ILLINOIS DISTRICT COURT REJECTS FEDERAL PREEMPTION CHALLENGES TO STATE ZERO-EMISSIONS CREDIT PROGRAM

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U.S. Power Alert

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UPDATE: On July 25, 2017, the New York court issued its decision, which also upheld New York's ZEC program. We will have more analysis of that decision in a later post.

On July 14, 2017, the U.S. District Court for the Northern District of Illinois issued an opinion dismissing challenges to the state of Illinois' zero-emissions credit ("ZEC") program. Illinois' ZECs are tradable credits created by statute that, in the court's words, put "money in the coffers of Exelon from the sale of ZECs that will give it a benefit when pricing its energy in the wholesale market relative to competing energy producers that do not receive ZEC payments." The ZECs represent the zero-emissions attributes of nuclear power and would provide additional revenue for nuclear power plants, whose owners state they are unable to cover their costs in the current low-price wholesale energy and capacity markets.

In its decision in the companion cases *Village of Old Mill Creek v. Star* and *Electric Power Supply Association v. Star* upholding the ZEC program, the court rejected arguments that Illinois' program is preempted by the Federal Power Act and further concluded that ZECs do not discriminate under the dormant commerce or equal protection clauses. If affirmed on appeal, the opinion could have important implications for the future of other states' programs aimed at supporting at-risk nuclear power plants and may influence the Federal Energy Regulatory Commission's ("FERC") outlook on its role in integrating state programs and policies into wholesale energy markets.

BACKGROUND

In June 2016, Exelon Corporation ("Exelon") announced that it would shut down two of its nuclear power plants, Clinton and Quad Cities, located in Illinois. Due to low prices in wholesale energy and capacity markets, Exelon reported that the plants had lost money for several years. Responding to calls for legislative support for nuclear generators that were at risk of closing in the current low price environment, the Illinois General Assembly passed the Future Energy Jobs Act, which included the ZEC program. After the governor signed the bill into law in December 2016, Exelon announced that Clinton and Quad Cities would operate for another ten years.

Under Illinois' program, a ZEC is a tradable credit representing the environmental attributes of one megawatt hour of energy produced from a "zero emission facility" (i.e., a nuclear power plant) interconnected with one of the two regional transmission organizations operating wholesale electric markets in Illinois — the Midcontinent Independent System Operator, Inc. and PJM Interconnection, L.L.C. ("PJM"). Utilities and retail suppliers are required to purchase all ZECs from designated zero-emissions facilities for ten-year terms, and the costs will be passed on to customers. The ZECs are priced at the Social Cost of Carbon, with a potential downward adjustment if an index price, based on projected prices in PJM's wholesale energy and capacity markets, exceeds a specified baseline price. ZEC sales provide the selected nuclear generators with payments for each megawatt hour of electricity they produce, providing the generators with additional revenue beyond what they could otherwise earn from wholesale energy and capacity markets.

In February 2017, a coalition of electric generators and a group of Illinois consumers filed separate lawsuits, later consolidated, arguing that the legislation's asserted goal of "environmental protection" was a pretext for bailing out the Clinton and Quad City plants that would harm the wholesale markets, competitors, and consumers. The plaintiffs argued that the Federal Power Act preempted the ZEC program because it (1) "effectively replaces" wholesale prices and intrudes on FERC's exclusive jurisdiction over wholesale sales and (2) conflicts with FERC's regulatory regime by "distorting" the outcomes in FERC-regulated markets. Plaintiffs also argued that the ZEC program violates the dormant commerce clause and the equal protection clause by favoring in-state plants and imposing additional costs on Illinois consumers.

DISTRICT COURT'S DECISION

In granting Exelon's motions to dismiss, the court found that the plaintiff consumer groups lacked standing for several claims, but addressed head on the preemption claims brought by the coalition of electric generators, as well as the plaintiffs' dormant commerce clause and equal protection clause claims.

The court concluded that neither the Federal Power Act nor FERC's exclusive authority to regulate wholesale markets preempted the ZEC program, discussing why each of the three recent Supreme Court cases on state and federal jurisdiction in the energy industry, *Oneok, Inc. v. Learjet, Inc.*, *Federal Energy Regulatory Commission v. Electronic Power Supply Association* ("EPSA"), and *Hughes v. Talen Energy Marketing*, did not support preemption in this case. The court found that Oneok did not support preemption because "[a]lthough the ZEC program will affect wholesale electricity rates, those rates were not its target." The court also found that because receiving ZECs is not conditioned on the nuclear generators clearing the wholesale energy or capacity auctions and the ZECs did not change the amount of money that is actually exchanged for wholesale electricity, the ZEC program has only an indirect effect on wholesale markets and is not preempted. Applying both *EPSA* and *Hughes*, the court concluded that "influencing the market by subsidizing a participant, without subsidizing the wholesale transaction, is indirect and not preempted." The court concluded that, "[s]o long as FERC can address any problem the ZEC program creates with respect to just and reasonable wholesale rates . . . there is no conflict."

With respect to plaintiffs' dormant commerce clause argument, the court found that the ZEC program is not facially discriminatory because it allows out-of-state generators to submit bids for ZECs. The court also found that the plaintiffs' dormant commerce clause arguments must fail because the incidental alleged harm to out-of-state competitors in the wholesale energy and capacity markets cannot outweigh the Illinois' legitimate state interests. The court similarly relied on the legitimate state interests Illinois used to justify the ZEC program to reject the plaintiffs' equal protection claims.

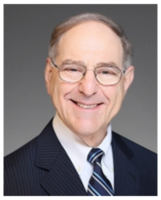
IMPACT OF THE DISTRICT COURT'S DECISION

While firm conclusions will likely have to await appeal of the dismissal to the Seventh Circuit Court of Appeals, the policy impact of the District Court's decision may be felt far beyond Illinois' ZEC program. With the influx of cheaper natural gas and renewable technologies into the wholesale electric markets, states continue to grapple with whether and how to preserve the fuel diversity, grid resiliency, local employment, and zero-emissions benefits of nuclear power. Notwithstanding that the value of the ZEC would decline as projected wholesale market prices increased, the court found that the ZECs were an "unbundled" energy credit program similar to renewable energy credits, and distinguishable from state programs tied directly to wholesale market prices, like Maryland's program at issue in *Hughes*. If this distinction is upheld, it will be instructive for other states, including New Jersey and Pennsylvania, that are considering legislation to support nuclear facilities.

A New York federal district court is also reviewing challenges to New York's ZEC program, which is nearly identical to Illinois' program. While the Illinois decision will not bind that court, even if affirmed on appeal, it will surely be considered. And a decision in the New York case may be the first indication of whether a circuit split is likely to occur, which could lead the Supreme Court to review state and federal jurisdictional issues in the energy industry again, an issue it has not been reluctant to address recently.

FERC will also have to grapple with the implications of the court's decision, which left it to FERC to fix any market-distorting effects of ZECs that result in unjust and unreasonable rates. As the court noted, however, FERC is currently "paralyzed" by a lack of a quorum and could not even rule on a complaint before it related to Illinois' ZEC program. While without a quorum, FERC convened a technical conference to discuss the impact of state programs on wholesale energy markets and is building a substantial record. Upon the confirmation of new commissioners, this record will guide FERC's consideration of new policies and rules aimed at balancing states' interests in programs, like ZECs, but still ensuring that the nation's wholesale electric markets produce rates that are just and reasonable.

KEY CONTACTS



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