COMMERCE CLAUSE ANALYSIS OF *PPL v. NAZARIAN* AND *SOLOMON v. HANNA*

ADDITIONAL GUIDANCE FOR STATES SEEKING TO RETAIN RPS BENEFITS IN STATE

Prepared for the

State-Federal RPS Collaborative

by

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Disclaimer

Commerce Clause Analysis of *PPL v*. *Nazarian* and *Solomon v. Hanna*

Abstract

This paper summarizes two recent federal district court cases, *PPL v. Nazarian*, Docket No. 12-1286 (D. MD September 30, 2013) and *PPL v. Hanna*, CA11-745 (D. NJ October 11, 2013) which involved constitutional challenges to Maryland and New Jersey programs designed to spur development of in-state generation through subsidized long-term power contracts. This paper discusses the potential implications of *Nazarian* and *Hanna* for the constitutionality of state renewable portfolio standard (RPS) programs.

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Additional Guidance for States Seeking to Retain RPS Benefits In State

This paper summarizes two recent federal district court cases, *PPL v. Nazarian*, Docket No. 12-1286 (D. MD September 30, 2013)[1] and *PPL v. Hanna*, CA11-745 (D. NJ October 11, 2013)[2] which involved constitutional challenges to Maryland and New Jersey programs designed to spur development of in-state generation through subsidized long-term power contracts. In both cases, the court ruled that the programs complied with the Commerce Clause of the United States Constitution because the states' strong interest in reliability justified the preference for in-state development. Ultimately, however, both courts invalidated the programs on Supremacy Clause grounds, finding that the state-mandated subsidized contract rates designed to encourage new generation interfered with the Federal Energy Regulatory Commission's (FERC) regulation of wholesale markets and therefore were preempted.

The Commerce Clause prohibits states from favoring local industry to the disadvantage of out-of-state competitors for economically protectionist reasons. Under the Supremacy Clause, when both the federal government and the states attempt to regulate or encroach on an area exclusively within the federal government's jurisdictional purview, federal law takes supremacy over (or "preempts") conflicting state law.

This paper discusses the potential implications of *Nazarian* and *Hanna* for the constitutionality of state renewable portfolio standard (RPS) programs. Although *Nazarian* and *Hanna* did not address RPS programs specifically, they can provide additional guidance to states seeking to retain economic benefits of these programs.[3] This is because *Nazarian* and *Hanna* involve the electric utility sector and ultimately held that the disputed state programs complied with the Commerce Clause. Thus, they shed some light on key factors that may gird an RPS program against a constitutional challenge.

Although this paper also describes the aspects of the rulings dealing with the Supremacy Clause in order to provide context, the Supremacy Clause has little bearing on RPS programs. FERC has held that states and not the federal government have exclusive authority to create

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[1] The decision is available at http://hblaw.com/blog/energymatters/wp-content/uploads/2013/10/PPL-Energy-Plus-v-Nazarian-Dist-Ct-Op..pdf.

[2] The decision is available at http://scholar.google.com/scholar_case?case=12897546529430595655&q=hanna+ppl+ferc&hl=en&as_sdt=20006&as_ylo=2013.

[3] See Carolyn Elefant and Ed Holt, *The Commerce Clause and Implications for State Renewable Portfolio Standards* (Montpelier: Clean Energy States Alliance, 2011). Available at http://www.cleanenergystates.org/assets/Uploads/CEG-Commerce-Clause-paper-031111-Final.pdf. This report provides options for states to implement RPS programs without running afoul of the Commerce Clause.

and implement RPS programs – and therefore, the state decisions about RPS programs cannot conflict with or encroach upon a federally regulated matter in violation of the Supremacy Clause.[4]

I. Overview

Maryland and New Jersey are part of PJM, a regional transmission organization (RTO) that administers wholesale electric power markets for the mid-Atlantic region. In 2007, PJM implemented a program known as the Reliability Pricing Model (RPM), which is designed to create long-term price signals to attract investments in reliability and new generation.[5] As part of the RPM program, PJM conducts competitive auctions to procure capacity that is still needed after market participants have obtained self-supply or entered into bi-lateral contracts. The auctions establish the market price for capacity, with higher prices signaling increased demand – which in theory, incentivizes generators to construct new facilities. In addition, prices in PJM markets reflect congestion costs, which results in higher rates in more congested areas.

In contrast to other states in PJM, Maryland and New Jersey lacked adequate generation in-state and were therefore forced to rely more heavily on PJM markets to procure capacity. At the same time, because both New Jersey and Maryland have relatively high congestion costs, they paid higher prices for capacity procured through PJM.

Yet higher prices failed to attract new generation to Maryland and New Jersey. Concerned about higher rates and capacity shortfalls, Maryland and New Jersey took matters into their own hands. Maryland enacted the EmPOWR Maryland Energy Efficiency Act of 2008, which directed the Public Service Commission to study generation adequacy within the state of Maryland.[6] In 2011, New Jersey adopted the New Jersey Long Term Capacity Addition Pilot Program (LCAPP), designed to "address the lack of incentives in the [PJM pricing model]" and to foster construction of new, efficient generation to be available to the region and New Jersey customers.

Various wholesale sellers within PJM challenged the Maryland and New Jersey programs, arguing that the states' action violated the Supremacy Clause and the Commerce Clause of the United States Constitution. The details of each state program and the constitutional challenges are addressed in the discussion below.

II. *PPL v. Nazarian*

4 *See* ***Am***. *Ref. Fuel Co.*, 105FERC¶ 61,004, at 61,007 (2003) (holding RPS are a creature of state law).

5 *See* PJM description of RPM program and capacity auctions, online at http://www.pjm.com/markets-and-operations/rpm.aspx (last visited March 27, 2013).

6 *Nazarian* at n. 35 and text (describing provisions of the EMPower statute).

In *PPL v. Nazarian*, petitioners challenged a program devised by the Maryland Public Service Commission to incentivize construction of additional generation in Maryland. The Maryland Commission found that long-term capacity shortages might jeopardize reliability, particularly in the transmission-congested Southwest Mid-Atlantic Area Council (SMAAC) zone of PJM. Testimony before the court established that approximately 98 percent of SWMAAC is within Maryland, with the remaining two percent in the District of Columbia.

Accordingly, the Maryland Commission issued a request for proposals (RFP) seeking new gas fired generation capacity resources, "physically located inside the SWMAAC zone of the PJM region."[7] In addition, the RFP required bidders to identify any reliability and economic benefits to Maryland ratepayers, which constituted 2.5 percent of the non-price criteria for scoring bids.

The Maryland Commission selected CPV as the RFP winner. Subsequently, the Maryland Commission ordered the state's utilities to enter into long-term contracts with CPV and pay the difference between the contract price (designed to provide for recovery of plant costs) and PJM wholesale market prices. By providing the seller a guaranteed price, the "contract for differences" program provided the generator with a secure income stream that would facilitate project financing.

At the same time, because ratepayers would make up the difference between the contract price and PJM market prices, CPV had no incentive to maximize its bids in the PJM capacity auctions. Instead, CPV could submit bids lower than its actual costs to ensure that PJM would buy its output,[8] knowing that it would still recover its full contract cost from ratepayers.

Petitioners challenged the Maryland program in federal court, alleging that the program violated both the Supremacy Clause and the Commerce Clause. The court found that the Maryland Program encroached on federal authority in two ways. First, the court held that the "contract for differences" program effectively set a "fixed contract rate" for the utilities' wholesale power purchases from CPV. However, under the Federal Power Act, FERC and not the states has exclusive authority to set wholesale rates. Maryland was thus preempted from doing so.

Second the court found that even if a contract for differences program was viewed as some type of financial arrangement or subsidy rather than a ratemaking, it was still invalid under the Supremacy Clause. The court explained that by subsidizing CPV, Maryland interfered with PJM's FERC-approved RPM program – since CPV could underbid and depress prices within

[7] *See Nazarian* at n. 40 and text (describing terms of RFP).

[8] PJM establishes rules on bids below the auction clearing price, and does not permit generators to bid too low to avoid "dumping" capacity on the market and depressing prices. Nevertheless, the rules allow some flexibility for generators to make lower bids within certain parameters.

PJM markets. Indeed, the court found that low bids by CPV significantly reduced PJM market prices on at least two occasions. The court also found that price fluctuations caused by CPV's low bids distorted market signals on the need for capacity and made it difficult for generators to determine whether or not to construct additional generation.

Although the court invalidated the Maryland Program on Supremacy Clause grounds, it went on to address whether the Maryland RFP violated the Commerce Clause by discriminating against out-of-state projects. Although the petitioners acknowledged that the Maryland RFP did not expressly mandate location of the plant in Maryland, they argued that an in-state project was the only viable location given RFP requirements that the plant (a) have the capability of serving the SMAAC zone and (b) provide benefits to Maryland ratepayers. In response, Maryland argued that the program (1) was a direct state subsidy that a state may permissibly limit to entities in the state; (2) fell within the market participant exception to the Commerce Clause;[9] and (3) did not discriminate against out-of-state interests and served a compelling state interest of ensuring sufficient capacity and reliability for residents.

The court rejected Maryland's first two arguments. First, the court found that Maryland's program was not a direct subsidy because the utilities and not the state subsidized the project by making up any shortfall between market prices and contract rates through the contract for differences.

Second, the court determined that the program did not fall within the market participant exception because the Maryland Commission acted in its regulatory capacity by enacting the "contract for differences" program, rather than as a participant in the market. The court also helpfully laid out several factors that it considered in determining whether Maryland was a market participant, including:

- The Maryland Commission did not spend state dollars to construct the project.
- The Maryland Commission was not a signatory on the power purchase agreement (PPA).
- The Maryland Commission will not own the plant.
- The Maryland Commission did not issue bonds to fund the plant.

Finally, the court agreed with Maryland's argument that the Maryland RFP did not discriminate against out-of-state interests or interfere with interstate commerce. Initially, the court expressed concerns about the RFP's requirements since they essentially ensured that the

[9] Under the market participant exception to the Commerce Clause, a state that actively participates in the market may discriminate in its favor by requiring in-state benefits. For example, when a state funds a hospital or other project, it may limit contracts to in-state companies without violating the Commerce Clause's prohibition on discrimination against out of state interests.

project would be located in Maryland. In this regard, the court cited to testimony that only two percent of the SWMAAC zone is in the District of Columbia and further, that there were few viable sites for a plant within the District of Columbia.

Despite findings that the RFP substantially favored in-state location, the court held that the program did not discriminate against out-of-state interests in violation of the Commerce Clause. First, the court found that out-of-state entities were permitted to compete in the RFP and further, were not required to establish a presence in the state that might potentially impose an added burden on out-of-state entities. Next the court observed that the Maryland program did not burden interstate commerce, noting that it did not prohibit utilities from purchasing out-of-state power, or prevent CPV from selling power out of state. Finally, the court found that even if Maryland's order "could be viewed as placing...some burden on interstate commerce, the burden would be de minimis" and far outweighed by Maryland's legitimate interest in ensuring that Maryland residents have an adequate and reliable supply of energy.

One final point is worthy of mention. Because the petitioners raised constitutional challenges to Maryland's program, they also asserted an independent claim under Section 1983 (42 USC §1983), a civil rights statute that allows parties to sue governmental entities for constitutional violations committed "under color of state law." The advantage of Section 1983 is that it allows prevailing parties to recover attorney fees under a companion provision, Section 1988, which could potentially expose states to significant liability. Fortunately for states, the court rejected the Section 1983 claims, citing a Fourth Circuit ruling, Md. *Pest Control Ass'n v. Montgomery County*, 884 F.2d 160, 162-63 (4th Cir. 1989) holding that Section 1983 applies only to violations of individual constitutional rights and not to constitutional challenges to a state law or regulation.[10]

III. *PPL Energy Plus v. Hanna*

PPL Energy Plus v. Hanna involved a Supremacy Clause and Commerce Clause challenge to a New Jersey program, which like Maryland's program, aimed to encourage increased capacity within the state. Issued a month after *Nazarian*, the *Hanna* court had the benefit of the Maryland federal district court's ruling. Although the reasoning in *Hanna* is not identical to *Nazarian*, the decision relies heavily on the Maryland court's ruling and thus, is not as lengthy or detailed.

Like Maryland's program, New Jersey's LCAPP Act authorized the construction of several generators in or near New Jersey to "address the lack of incentives under the [PJM pricing

[10] The Tenth and Seventh Circuit adopt the same position. *See J. & J. Anderson, Inc. v. Town of Erie*, 767 F.2d 1469 (10th Cir.1985) (holding that Commerce Clause and Supremacy Clause "do not secure rights cognizable under § 1983."); *accord*, *Gould, Inc. v. Wisconsin Department of Industry, Labor & Human Relations*, 750 F.2d 608 (7th Cir.1984), aff'd on other grounds, 475 U.S. 282, 106 S.Ct. 1057, 89 L.Ed.2d 223 (1986).

model]" and foster sufficient generation for users within the state. The Act established a "pilot program," overseen by the Board of Public Utilities, to conduct a competitive bidding process to select eligible generators. The statute also specified that the Board was required to prequalify generators based on a showing of "community benefits," among other factors. Upon conclusion of the bidding process, the Act then required New Jersey's four utilities to enter into contracts with the chosen generators and obligated them to pay any difference between the PJM auction prices for capacity and the rates based on the actual development costs of the project, as approved by the Board.

Petitioners, a group of wholesale generators participating in PJM markets, challenged the LICAPP statute on the same grounds as in the Maryland case. The court reached an almost identical holding on the Supremacy Clause issue, ruling that the New Jersey program impermissibly encroached on FERC-regulated markets and, as such, was preempted.

With respect to the Commerce Clause claims, petitioners argued that the "community benefit" component of the RFP's prequalification process favored New Jersey generators and effectively prohibited out-of-state generators from becoming eligible to compete for contracts. In support of their claim of discrimination, petitioners relied on the following evidence:

- A letter from the Board of Public Utilities to the Governor mentioning a preference for in-state generation;
- An initial draft of the LCAPP legislation that promoted construction of in-state generation – though the language was deleted before the statute was enacted;
- Language in the LCAPP which required the Board to consider economic and community benefits of the project; and
- Language in a 2011 New Jersey Energy Master Plan discussing the commercialization of new generation in New Jersey.

The court found unpersuasive petitioners' evidence of discrimination. Instead, the court referenced evidence produced at trial related to locational deliverability requirements, including testimony from one witness who emphasized that reliability issues could only be resolved by siting generation in or near the location where the reliability issues will occur. Thus, the court concluded that the community benefits component of the RFP, which would incentivize construction within New Jersey, was a rational decision and was not motivated by discriminatory intent.

The New Jersey court's ruling on the Commerce Clause issues was cursory, comprising just two paragraphs of a 38-page decision. Still, the New Jersey decision suggests that evidence (albeit scant) of discriminatory purpose can be readily outweighed by proof that locational requirements are necessary to meet legitimate state goals such as reliability.

IV. Implications of *Nazarian* and *Hanna* for RPS Programs

Significantly, both *Nazarian* and *Hanna* show that states may impose locational requirements so long as the policies avoid expressly stating a preference for the particular state and are clearly justified by legitimate state policy.

In both *Nazarian* and *Hanna*, the policies did not overly favor the state. For example, the Maryland RFP solicited projects located in the SWAAC region but did not state that only Maryland projects could qualify. Likewise, CAPP Act did not mandate that the utilities enter into contracts with New Jersey generators, but rather, included "community benefits" – which favored New Jersey projects but did not exclude others -- as a prequalification criteria. Even so, *Nazarian* in particular, comes close to the line in that it specified a narrow region for location of the project which only included one other jurisdiction, *i.e.*, the District of Columbia.

Nevertheless, it appears that what actually spared both *Nazarian* and *Hanna* from invalidation under the Commerce Clause is not so much that they did not overtly discriminate on their face, but rather that the states had a legitimate interest for in-state location. *Nazarian* and *Hanna* affirm that states have a legitimate interest in ensuring generation adequacy and reliability and that this interest outweighs any burdens that a state program may have on interstate commerce. In both *Nazarian* and *Hanna*, there was expert testimony explaining the nexus between the proposed projects' location to reliability and generation adequacy within the state. Likewise, state RPS programs that potentially impact interstate commerce can be justified by showing a connection between the program and state goals of reliability and generation adequacy.

In addition, the *Nazarian* ruling provides useful guidance on the market participant exemption through a listing of readily-understandable factors that courts consider in evaluating whether the exemption applies. And the court also made clear that parties prevailing on constitutional claims under the Supremacy Clause and Commerce Clause cannot avail themselves of the attorney fees recovery provisions of Section 1983.

Although the Maryland and New Jersey programs withstood the Commerce Clause challenges, it bears emphasizing that both courts --particularly the *Nazarian* court -- took the Commerce Clause allegations challenges seriously. Indeed, given that the courts had already invalidated the programs on Supremacy Clause grounds, they could have declined to reach the Commerce Clause issues at all. Yet, both courts subjected the state programs to close scrutiny, examining the statutory and regulatory language and considering testimony regarding the program's impact on commerce and the state's rationale for the program. In short, *Nazarian* and *Hanna* suggest that while states can avoid succumbing to Commerce Clause challenges, they must also be able to show non-discriminatory, legitimate state interest for RPS programs that impact commerce.

It remains to be seen whether *Nazarian* and *Hanna* are the last word on the constitutionality of the Maryland and New Jersey programs. *Nazarian* is now pending appeal before the Fourth Circuit, while *Hanna* is before the Third Circuit. At this point, only the states have appealed the courts' invalidation of the programs under the Supremacy Clause, though it is possible that the petitioners could file a cross-appeal seeking review of the courts' ruling on the Commerce Clause arguments.

About the Author

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About the State-Federal RPS Collaborative

The State-Federal RPS Collaborative, mangaed by the Clean Energy States Alliance, serves as a forum for the exchange of experiences and lessons learned regarding the implementation of state Renewable Portfolio Standard (RPS) policies. It was established to advance dialogue and cooperation among a broad network of state and federal government officials, renewable energy certificate tracking system administrators, NGO experts, industry representatives, and other stakeholders. It is supported by the U.S. Department of Energy and the Energy Foundation. The Collaborative offers a free monthly newsletter, regular webinars, reports, an annual National Summit on RPS, and opportunities for information exchange.

For more information see http://www.cleanenergystates.org/projects/state-federal-rps-collaborative/.

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