

FERC Opens the Door to Carbon Pricing in Organized Wholesale Electricity Markets

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On April 15, 2021, the Federal Energy Regulatory Commission (“FERC”) issued a policy statement on Carbon Pricing in Organized Wholesale Electricity Markets (the “Policy Statement”). It provides a non-binding policy framework for Regional Transmission Organizations (“RTO”) and Independent System Operators (“ISO”) to consider when submitting filings under section 205 of the Federal Power Act (“FPA”) to incorporate state-determined carbon prices in the wholesale electricity markets administered by the RTOs/ISOs. FERC’s framework will be applied on a case-by-case basis. Two Commissioners dissented in part, laying the groundwork for jurisdictional challenges to future section 205 filings that might be made by RTOs/ISOs on the basis of the Policy Statement.

What is Carbon Pricing?

In the Policy Statement, FERC uses the term carbon pricing to include both “price-based” and “quantity-based” methods of carbon pricing. Price-based methods place a charge on each ton of greenhouse gas (“GHG”) emissions, such as a carbon fee. Quantity-based methods limit permissible GHG emissions for a group of entities over a defined period of time, such as a cap-and-trade system. Quantity-based methods result in indirect carbon pricing as entities trade GHG emissions allowances.

Twelve states already impose some form of carbon pricing, and several more states currently are considering implementing carbon pricing¹ or currently use a carbon price to inform state agency actions.²

The Policy Statement

The Policy Statement established that it is official FERC policy “to encourage efforts of RTOs/ISOs and their stakeholders to explore and consider the value of incorporating a state-determined carbon price into RTO/ISO markets.”³ After presenting the jurisdictional analysis on which the Policy Statement is based, FERC then provided guidance to RTOs/ISOs that make FPA section 205 filings to incorporate state-determined carbon prices.

A majority of the FERC Commissioners concluded that considering state-determined carbon prices is within FERC’s FPA jurisdiction over practices affecting wholesale rates. In reaching that conclusion, FERC leaned heavily on the Supreme Court’s 2016 *EPISA*⁴ opinion, in which the Supreme Court outlined a two-part test to determine whether FERC action is within its practices affecting jurisdiction: (1) the activity must “directly affect” wholesale rates; and (2) the activity must not be a matter that FPA section 201(b) reserves exclusively to the states.

FERC concluded that the Policy Statement satisfies both prongs of the *EPISA* test. As to the first prong, FERC found that wholesale market rules that incorporate state-determined carbon prices can directly affect wholesale rates because those rules govern how resources participate in the RTOs/ISOs, how those resources are compensated, and how those resources are dispatched. However, the Commissioners took care to note that filings will be assessed on a case-by-case basis. Therefore, there is a risk that an individual filing seeking to incorporate a state-determined carbon price may be found to not directly affect wholesale rates, causing the filing to fall outside of FERC’s jurisdiction. As to the second prong, FERC determined that the Policy Statement does not regulate an activity that FPA section 201(b) reserves to the states because states retain authority over the “carbon price as well as other measures for regulating generation facilities.”⁵

The Six Questions and Issues that Section 205 Filers Should Consider in their Filings

FERC did not prescribe any particular methods or market designs for incorporating state-determined carbon prices into RTO/ISO markets, opting instead to leave that to the RTOs’/ISOs’ to explore with their stakeholders.⁶ FERC stated that it would

review proposals on a case-by-case basis. However, FERC outlined six considerations that filers should address in an FPA section 205 filing that seeks to incorporate a state-determined carbon price into RTO/ISO markets:

- How, if at all, do the relevant market design considerations change depending on the manner in which the state or states determine the carbon price (e.g., price-based or quantity-based methods)? How would state-determined carbon prices, including any changes to these prices, be reflected in RTO/ISO tariffs or market designs?
- How would the FPA section 205 proposal provide adequate price transparency and enhance price formation?
- How would the carbon price be reflected in locational marginal prices?
- How would the incorporation of the state-determined carbon price into the RTO/ISO market affect the RTO/ISO's resource dispatch? Would the state-determined carbon price affect how the RTO/ISO co-optimizes energy and ancillary services? Would any reforms to RTO/ISO co-optimization rules be necessary in light of the state-determined carbon price? Would any reforms to other market design elements be necessary, such as to market power mitigation rules or other rules that affect whether the market produces just and reasonable rates?
- Would the filer's proposal result in economic or environmental leakage?⁷ If so, how might the proposal address any such leakage?
- What elements of the proposal affect the wholesale rates paid by customers? How does the proposal consider this impact and the impact on consumers overall?

Legal and Regulatory Uncertainty Persists

Although a majority of the FERC Commissioners concluded that the agency has jurisdiction to consider state-determined carbon prices in FPA section 205 filings, two Commissioners issued partial dissents to express concerns that the Policy Statement exceeds FERC's jurisdiction.

Commissioner Christie concurred with the Policy Statement to the extent that section 205 filings will continue to be evaluated on an individual basis. However, he vigorously dissented from most of the Policy Statement, concluding that FERC likely will exceed its jurisdiction in implementing this Policy Statement.

Commissioner Christie asserted that "carbon prices" really are carbon taxes that

will increase the price of electricity. Based on that premise, Commissioner Christie then raised certain jurisdictional issues regarding carbon taxation. Commissioner Christie concluded that states can impose carbon taxes and FERC can allow an RTO/ISO to recognize such a state-imposed carbon tax in the RTO/ISO's wholesale market rules. However, he concluded that FERC itself cannot impose a carbon tax at the wholesale level through its power to regulate the RTOs/ISOs, unless Congress were to delegate such power to FERC. Similarly, he concluded that FERC cannot allow an RTO/ISO to impose a carbon tax on wholesale sales of power.

In a brief, separate writing, Commissioner Danyl registered his partial dissent from the majority to the extent the Policy Statement "attempts to prejudge the jurisdictional merits of any future section 205 proposals."⁸

Looking Ahead

In recent years, various stakeholders have pushed certain RTOs/ISOs to develop wholesale market rules that incorporate state-determined carbon prices. In response, some RTOs/ISOs – perhaps most notably the New York Independent System Operator – have undertaken stakeholder processes to explore such rule changes. However, in part due to regulatory uncertainty over how FERC would view such rule changes, those efforts have moved relatively slowly and no such rule changes have been filed with FERC.

The Policy Statement alleviates some of the regulatory uncertainty that has hindered those RTO/ISO efforts by establishing considerations that filers should address in section 205 filings. As a result, the Policy Statement can be expected to reinvigorate stakeholder conversations at the RTOs/ISOs around developing wholesale market rules that incorporate state-determined carbon prices. However, some legal and regulatory uncertainty remains.

In addition to the concerns raised by the dissenting Commissioners, there is regulatory risk associated with future policy changes in this area because the Policy Statement "does not establish any binding rule, regulation, or other precedent."⁹ It therefore does not impose any binding obligation on RTOs/ISOs, and FERC itself is free to change policy direction with minimal process. Given the ever-evolving state-level politics of carbon pricing, the economic and operational complexities of incorporating carbon prices into RTO/ISO market designs, and the often lengthy stakeholder engagement processes RTOs/ISOs typically follow to

develop such market design changes, most RTOs/ISOs likely will not be in position to file market design changes based on the Policy Statement for many months, if not years. Because further policy development in this area likely will proceed in parallel at the state-, RTO/ISO-, and FERC-levels, market participants should closely monitor policy activity at all three levels going forward.

1. As of this writing, proposed carbon pricing legislation is pending in 18 states: Colorado, Connecticut, Georgia, Hawaii, Indiana, Kansas, Maryland, Massachusetts, Minnesota, Montana, New Hampshire, New York, North Carolina, Oregon, Pennsylvania Rhode Island, Texas and Washington. See Policy Statement at P 7, n.15, citing <https://www.ncel.net/carbon-pricing/#stateinfo>. The Policy Statement also notes that Pennsylvania and Washington currently are pursuing carbon pricing through rulemakings.↩

2. According to the Policy Statement, “[a]t least 11 states—California, Colorado, Illinois, Maine, Maryland, Minnesota, Nevada, New Jersey, New York, Virginia, and Washington—use a state-determined carbon price as a decision-making tool in various contexts, such as policy analysis, utility integrated resource planning, and retail ratemaking for distributed energy resources.” Policy Statement at P 7, n.16, citing <https://costofcarbon.org/states>.↩

3. Policy Statement at P 11.↩

4. *FERC v. Elec. Power Supply Ass’n*, 136 S. Ct. 760, 774-75 (2016), as revised (Jan. 28, 2016) (“*EP SA*”).↩

5. Policy Statement at P 16.↩

6. However, the Policy Statement notes that FERC has previously accepted filings to establish wholesale market rules that address how a state-determined carbon price operates in multi-state markets. Policy Statement at P 10 (citing *Cal. Indep. Sys. Operator Corp.*, 153 FERC ¶ 61,087 at PP 9-11, 57 (2015)).↩

7. “Environmental leakage” is when carbon pricing shifts emissions from one state or region to another, rather than reducing overall emissions. “Economic leakage” is when the cost of carbon pricing or the energy price effects of carbon pricing are borne by people outside of state or region that imposed the carbon price.↩

8. Policy Statement (Danly, Comm’r concurring in part, dissenting in part) at P 2.↩

9. See Policy Statement at P 5.↩

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