes that recognize shared jurisdictional areas therefore need to anticipate and facilitate regulatory exchange in their exit strategies, and acknowledge how exchange connects to their statutory constraints and regulatory objectives. This is not a new problem, and it is certainly not unique to

159. *See* Ruhl & Salzman, *supra* note 3, at 1319 ("A rare example among regulatory statutes, the very purpose of the [Endangered Species Act] is to put itself out of business by promoting the recovery of listed species to the point of justifying delisting.").

160. Again, we use cooperative federalism in the loose sense. *See supra* note 9.

energy law. Professor William Buzbee, for example, has recognized how some environmental statutes can create new forms of regulatory gaps that are at odds with their goals.[161] Complex and overlapping jurisdiction may heighten the need for agency initiatives that anticipate and facilitate regulatory exchange as a pragmatic solution to better manage other institutions. We think that mechanisms such as a veto, which engages other institutions (namely states) in federal exit initiatives, is one way to help create a balance between entrenchment and flexibility in regulatory exchange. And the experience of energy regulation with this approach shows some promise in striking such a balance—and that, in the context of statutes such as the FPA, which are aimed at filling regulatory gaps, addressing or anticipating hydraulic regulatory exchange may even be required as a way of mitigating market power in energy supply.

In adopting regulatory exchange strategies, agencies must also be mindful of how overlapping regulators can create new market power problems. Regulatory exchange might encourage dysfunctional behaviors—such as selective disclosure of information or lobbying by private entities—and it could lead to protectionism or dysfunctional clashes between different regulators. These are certainly risks, though a *failure* to acknowledge exchange in exit strategies increases the risks of strategic disclosure, lobbying, or dysfunctional competition for regulation. In addition, at some level, giving other institutions too much of a voice can be obstructive or could lead to situations in which other institutions overwhelmingly reject the approach of federal regulators. This is something that might be managed to the extent that federal regulators give other institutions a voice through mechanisms such as a veto and use this as an information-gathering device that allows the federal government to learn from these experiences, influencing the course of federal policies in the future. For example, FERC has done this with demand response[162] and in its approach to transmission planning, which requires regional energy market operators to take into account state public policy objectives including renewable power requirements in planning for new transmission facilities.[163] In this sense, hydraulic regulatory exchange thus not only

161. *See generally* William W. Buzbee, *Recognizing the Regulatory Commons: A Theory of Regulatory Gaps*, 89 IOWA L. REV. 1 (2003) (focusing on the need for a way to address regulatory gaps in environmental enforcement under cooperative federalism statutes).

162. *See supra* note 115 and accompanying text (discussing FERC learning from state demand response initiatives).

163. FERC Order No. 1000, *supra* note 67, at 49,845–46 (requiring transmission planning

gives a voice to other institutions but produces valuable information for federal regulators, as well as markets, that can help in mitigating market power.

Ruhl and Salzman are correct to warn against pure exit as a way of dismantling energy regulation and to recommend adaptive exit as a strategy for energy markets.[164] Ultimately, however, we might question whether the regulatory transition in energy markets is a form of exit at all. Energy markets were created for an interventionist reason—to mitigate market power—and need regulation to succeed. Exit from traditional regulation might be justified where it works to mitigate market power, but in other contexts exit may not be consistent with the goals of modern energy markets. Importantly too, the notion that there is a single regulator in modern energy markets is a myth. Exiting one evil can readily open up the possibility of another one, including the possibilities for new forms of exit that (often unintentionally) increase rather than mitigate market power. As federal agencies exit some of their traditional regulatory tasks, they must also devise strategies to strike a new regulatory balance as stakeholders demand new forms of regulation to fill in the void. At bottom, hydraulic regulatory exchange in the context of the federal transition to competitive energy markets shows how some government decisions that can be described as regulatory exit are nothing more than decisions to shuffle primary regulatory authority between different institutions who have comparative advantages and disadvantages in addressing market power in energy supply. Perhaps they should be approached as such.

processes that "identify and evaluate transmission needs driven by relevant Public Policy Requirements").

164. Ruhl & Salzman, *supra* 3, at 1321–22.