

# In the wake of Hughes v. Talen Energy, might states turn to CHP to help meet future energy demand?

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States have a primary role in ensuring resource adequacy within their territory at a just and reasonable cost to retail energy consumers. Over the past decade, the Federal Energy Regulatory Commission has approved wholesale capacity market constructs in various regions to meet resource adequacy goals, resulting in jurisdictional battles between FERC and the states. This column looks at how combined heat and power may serve as a tool states can look to in order to achieve resource adequacy goals in regions with FERC-jurisdictional capacity markets.

Combined heat and power offers geographically concentrated load centers a cost-effective solution to meet energy needs locally, while providing emission reduction and other benefits. For example, the U.S. Department of Energy lists among the benefits of CHP: (1) enhanced energy security by reducing national energy requirements; (2) increased resiliency of the energy infrastructure by limiting congestion and offsetting transmission losses; (3) greater diversification of energy supply by enabling further integration of domestically produced fuels; and (4) improved energy efficiency by capturing heat that would normally be wasted. Despite all

these benefits, states struggling with declining energy reserve margins or high energy prices often overlook CHP as a solution to meet future energy demand.

The United States has seen significant amounts of generation capacity retired in the past several years. In 2015 alone, roughly 18 GW of generation capacity were retired, most of which was conventional, coal-fired generation. About 5 GW of coal-fired generation are expected to be retired in 2016. Five nuclear power plants were decommissioned in the past five years (amounting to roughly 5 GW of capacity), and between 10 and 15 nuclear power plants across the country are considering early retirement. Given these developments, there is a clear need to invest in generation to meet future energy demand.

The question states must answer is how to best support the financing of these necessary investments. Is it better to rely primarily or exclusively on revenues from FERC wholesale markets? Or should states continue to exercise their authority over resource adequacy to incentivize generation investments?

## ARE STATES PREEMPTED FROM PROVIDING INCENTIVES FOR NEW GENERATION?

The Supreme Court decision in *Hughes v. Talen Energy* (136 S. Ct. 1288, 1300 [2016]) sheds some light on how states may act to meet resource ad-

equacy concerns within the state. The case sparked a jurisdictional debate about the role that states play in the development of new generation resources and the impact of state resource adequacy initiatives on FERC-jurisdictional wholesale prices. The high-level issue was whether state programs subsidizing generation assets may be preempted by the Federal Power Act in instances where FERC has approved a wholesale market structure setting the wholesale rates that generators receive.

The FPA provides that federal regulation of matters relating to generation is necessary only to the extent that those matters are not regulated by the states (16 U.S.C. § 824(a)) and that FERC does not have jurisdiction over facilities used for the generation of electric energy (16 U.S.C. § 824(b)(1)).

However, FERC has exclusive authority to set wholesale rates (16 U.S.C. § 824d(a)).

In 2011, Maryland initiated a state-run program to subsidize generation assets built in the state. The program required load-serving entities to enter into a contract for differences with selected generator developers. The contract for differences established the price that the developer would receive for capacity, provided that its capacity offers into the wholesale capacity market cleared the market auction price. If the developer's offer into the organized wholesale market did not clear, it would not receive a subsidy. Once the developer's capacity offer

cleared, and if the market price were higher than the contract price, the developer would return the difference to ratepayers in Maryland. But, if the market price were lower than the contract price, load-serving entities in the state would pay the difference to the developer. Incumbent generators challenged the Maryland program, arguing that the state subsidy could artificially suppress the wholesale market price. The case was appealed until it reached the Supreme Court.

In *Hughes v. Talen Energy*, the Supreme Court found the Maryland program to be preempted by FERC's exclusive authority to set wholesale rates under the Federal Power Act. While recognizing that bilateral contracts for the purchase of capacity also set the wholesale capacity prices, the court drew a distinction between the contract for differences and bilateral capacity contracts, in that the latter transfer ownership of capacity to the buyer of capacity. In contrast, the contract for differences did not transfer ownership of capacity; rather, it was a hedge. The underlying concern of the court was that, by requiring developers to clear in the PJM capacity market, the Maryland program incentivized subsidized developers to bid low, thereby artificially suppressing FERC-jurisdictional wholesale market prices. Indeed, the Supreme Court made clear that states had many options available to them to incentivize the development of generation and that, "[s]o long as a State does not condition payment of funds on capacity clearing the auction, the State's program would not suffer from the fatal defect that renders Maryland's program unacceptable" (*Hughes v. Talen Energy* at 1299).

**WHAT ARE STATES DOING TO ADDRESS RESOURCE ADEQUACY CONCERNS?**

In general, states appear to be frustrated with the inability of organized wholesale markets to provide the long-term revenue stream that investors require. Concerned about declining reserve margins, fuel diversity and high prices for capacity, several states are testing the boundaries set in *Hughes v. Talen Energy* and approving programs to support needed generation investments. Ohio, for


example, approved a program allowing First Energy Corp. and American Electric Power to enter into long-term power purchase agreements with their generation affiliates in order to prevent early retirement of various nuclear and coal-fired generation units in the state. New York approved a program to subsidize at-risk nuclear generation assets by establishing a mechanism compensating for their zero-emission attributes. The Massachusetts legislature passed a bill approving long-term power purchase agreements to support investments in new offshore wind resources and renewable energy from a broad range of technologies. All of these initiatives (and more to come) risk the potential for litigation with incumbent generators and other stakeholders concerned about the impact of these state programs on the capacity prices set through organized wholesale markets.

**HOW CAN COMBINED HEAT AND POWER HELP ADDRESS RESOURCE ADEQUACY?**

Combined heat and power typically delivers energy to local load without using the extra high-voltage network integrated transmission system or the local distribution system. These CHP facilities are located "behind the utility's meter" and do not sell their energy output into organized wholesale markets, although they may have the option to participate in these markets as demand response.

Participation by demand response in organized wholesale markets is voluntary. By contrast, in mandatory capacity markets (such as the Reliability Pricing Model) wholesale generators must offer their output into the organized wholesale market. This different treatment of generation and demand response is important because state subsidization of generation assets that are required to participate in organized wholesale markets could be challenged on preemption grounds. The risk of preemption is higher if the state subsidization program conditions the subsidy on the subsidized generation's capacity clearing the market. However, even if the state program does not condition obtaining the subsidy on the generator's capacity clearing in a wholesale market, there is still a litigation risk. Other resources participating

in the organized wholesale market could argue that the subsidized generation asset suppresses the market price and, as such, inappropriately interferes with the wholesale price for capacity that FERC has found to be just and reasonable through the normal operation of markets. By contrast, state subsidies that support construction of behind-the-meter CHP likely face little-to-no risk of being challenged on preemption grounds, provided the CHP unit is not offered in organized wholesale markets as demand response.

Given the many benefits of CHP and the lower risk of successful litigation on preemption grounds, states looking to incentivize resource development to address their energy policies and concerns may wish to consider supporting CHP development as one alternative to subsidizing centralized generation assets that must participate in organized wholesale markets. 



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