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Courts Leave States Few Tools To Spur Plant Projects

By Keith Goldberg

Law360, New York (October 22, 2013, 5:44 PM ET) -- The ability of U.S. states to encourage developers to build new power plants in order to lower energy costs and ensure grid reliability may be severely limited after a pair of federal courts recently held that subsidies offered by New Jersey and Maryland intruded on the Federal Energy Regulatory Commission's exclusive authority over wholesale electricity markets, experts say.

While the courts rejected claims that the subsidies violated the Constitution's dormant commerce clause by discriminating against out-of-state generation, they did find them in violation of the supremacy clause, leaving states to wonder if they can offer any sufficient inducements for the development of new generation without stepping on the toes of the federal government.

"People have long understood that states have the ability to administer supply procurement programs," Akin Gump Strauss Hauer & Feld LLP energy regulatory partner Chip Cannon said. "I personally think the biggest takeaway is that there's still a lot of uncertainty as to what the states can do."

On Sept. 30, a Maryland federal judge threw out the state's administrative order subsidizing development of new natural gas-fired generation, ruling that utility regulators usurped FERC's ability to regulate wholesale energy rates by directing several state-owned utilities to enter into long-term power supply contracts with a company regulators picked to build a 660-megawatt gas-fired power plant.

Less than two weeks later, a New Jersey federal judge nixed on similar grounds a program in which New Jersey utility regulators established settled capacity purchase agreements, which would set a long-term "floor price" for new generation capacity from companies that would build new natural gas-fired electric generators in the state.

Although the rulings barred those types of subsidies, states have other potential carrots to offer, including tax breaks for developers, favorable lease terms for state-owned property and an expedited permitting process. However, even if that entices project developers to set up shop in a certain state, they'd still be selling power and capacity in regional wholesale markets.

"The question is whether the states feel tax programs give them sufficient certainty that the projects will provide benefits to the states," Cannon said.

Those benefits could also be subject to the federal preemption challenges raised over the Maryland and New Jersey programs, experts say.

"When you have a market scheme that's integrated under federal law, you have to ask the broader question: What state interest permits a state to subsidize new power plant construction in a manner that would interfere with operation of market pricings that are supposed to be providing the revenue and price signals to encourage development of new resources?" Stroock & Stroock & Lavan LLP partner Jon Mostel said. "That clearly infringes on FERC's authority to regulate the sale of wholesale power in interstate commerce."

Although state utility regulators may be the losers in the two court cases, experts say, existing generators and utilities are the big winners, because absent the incentives for new generation projects, they can profit from higher capacity prices as long as there aren't any grid reliability issues that would prioritize new generation construction.

Yet if the courts had upheld the Maryland and New Jersey subsidies, they would have undermined the competitiveness of the wholesale energy markets by artificially suppressing prices and discouraging both new and existing generators from making investments, said Sandy Rizzo, who chairs Bracewell & Giuliani LLP's energy regulatory group.

"No one would put their own capital in a state that every time prices would otherwise rise, someone would act to keep them low," Rizzo said. "You would never have the revenue stream to build a new facility. We would essentially go back to a regulated model."

Given the potential shackles the Maryland and New Jersey rulings are imposing on state regulators, the legal battle is far from over, experts say.

"I would not be surprised if there are appeals of this issue," Rizzo said. "I don't think the states are going to go quietly."

Experts say the rulings are a vindication of FERC's authority over wholesale energy market issues and send a message to states looking to coax new power development within their borders: Tread carefully.

"You might have legitimate interests in having jobs in your states or environmentally friendly generation, and if it's done in a fair way, that's fine," Rizzo said. "But if it's done in a discriminatory way that affects the fair wholesale price, that crosses the line. "

--Additional reporting by Joshua Alston and Jeff Sistrunk. Editing by Jeremy Barker and Philip Shea.