

# ENERGY DEFERENCE

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## INTRODUCTION

Electricity law is complex, and the Supreme Court knows it. Lawyers are familiar with the adage that generalist courts tend to defer to agency decisions where the subject matter is complex or technical. But how exactly do deference regimes work in the presence of complexity? *Federal Energy Regulatory Commission v. Electric Power Supply Ass'n* (“EPSC”),<sup>1</sup> which the Supreme Court decided this spring, provides some insights.

The case has garnered attention primarily for its jurisdictional implications. In fact, the jurisdictional question was the only one the parties presented to the Supreme Court. Nevertheless, in granting certiorari, the Court added a second question *sua sponte*: whether the price the Federal Energy Regulatory Commission (“FERC”) set for demand response in wholesale markets was arbitrary and capricious. This essay will focus on that second, administrative law question.

Demand response is a service provided by end-use customers (residential, commercial, or industrial) in which they reduce their electricity usage in exchange for compensation. In a 2011 order, FERC required that demand response resources in wholesale markets be paid for their reductions at the same rate—called the “locational marginal price” (“LMP”) because it varies based on geography—as power generators are paid for their electricity.<sup>2</sup> FERC’s dominant justification for this choice was that demand response resources provide a value to the grid comparable to what generators provide.<sup>3</sup> Essentially, both demand response resources and generators help to maintain the balance of supply and demand in wholesale electricity markets.<sup>4</sup> This balance is vital to ensure reliable electricity service at a reasonable price. According to FERC, comparable contributions deserve comparable compensation. In response to concerns that the pricing scheme might result in higher wholesale prices in some circumstances, FERC included a safety valve: demand response resources

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<sup>1</sup> 136 S. Ct. 760 (2016).

<sup>2</sup> See Demand Response Compensation in Organized Wholesale Energy Markets, 134 FERC ¶ 61,187, para. 20 (2011) (codified at 18 C.F.R. § 35).

<sup>3</sup> *Id.*

<sup>4</sup> See *id.* para. 10.

would receive the LMP only where “cost-effective” as determined by a “net benefits” test that compared the cost of procuring the demand response with the savings from lower wholesale electricity prices.<sup>5</sup> The Commission justified its entire scheme, in part, by reference to the conclusions of economist and regulatory scholar Alfred Kahn, whose expert declaration appears in the rule-making record.<sup>6</sup>

Electric power generators challenged the pricing scheme as arbitrary and capricious. Why? Demand response resources, so the argument goes, are already benefitting from not having to pay for the electricity they forgo. To pay them the full wholesale price would therefore compensate them twice. The proper price, according to the challengers, would be the wholesale price (“LMP”) *minus* the retail cost of the electricity (“G”). An amicus brief from economist Robert Borlick and several others supported this conclusion,<sup>7</sup> as did comments filed during the rulemaking process by economist William Hogan.<sup>8</sup>

How is a court to weigh in on this debate? Answer: very carefully. The Supreme Court ultimately sided with FERC, applying a set of overlapping deference doctrines and concluding that the pricing scheme was a reasonable exercise of FERC discretion. The ensuing sections take a closer look at how these deference doctrines operate in the energy law context. Part I suggests that the Court’s deferential approach to arbitrary and capricious review in *EPSA* is consistent with a new theory of “thin” rationality review articulated by Jacob Gersen and Adrian Vermeule.<sup>9</sup> Part II notes that energy decisions have traditionally received an extra layer of deference (what Emily Hammond has called, in another context, “super deference”<sup>10</sup>), and that *EPSA* is faithful to that approach. Finally, Part III offers insights into how both “thin” rationality review and “super deference” operate in practice. While some judges and Justices are more willing than others to educate themselves about energy policy, all rely to some extent on “deference proxies” in reviewing FERC’s decisions. These proxies—which include procedural regularity, expert support, and the presence or absence of a dissenting decisionmaker—can be used to confirm a

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<sup>5</sup> *Id.* paras. 50–54.

<sup>6</sup> *Id.* para. 20.

<sup>7</sup> See generally Brief for Robert L. Borlick et al. as Amici Curiae Supporting Respondents, *FERC v. EPSA*, 136 S. Ct. 760 (2016) (No. 14-840, 14-841).

<sup>8</sup> See generally Dr. William W. Hogan, Providing Incentives for Efficient Demand Response, Comments on PJM Demand Response Proposals (Oct. 29, 2009).

<sup>9</sup> See Jacob Gersen & Adrian Vermeule, *Thin Rationality Review*, 114 MICH. L. REV. (forthcoming 2016).

<sup>10</sup> Emily Hammond Meazzell, *Super Deference, the Science Obsession, and Judicial Review as Translation of Agency Science*, 109 MICH. L. REV. 733, 734 (2011).

judge's intuitions about agency rationality. As this case demonstrates, however, proxies are an imperfect assessment tool and can be used selectively to support divergent outcomes.

## I. "THINNER" RATIONALITY REVIEW

Courts review a significant fraction of agency action, including most rule-makings, under the Administrative Procedure Act's ("APA") "arbitrary and capricious" standard. This standard, originally thought of as similar to constitutional rationality review,<sup>11</sup> requires reviewing courts to set aside agency action that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."<sup>12</sup> In a set of decisions in the 1970s and '80s, the Supreme Court appeared to interpret this standard to require a more searching inquiry into agency decisionmaking.<sup>13</sup> The traditional formulation of this "harder look" requires courts to satisfy themselves that the agency has considered the relevant factors and that there is a "rational connection between the facts found and the choice made."<sup>14</sup> However, the courts of appeals and the Supreme Court remain significantly more likely to defer to agency action under this standard than to overturn it.<sup>15</sup>

In a recent article, Jacob Gersen and Adrian Vermeule offer a series of novel arguments in defense of a "thin" conception of rationality review. Thinner review is desirable, they argue, because even rational agencies sometimes "have good reason to decide in a manner that is inaccurate, non-rational, or arbitrary."<sup>16</sup> For example, agencies might have to select between equally plausible alternatives in the presence of genuine "Knightian" uncertainty (where insufficient information exists even to assign likelihoods to possible states of the world).<sup>17</sup> There might also be good second-order reasons for making a decision that is "good enough" but not perfect ("satisficing"), for instance where

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<sup>11</sup> Gillian Metzger, *Ordinary Administrative Law as Constitutional Common Law*, 110 COLUM. L. REV. 479, 491 (2010).

<sup>12</sup> 5 U.S.C. § 706(2)(A) (2012).

<sup>13</sup> See *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402 (1971); *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983).

<sup>14</sup> *State Farm*, 463 U.S. at 43 (quoting *Burlington Truck Lines v. United States*, 371 U.S. 156, 168 (1962)).

<sup>15</sup> Gersen & Vermeule, *supra* note 9, at 1; David Zaring, *Reasonable Agencies*, 96 VA. L. REV. 135, 169 (suggesting that agencies win nearly 70% of cases in the courts of appeals regardless of the standard of review employed).

<sup>16</sup> Gersen & Vermeule, *supra* note 9, at 2.

<sup>17</sup> *Id.* at 26.

information gathering is costly or where there are opportunity costs associated with more deliberate action.<sup>18</sup> Deference might even be justified, Gersen and Vermeule conclude, where an agency fails to communicate convincing reasons for its decision. This is so since agencies might be relying on “tacit expertise”—Hayekian local knowledge that cannot be communicated to courts at acceptable cost.<sup>19</sup>

*EPSA* provides yet another data point in support of Gersen and Vermeule’s descriptive thesis that arbitrary and capricious review in the Supreme Court is quite deferential. The Court in *EPSA* declined to “ask whether a regulatory decision is the best one possible or even whether it is better than the alternatives.”<sup>20</sup> Rather, it found that its task was simply to review the agency’s decision under the “narrow” standard of *State Farm*,<sup>21</sup> asking whether the agency “examine[d] the relevant [considerations] and articulate[d] a satisfactory explanation for its action[,] including a rational connection between the facts found and the choice made.”<sup>22</sup> In other words, the Court accepted that the agency could engage in what Gersen and Vermeule call “satisficing”: selecting a “good enough” alternative rather than exhausting time and resources in pursuit of a single “best” choice.

The decision also offers support for Gersen and Vermeule’s argument that an agency’s “local knowledge” may sometimes justify its choice, even though this type of specialized information may be costly to communicate effectively to a reviewing court. In Order 745, FERC noted that “the Commission is not limited to textbook economic analysis of the markets subject to our jurisdiction, but also may account for the practical realities of how those markets operate.”<sup>23</sup> Here, FERC knew from its experience observing wholesale market dynamics over a course of years and from its repeated interactions with relevant stakeholders that setting the price for demand response any lower than LMP would fail to overcome existing barriers to demand response participation in wholesale markets.<sup>24</sup> Even if FERC failed to articulate precisely how that experience supported its pricing decision, the Court was right to give it the benefit of the doubt.

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<sup>18</sup> *Id.* at 30.

<sup>19</sup> *Id.* at 36–37.

<sup>20</sup> *FERC v. EPSA*, 136 S. Ct. 760, 782 (2016).

<sup>21</sup> *Motor Vehicle Mfrs. Ass’n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983).

<sup>22</sup> *EPSA*, 136 S. Ct. at 782 (quoting *State Farm*, 463 U.S. at 43) (alterations in original).

<sup>23</sup> Order 745, 134 FERC ¶ 61,187 para. 46.

<sup>24</sup> *See id.* paras. 59–61.

## II. ENERGY “SUPER DEFERENCE”

Certain agency actions qualify for even greater deference than that typically afforded under the arbitrary and capricious standard. This is because complexity also impacts the “thickness” of a court’s deference regime. Reviewing courts are to be at their “most deferential” in reviewing agency determinations “within [the agency’s] area of special expertise,” especially those “at the frontiers of science.”<sup>25</sup> Broad deference is also appropriate where an agency program is “technical” and “complex.”<sup>26</sup> Emily Hammond has termed this special solicitude for scientific or technical agency decisionmaking “super deference.”<sup>27</sup>

Many aspects of energy decisionmaking have qualified for a heightened level of deference, including ratemaking and the evaluation of complex market conditions.<sup>28</sup> The Supreme Court has suggested that increased deference is due more generally to an energy agency simply because its decisionmaking takes place in the context of a complex regulatory regime.<sup>29</sup> In another case, the Court premised enhanced deference on the fact that certain FERC statutory authorizations are “incapable of precise judicial definition.”<sup>30</sup>

The majority’s articulation of the deference due to the Commission in *EPSA* is consistent with general principles of “super deference”: “[W]e afford great deference to the Commission in its rate decisions,”<sup>31</sup> Justice Kagan wrote for the majority, later noting that “[t]he disputed question here involves both technical understanding and policy judgment.”<sup>32</sup> In his dissent below, Judge Edwards framed the principle of deference in similar terms, finding that “[w]e . . . afford significant deference to FERC in light of the highly technical

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<sup>25</sup> *Balt. Gas & Elec. Co. v. Nat. Res. Def. Council, Inc.*, 462 U.S. 87, 103 (1983).

<sup>26</sup> *Thomas Jefferson Univ. v. Shalala*, 512 U.S. 504, 512 (1994) (applying *Auer* deference, rather than the arbitrary and capricious standard).

<sup>27</sup> See generally Hammond Meazell, *supra* note 10.

<sup>28</sup> See, e.g., *Sacramento Mun. Util. Dist. v. FERC*, 616 F.3d 520, 541–42 (D.C. Cir. 2010) (“This court properly defers to policy determinations invoking the Commission’s expertise in evaluating complex market conditions.” (quoting *Tenn. Gas Pipeline Co. v. FERC*, 400 F.3d 23, 27 (D.C. Cir. 2005))); *Transcon. Gas Pipe Line Corp. v. FERC*, 922 F.2d 865, 871 (D.C. Cir. 1991) (“[O]ur traditional duty to defer can only be enhanced in the present situation by the complexity and technical nature of the ratemaking process.”).

<sup>29</sup> See *California v. FERC*, 495 U.S. 490, 499 (1990) (discussing the interpretation of a section of the Federal Power Act).

<sup>30</sup> *Morgan Stanley Capital Grp. Inc. v. Pub. Util. Dist. No. 1 of Snohomish Cty.*, 554 U.S. 527, 532 (2008) (discussing the Federal Power Act’s requirement that rates be “just and reasonable”).

<sup>31</sup> *FERC v. EPSA*, 136 S. Ct. 760, 782 (2016) (quoting *Morgan Stanley*, 554 U.S. at 532) (alteration in original).

<sup>32</sup> *Id.* at 784.

regulatory landscape that is its purview.”<sup>33</sup> Perhaps Justice Sotomayor put it best at oral argument when she asked, with respect to the pricing question, “[H]ow do we choose to go into the weeds of something as technical as that?”<sup>34</sup>

Notwithstanding Justice Sotomayor’s cautionary statement about delving too deeply into a technical area, many judges do appear more comfortable with complex subject matter. To be sure, some investigation of substance is unavoidable. Deference, after all, does not mean abdication. Judges must still assure themselves that the agency’s choice satisfies some threshold level of rationality. At a minimum, this requires judges to attain sufficient comfort with the subject matter to comprehend the agency’s choice and its reasoning.

Some judges, however, evince a particularly keen desire to understand the landscape before them, regardless of (or perhaps due to) its complexity. These judges engage in a process of exploration and distillation. Justice Kagan’s majority opinion and Judge Edwards’s dissent in the D.C. Circuit both exhibited a thirst for understanding absent from Judge Brown’s majority opinion below. For example, while Justice Kagan engaged in a meticulous and thorough exposition of the major support for FERC’s pricing scheme,<sup>35</sup> Judge Brown failed to engage with the particulars of FERC’s choice, citing an unwillingness to “delve now into the dispute among experts” and noting only that aspects of the decision “seem[] troubling . . . .”<sup>36</sup> Even at oral argument it was clear that some Justices had a greater appetite for detail than others. Justice Breyer, for example, assured counsel for the respondents that he would “read Kahn’s testimony, I promise. I will read Cicchetti, and I will read Hogan too.”<sup>37</sup> While a genuine understanding of the underlying technical and economic principles may not be required under a highly deferential standard of review, it makes judges more comfortable with their reasonableness findings. It is to this tension—between the judicial instinct to make well-informed, “correct” decisions, on the one hand, and the institutional obligation to defer, in certain circumstances, to agency decisions, on the other—that the next section turns.

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<sup>33</sup> *EPSA v. FERC*, 753 F.3d 216, 236 (D.C. Cir. 2014) (Edwards, J., dissenting).

<sup>34</sup> Transcript of Oral Argument at 47, *FERC v. EPSA*, 136 S. Ct. 760 (2016) (No. 14-840).

<sup>35</sup> See *EPSA*, 136 S. Ct. at 782–84.

<sup>36</sup> *EPSA*, 753 F.3d at 225.

<sup>37</sup> Transcript of Oral Argument, *supra* note 34, at 53.

## III. TRUST, BUT VERIFY

*EPSA* therefore stands for the proposition, first, that the Supreme Court applies a “thin” version of rationality review to agency action and, second, that the Court shows even greater deference to many FERC decisions because their subject matter is technical and complex. But the opinion also yields insights about how both “thin” rationality review and “super deference” operate in practice.

In both cases, judges rely on what I call “deference proxies” to confirm their generalist instincts. This process might best be described by the phrase “trust, but verify,” an old Russian proverb popularized by President Reagan in describing the United States’ approach to international arms control regimes.<sup>38</sup> Proxies give the judge greater confidence in the agency’s approach without requiring a full understanding of the underlying subject matter.

Procedural safeguards are classic proxies used to evaluate the substantive rationality of agency action.<sup>39</sup> This approach has clear institutional advantages in that it saves generalist judges from having to opine on substantive issues outside of their comfort zone while allowing them to focus on one of their areas of expertise: procedure. In *EPSA*, Justice Kagan’s majority opinion, as well as the two opinions below, all relied to some extent on this technique. Justice Kagan, for example, noted that FERC “responded at length to *EPSA*’s” argument that LMP overcompensated demand response providers.<sup>40</sup> The very act of responding, and especially doing so “at length,” seems to be a significant indicator of rationality, even before considering the content of that response.

Proxies might also include the presence or absence of expert opinions sanctioning the agency’s approach. These expert opinions might be part of the record below, or they might appear in amicus briefs.<sup>41</sup> In *EPSA*, Justice Kagan noted FERC’s reliance “on an eminent regulatory economist’s views” in arriving

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<sup>38</sup> See, e.g., Nina Porzucki, Suzanne Massie Taught President Ronald Reagan This Important Russian Phrase: ‘Trust, but Verify’, PUBLIC RADIO INT’L (Mar. 7, 2014), <https://perma.cc/BR7V-VG72>.

<sup>39</sup> See e.g., Cass R. Sunstein, *Deregulation and the Hard-Look Doctrine*, 1983 SUP. CT. REV. 177, 181 (identifying both substantive and procedural components of arbitrary and capricious review); Louis J. Virelli III, *Deconstructing Arbitrary and Capricious Review*, 92 N.C. L. REV. 721, 767 (2014) (noting that judges can review an agency’s procedures for gathering technical or scientific “inputs” even if they are ill-qualified to review the inputs themselves).

<sup>40</sup> *EPSA*, 136 S. Ct. at 783.

<sup>41</sup> While judges must focus only on an agency’s contemporaneous explanations for its actions in evaluating rationality, see *SEC v. Chenery Corp.*, 318 U.S. 80, 87 (1943), post hoc explanations can give the judge more comfort with the agency’s approach.

at its conclusions.<sup>42</sup> The opinion cited repeatedly to Dr. Alfred Kahn's affidavit.<sup>43</sup> Of course, the other side produced an army of economists disputing Dr. Kahn's approach, including one responsible for the independent monitoring of PJM, the regional transmission organization with the most practical demand response experience to date.<sup>44</sup> And in fact, Justice Scalia's dissent, though professing "neither need nor desire" to address the pricing issue, hinted that he would have found FERC's price arbitrary and capricious based on the amicus brief of economist and management consultant Robert Borlick.<sup>45</sup>

Finally, judges sometimes use an absence of unanimity at the agency as a proxy for irrationality. This proxy cuts in the other direction—the presence of one or more dissenting views on the Commission can be seen as reason to doubt the rationality of the majority's decision. Judge Brown's majority opinion in the D.C. Circuit emphasized the existence of a dissenting view on the Commission: the opinion cited to Commissioner Moeller's dissent in support of its conclusion that FERC's pricing scheme was arbitrary.<sup>46</sup>

The use of proxies is a rational response to both cognitive and institutional limitations as well as resource constraints. Judges, too, must "satisfice." But the process has costs as well. First is the peril of "proxy shopping." Like Justice Kagan and Judge Edwards, Judge Brown relied on deference proxies; each judge simply selected different proxies. By focusing on one type of proxy (a Commissioner's dissent) to the exclusion of others (the procedural safeguards and expert opinions highlighted by Justice Kagan and Judge Edwards), Judge Brown reached a very different result. Even where two opinions rely on the same type of proxy, they might select versions that point in different directions. A good example is Justice Kagan's reliance on the expert views of Alfred Kahn, which supported FERC's pricing scheme, while Justice Scalia relied on the expert opinion of Robert Borlick, which criticized it.

A second drawback to the use of proxies is that some proxies are inherently more reliable than others. A procedural deficiency (such as a failure to respond to key comments) may be more likely to indicate a substantive problem with a decision than one Commissioner's dissent (which might be motivated by law, policy, or even politics and may be less carefully crafted than the official Commission order). If judges do not reflect carefully on the inherent reliability of

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<sup>42</sup> *EPSA*, 136 S. Ct. at 782.

<sup>43</sup> *See id.* at 769, 782.

<sup>44</sup> Brief for Robert L. Borlick et al., *supra* note 7.

<sup>45</sup> *EPSA*, 136 S. Ct. at 789 (Scalia, J., dissenting).

<sup>46</sup> *EPSA*, 753 F.3d at 225.



their chosen proxies, they may ultimately construct their opinions on unstable foundations.

#### CONCLUSION

Energy cases in the Supreme Court are a rarity. Perhaps this explains, in part, the Court's apparent eagerness to consider the pricing issue in *EPSA*. Had it allowed the D.C. Circuit's ruling on that question to stand, it might have been another five or even ten years before the Court could clarify its position on deference in energy cases.

The lessons for FERC are clear: the Supreme Court maintains its deferential approach to energy decisionmaking in general and to energy ratemaking in particular. Some Justices clearly hunger to understand the electricity system and electricity policy, and FERC should provide clear explanations of its actions in future rulemakings with this audience in mind. However, all judges ultimately rely on deference proxies in evaluating agency decisionmaking under deference regimes. Thus, at least where there is a significant litigation risk, FERC should ensure that as many of these proxy signals as possible support its decision.