



# The State of Energy Regulation in the United States

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# Constitutional Basis of American Regulatory Structure

- Powers of Federal and State Governments enumerated in the United States Constitution
- Article VI of the Constitution provides that the “Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land”
- Article I, Section 8 of the Constitution allows the Federal Government to “regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes”
- Tenth Amendment to the Constitution provides that the “Powers not delegated to the United States by the Constitution, nor prohibited to it by the States, are reserved to the States respectively, or to the people”

# Scope of Federal Authority to Regulate Commerce

- Federal Commerce Clause has a positive and a negative component
- Grants Federal Government broad authority to affirmatively regulate activities that have an effect on commerce between the States
- Prohibits State Governments from imposing an undue burden on the free flow of interstate commerce
- State actions that are inconsistent with affirmative Federal action under the Commerce Clause or unduly interfere with the free flow of interstate commerce are preempted under the Supremacy Clause

# Scope of State Authority to Regulate Business Enterprises

- State Governments retain the “Police Power”
- “Police Power” provides a State Government with broad authority to regulate business enterprises for the protection of the health, safety, morals, and general welfare of its citizens
- As a general proposition, a State Government is free to adopt any scheme for regulating businesses it prefers as long as that scheme
  - Does not interfere with the exercise of Congress’ authority to regulate interstate commerce or violate other provisions of the Federal Constitution
  - Does not result in the taking of private property without just compensation

# Legal Basis for Regulation of Specific Industries

- Economic regulation initially developed at the State level
- Rested on English common law concept of “property clothed with a public interest” found in the writings of Sir Matthew Hale
- Particular business “clothed with a public interest when used in a manner to make it of public consequence, and affect the community at large” (Munn v. Illinois, 94 U.S. 113, 125 (1877))
- When a business is “clothed with a public interest,” the owner, “in effect, grants to the public an interest in that use, and must submit to be controlled by the public for the common good, to the extent of the use that he has created” (Munn v. Illinois, 94 U.S. 113, 125 (1877))

# Industries Deemed “Clothed with a Public Interest”

- Factors leading to the treatment of an industry as “clothed with a public interest” initially included common law precedent, the importance of the industry to the economic life of the State and nation, and the extent to which participants in that industry exercised monopoly power
- Under the decision in Nebbia v. New York, 291 U.S. 502 (1943), all modern business enterprises probably clothed with sufficient “public interest” to be deemed subject to regulation under the Federal Constitution
- Initial list of industries deemed “clothed with a public interest” included ferries, wharves, warehouses, and common carriers such as railroads
- Other industries added to the list over time, including electric power, natural gas, telephone and telegraph, and water and sewer companies

# Specific Constitutional Constraints on Federal and State Ratemaking

- Early efforts at economic regulation of specific industries subject to significant constitutional challenge
- Initially, Supreme Court held that, as a constitutional matter, “all calculations as to the reasonableness of rates . . . must be [based upon] the fair value of the property being used . . . for the convenience of the public” (Smyth v. Ames, 169 U.S. 466, 547 (1898))
- For many years, Supreme Court required to address detailed constitutional challenges to specific aspects of State and Federal ratemaking decisions
- Finally, Supreme Court effectively ended this exercise by adopting the “end result” test, under which “the impact of the rate order” rather than “the method employed” is determinative of its constitutionality (FPC v. Hope Natural Gas, 320 U.S. 591, 602 (1944))
- Hope “end result” test reaffirmed in 1989 and remains the applicable standard for evaluating constitutional challenges to State and Federal ratemaking decisions (Duquesne Light Co. v. Barash, 488 U.S. 299 (1989))

# Electric Power Initially Subject to Regulation at the State Level

- Commercial electric industry began to develop in the United States in the late 19<sup>th</sup> Century
- By 1920, most States had subjected the electric industry to economic regulation by State Commissions
- Today, all 50 States exercise some degree of regulatory control over the electric industry



# State Regulatory Authority in Traditionally-Regulated States

- State Commission regulatory authority generally extends to all components of electric service provided by investor-owned electric companies directly to end-user customers for compensation
- State Commission regulatory authority may or may not extend, in whole or in part, to
  - Municipal distribution systems
  - Rural electric cooperatives

# Components of Traditional State Regulation of Electric Industry

- Establishment of monopoly franchised service territory
- Obligation to provide reasonably adequate service on a non-discriminatory basis to customers located within that service territory
- Rates for service established on the basis of the cost of providing service plus a reasonable return on investment

# Other Aspects of Traditional State Regulation of Electric Industry

- Regulated companies prohibited from charging rates other than those established or allowed by the State Commission
- State Commissions have the authority to order regulated companies to make specific service improvements
- State Commissions approve company resource expansion plans
- State Commissions prescribe the manner in which company books of account are to be kept
- State Commission approval required for mergers, acquisitions, or transfers of control of significant company assets
- State Commission approval required for the issuance of debt or equity securities
- Affiliate transactions subject to close State Commission scrutiny

# Retail Regulation in Restructured States

- Within the last decade, many States have begun the process of deregulating the generation component of electric service
- Restructuring movement resulted from dissatisfaction with results of traditional regulation and belief that deregulatory policies applicable to other industries had proven successful
- State restructuring plans vary widely from one State to another
- State restructuring plans generally
  - Exempt municipal and rural cooperative systems
  - Retain pervasive regulatory control over the distribution function
  - Allow market pricing for customers electing to shop for generation service
  - Allow customers electing to shop to aggregate their loads
  - Require the distribution utility or some other entity to provide default generation service to those customers that have not affirmatively elected an alternative generation supplier

# Origins of Federal Regulation of the Electric Industry

- No Federal regulation of any aspect of the electric power industry until 1920, when Federal Water Power Act was enacted
- In 1927, Supreme Court held that a State Commission attempt to establish rates for power generated in that State and sold to a distributor in another State was an impermissible attempt by that State to regulate interstate commerce (Rhode Island PUC v. Attleboro Steam and Electric Company, 273 U.S. 83 (1927))
- Attleboro decision created a “regulatory gap” that was filled through the enactment of the Federal Power Act in 1935

# Scope of Federal Regulation of the Electric Industry

- As a Federal Constitutional matter, “the cord from a light plug to a toaster on the breakfast table is a facility for transmission of interstate energy if any part of the load is generated without the state” (Connecticut Light and Power Co. v. FPC, 324 U.S. 515, 529 (1945))
- However, Congress has not granted all constitutionally permissible authority to the FERC
- As a result, scope of the Federal Energy Regulatory Commission’s (FERC) regulatory authority hinges on the provisions of various Congressional enactments rather than on the contents of any Federal Constitutional provision

# Major Legislation Creating FERC's Existing Jurisdiction

- Federal Water Power Act of 1920
- Federal Power Act of 1935
- Public Utility Regulatory Policies Act of 1978 (PURPA)
- Energy Policy Act of 1992 (EPACT 1992)
- Energy Policy Act of 2005 (EPACT 2005)

# General Scope of Federal Jurisdiction

- FERC has jurisdiction over “ the transmission of electric energy in interstate commerce and . . . the sale of electric energy at wholesale in interstate commerce” (16 U.S.C. § 824(b)(1))
- “[E]lectric energy shall be held to be transmitted in interstate commerce if transmitted from a State and consumed at any point outside thereof” (16 U.S.C. § 824(c))
- “[S]ale of electric energy in interstate commerce’ . . . means a sale of electric energy to any person for resale” (16 U.S.C. § 824(d))
- FERC has “jurisdiction over all facilities for such transmission or sale of electric energy” (16 U.S.C. § 824(b)(1))



# Limitations on FERC Jurisdiction

- FERC jurisdiction extends “only to those matters which are not subject to regulation by the States” (16 U.S.C. § 824(a))
- FERC lacks jurisdiction over
  - “facilities for the generation of electric energy” (16 U.S.C. § 824(b)(1))
  - “facilities used in local distribution” (16 U.S.C. § 824(b)(1))
- FERC jurisdiction generally applicable to “public utilities,” defined as “any person who owns or operates facilities subject to the jurisdiction of the Commission” (16 U.S.C. § 824(e))
- FERC lacks jurisdiction over “the United States, a State or any political subdivision of a State[, or] an electric cooperative that receives financing under the Rural Electrification Act of 1936” “or that sells less than 4,000,000 megawatt hours of electricity per year” in the absence of a specific provision of the Federal Power Act to the contrary (16 U.S.C. § 824(f))

# Scope of FERC Ratemaking Authority Over Public Utilities

- All rates and charges “made, demanded, or received by any public utility” relating to FERC-jurisdictional activities “shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful” (16 U.S.C. § 824d(1))
- “[A]ll rates and charges for any transmission or sale subject to the jurisdiction of the Commission” shall be filed with the FERC (16 U.S.C. § 824d(c))
- “[N]o change shall be made by any public utility in any such rate, charge, classification, or service . . . except after sixty days’ notice to the Commission,” subject to the FERC’s authority to suspend proposed rates (16 U.S.C. § 824d(d))
- “Whenever the Commission, after a hearing had upon its own motion or upon complaint, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any public utility for any transmission or sale subject to the jurisdiction of the Commission . . . is unjust, unreasonable, unduly discriminatory or preferential,” the FERC shall establish an appropriate rate (16 U.S.C. § 824e(a))

# Other Areas of FERC Regulatory Authority

- License and regulate hydroelectric generating facilities (16 U.S.C. § 797)
- Adopt rules encouraging cogeneration and small power production by electric utilities in instances in which an adequately competitive wholesale electric market does not exist (16 U.S.C. § 824a-3)
- Approve proposed dispositions, mergers, consolidations, acquisitions, or changes in control involving assets subject to the FERC's transfer jurisdiction (16 U.S.C. § 824a-4)
- Approve the formation and regulate the operations of an Electric Reliability Organization with the authority to develop, implement, and enforce mandatory reliability rules for the bulk power system (16 U.S.C. § 824o)
- Approve applications for authority to construct transmission facilities in national interest electric transmission corridors under limited circumstances (16 U.S.C. § 824p)
- Adopt rules facilitating price transparency in markets for the sale and transmission of electric energy in interstate commerce (16 U.S.C. § 824t)
- Address market manipulation issues (16 U.S.C. § 824v)

# Relationship Between Regulatory and Other Agencies

- American antitrust laws generally contain an exemption for regulated activities (Parker v. Brown, 317 U.S. 341 (1943))
- Federal Trade Commission has, on occasion, participated in FERC proceedings addressing wholesale market issues, usually for the purpose of advocating the use of structural solutions to competition-related issues
- As FERC has gained authority to address market manipulation issues, it has been ordered to act in conjunction with the Commodity Futures Trading Commission
- Signed a Memorandum of Understanding with the CFTC in 2005 that provided for the sharing of information as required by 16 U.S.C. § 824t(c)(1)
- FERC and the CFTC cooperated in a recent investigation into alleged natural gas futures market manipulation that affected physical natural gas markets over which FERC has jurisdiction
- FERC, with support from the States, has recently been involved in litigation over the extent of FERC's jurisdiction over the conduct at issue in that proceeding

# Regulatory Approach Adopted by FERC

- For many years, FERC regulated wholesale sales and transmission service provided by jurisdictional public utilities using traditional regulatory techniques such as cost-based ratemaking
- For various reasons, including the enactment of PURPA and EPACT 1992, FERC moved away from traditional cost of service regulation and attempted to facilitate the development of competitive wholesale electric markets
- Efforts to facilitate the development of competitive wholesale electric markets contemporaneous with movement to retail restructuring in some States

# FERC Initiatives to Facilitate Competitive Wholesale Markets

- Imposed open access requirements as a condition for approval of mergers and other transactions
- Authorized generators to charge market-based rates rather than cost-based rates to the extent that they did not possess inordinate market power
- Order 888 in 1996 found that the existing rules and regulations governing the transmission system were unduly discriminatory and required all FERC-jurisdictional public utilities to
  - unbundle transmission service from generation service for the purpose of making wholesale sales
  - offer unbundled transmission service on a non-discriminatory basis
- Allowed the formation of RTO-operated organized day-ahead and real-time wholesale generation markets that addressed congestion using locational marginal pricing
- Order 2000 in 1999 required all FERC-jurisdictional public utilities to either join or participate in the establishment of a regional transmission organization (RTO) or explain their decision not to do so
- FERC has continued to attempt to facilitate competitive wholesale electric markets by
  - establishing rules for the interconnection of generators to the transmission system
  - establishing tests for the presence of impermissible market power
  - adopting rules sanctioning market manipulation
  - refining rules for the operation of bilateral wholesale markets

# Current Jurisdictional Arrangements in the United States

- Current arrangements for the provision of electric service stem from the jurisdictional determinations made by FERC in Order 888
- Under Order 888, FERC has jurisdiction over
  - wholesale sales of electric energy
  - wholesale transmission service
  - transmission component of unbundled retail rates
- Under Order 888, State Commissions have jurisdiction over
  - distribution component of retail service
  - generation component of retail service
  - transmission component of bundled retail service
- Jurisdictional determinations made by FERC in Order 888 were affirmed by the Supreme Court in New York v. FERC, 535 U.S. 1 (2003)
- Actions taken by FERC within the scope of its jurisdiction binding on State Commissions (Nantahala Power and Light Co. v. Thornburg, 476 U.S. 953 (1986))

# Existing Hybrid System

- At present, a hybrid system for providing electric service exists in the United States
- Electric service currently provided to end-user customers in the United States in one of the following sets of circumstances
  - States with restructured retail markets and organized wholesale markets
  - States with traditionally-regulated retail markets and organized wholesale markets
  - States with traditionally-regulated retail markets and bilateral wholesale markets
- Regulatory rules different in each instance
- Congress could have changed existing jurisdictional arrangements in EPACT 2005, but did not do so
- Likely to have a hybrid system in the United States for the foreseeable future



# Current Federal-State Issues

- Jurisdictional tensions have existed between FERC and State Commissions in the past
- Likely to be similar jurisdictional tensions on occasion in the future
- At present, neither the FERC nor State Commissions have perfect jurisdiction over the electric industry
  - Some issues subject to exclusive FERC jurisdiction (rates for wholesale sales and interstate transmission service)
  - Some issues subject to exclusive State Commission jurisdiction (rates for distribution and retail generation service)
  - Some issues subject to concurrent FERC and State Commission jurisdiction (asset transfers and affiliate transactions)
- Have to work together to address issues of mutual concern

# Approaches to Jointly Addressing Issues of Federal/State Concern

- FERC and NARUC have been working to attempt to address issues arising from the existence of shared jurisdiction
- FERC and NARUC leaders communicate regularly about relevant issues
- FERC consulted extensively with State Commissions before adopting Order 890, in which it revisited certain issues addressed in Order 888, and before issuing a recent Advanced Notice of Proposed Rulemaking, which addressed issues relating to organized wholesale markets
- NARUC strongly supported FERC's efforts to address alleged manipulation of natural gas futures markets in such a manner as to affect natural gas physical markets
- FERC and NARUC have formed collaborative working groups to explore issues of common concern
  - demand response
  - competitive procurement
- Hopefully, these extensive joint FERC/State Commission activities will allow appropriate resolution of substantive regulatory issues without undue jurisdictional controversy