BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Implement the Commission's Procurement Incentive Framework and to Examine the Integration of Greenhouse Gas Emissions Standards into Procurement Policies.	Rulemaking 06-04-009 (Filed April 13, 2006)

COMMENTS AND LEGAL ANALYSIS OF THE COMMUNITY ENVIRONMENTAL COUNCIL ON MARKET ADVISORY COMMITTEE REPORT AND THE FIRST SELLER APPROACH

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August 6, 2007

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The Community Environmental Council ("Council") respectfully submits these comments in accordance with the "Joint Administrative Law Judges' Ruling Requesting Comments and Legal Briefs on Market Advisory Committee Report" ("ALJR"), dated July 19, 2007.

The Council is a member-supported environmental non-profit organization formed in Santa Barbara in 1970 and is the leading environmental organization in our region.

In 2004, the Council shifted its primary focus to energy issues and we are spearheading a regional effort to wean our communities from fossil fuels entirely during the next two decades. We are almost unique in combining on the ground work on a number of energy and climate change-related issues with our work on state and federal policy issues. Our state policy work is directly informed by our experience with what has worked, or will work, at the local level. More information on the Council and our energy program may be found at www.fossilfreeby33.org.

The Council supports a first-seller cap and trade approach, as it offers a number of advantages over a load-based approach – assuming a regional cap and trade system. We find that a first-seller cap and trade system should not be preempted by either the Federal Power Act or the dormant Commerce Clause. We also urge the Commission to examine the merits of a revenue-neutral carbon fee in lieu of, or in addition to, a cap and trade approach.

I. General Comments

A. Cap and trade versus a revenue-neutral carbon fee

As numerous commentators have opined, a revenue-neutral carbon fee is probably a better tool for reducing emissions than a cap and trade system.[1] Due to the many benefits a carbon fee would produce, the Council strongly urges the Commission to consider a carbon fee instead of a cap and trade as the optimal policy tool for reducing GHGs in the electricity and natural gas sectors. Such a fee already has precedent in the Commission's own "greenhouse gas adder," used as an accounting tool in long-term procurement to take into account the likely cost of greenhouse gas regulations for ratepayers in the future.[2] The adder could be modified into an actual fee, rather than being simply an accounting tool, as it is now. For example, in 2007, the adder is $8/ton. Next year, it rises to $12.50/ton. These figures are in the reasonable range for the starting point for a phased-in carbon fee.

If such a fee were imposed in concert with legislative action to reduce other taxes, the carbon fee could be made revenue neutral – an important feature in terms of ameliorating concerns about undue financial burdens on ratepayers.

We discuss in detail numerous other issues in relation to a revenue-neutral carbon fee versus a cap and trade in our draft policy paper that is nearing completion. We state in our draft:

> Perhaps unsurprisingly, the reports issued thus far by the Climate Action Team and Market Advisory Committee (part of CalEPA, formed by the Governor to advise the Air Resources Board on AB

[1] Significant information on carbon fees and their proponents is available at the Carbon Tax Center: www.carbontax.org.
[2] *See* D.04-12-048, in R.04-04-003.

32 implementation) only consider the cap-and-trade option. The reports neglect alternative options, most notably the option of a revenue-neutral carbon tax.[1] However, the June 30, 2007, MAC Report does not cite AB 32's definition of "market-based compliance mechanisms" as the rationale for not considering other options. Rather, it states only, after discussing the benefits of a cap and trade approach:

> Note that a carbon tax offers several of these same advantages. However, a carbon tax would not ensure a particular level of emissions reductions. Ensuring a specified emissions target is particularly desirable in view of the emissions goal established by the Global Warming Solutions Act.[3]

This argument is, however, specious, when we consider that a cap and trade program will not guarantee emissions reductions. We need look only to the example of the first phase of the EU's Emissions Trading System for an example of a cap and trade program that achieved practically no effect. The EU system over-allocated allowances in the first 2005-2007 trading period, based on inflated baseline emissions inventories for regulated entities, leading to a collapse in the price of carbon allowances and thus no incentive for companies to change behavior to reduce emissions. Moreover, AB 32 has set a cap for California's emissions: a return to 1990 emissions levels by 2020. The only issue that remains is deciding the best suite of tools to achieve that goal.

It is interesting to note that California's agencies have thus far excluded any consideration of an alternative model that is becoming preferred over cap-and-trade models by a majority of economists[2], major newspaper editorials[3], and a wide spectrum of policy advocates - ranging from oil industry giant Exxon, the American Petroleum Institute, the right of center policy think tank American Enterprise Institute, to former vice-president Al Gore[4]?

With inclusion of a number of cap and trade features proposed by the MAC Report and others, a cap and trade model could capture many of the benefits of a carbon fee. For example, if allowances are auctioned, some revenue could be

[3] MAC Report, p. 5.

used to offset the burden on low income families or could be used for rebates to all ratepayers, making the cap and trade model revenue-neutral, if desired. Also, if a price cap and/or price floor for allowances is included in a cap and trade system, market volatility could be significantly diminished as well as the opportunities for market abuse. And if a first seller approach is adopted as part of a cap and trade system, administrative simplicity is enhanced because the number of regulated entities may be lower than under a load-based approach.

Accordingly, the Council urges the Commission to examine the merits of a carbon fee as a better tool for mitigating GHG emissions, but acknowledges that politically (i.e., the Governor and certain state agencies under his control are pushing strongly for a cap and trade system) it will be very difficult in the near-term to change course in such a fashion. In light of this last consideration, we urge the Commission, if it declines to examine a carbon fee in this proceeding, to adopt measures that make a cap and trade model as much like a carbon fee as possible.

Another alternative, recommended by TURN and the Consumer Tax Reform Association in comments on the MAC Report to the Air Resources Board, is to impose a carbon fee of some sort starting in 2009 as a prelude to an auction under a cap and trade system to begin in 2012. This fee could help fund the system itself and could fund studies regarding optimal allocation of the revenue from a carbon fee and/or auctioned allowances.

II. Legal Analysis of First-Seller Approach

While the Council believes the Commission should examine carbon fees as a policy instrument, we fully support a first-seller approach over a load-based approach to a cap and trade system. We offer a detailed legal analysis of preemption issues under the Federal Power Act and the dormant Commerce Clause in Section III.

43. Would the Federal Power Act preempt adoption of the deliverer/first-seller approach? Why or why not? Does it make any difference that the federal government has not issued any regulations in this specific area?

Under a cap-and-trade system, a set number of emission allowances would be issued (the total number of allowances being "capped"), thereby limiting the aggregate emissions of regulated entities. Entities may trade allowances among themselves, but the total number of allowances (and emissions) is set for each compliance period, and will likely decrease over time to bring total emissions back to 1990 levels by 2020, as required by AB 32.

Under the developer/first-seller approach ("first-seller approach"), the responsible entity or point of regulation will be either a California power plant operator or the importing contractual party, depending on whether the electricity is generated in-state or out-of-state. The importing contractual party could be any wholesale power marketer. In a cap-and-trade scenario, the first sellers would be limited to the production and/or importation of electricity with emissions corresponding to their allowances. **For the reasons stated below, the Federal Power Act ("FPA") should not preempt adoption of the first-seller approach.**

A. Preemption Analysis Under the Federal Power Act

State laws in conflict with federal law are invalid under the Supremacy Clause of the U.S. Constitution. *See Gonzales v. Raich*, 545 U.S. 1, 29 (2005). Preemption can be either express or implied.

1. The First-Seller Approach is Not Expressly Preempted by the FPA

Express pre-emption arises when Congress or a federal agency, acting with the authority vested in it by Congress, has explicitly declared the Federal legislation or administrative dictate, respectively, to have a pre-emptive effect. *Jones v. Rath Packing Co.*, 430 U.S. 519, 525 (1977). As is clear from a review of the text of the FPA, **the FPA does not expressly preempt a cap and trade program or the first-seller approach**. Therefore, our analysis proceeds to address whether Congress has impliedly preempted the proposed first-seller approach.

2. The First-Seller Approach is Not Impliedly Preempted by the FPA

Implied preemption results where a state law conflicts with federal law such that compliance with both federal and state regulations is impossible. *Hillsborough Co. v. Automated Med. Labs., Inc.*, 471 U.S. 707, 710 (1985). Implied preemption may also result where the state law impedes the federal law's objective (*Hill v. Florida*, 325 U.S. 538 (1945)), or "the scheme of federal regulation is sufficiently comprehensive to make reasonable the inference that Congress 'left no room' for supplementary state regulation." *Rice v. Santa Fe Elevator Corp*, 331 U.S. 218, 230 (1947).

As explained below, the first-seller approach does not conflict with the FPA such that compliance with federal law is impossible, and will not impede federal objectives. Furthermore, Congress has not chosen to "occupy the field" in the FPA, but rather has specifically left room for the states to regulate. 16 U.S.C. § 824(a) (providing that other than transmission and wholesale sale of energy in interstate commerce, federal regulation is "to extend only to those matters which are not subject to regulation by the States.")

i. The First Seller Approach Does Not Conflict with the FPA and Will not Impede Federal Objectives

The first-seller approach does not conflict with the FPA's purpose of encouraging orderly development of plentiful supplies of electricity and natural gas at reasonable prices. A conflict between state and federal law does not arise such that the state law is preempted simply because the state law addresses the same subject matter as the federal law. If the state law serves a different purpose, and does not necessarily obstruct the federal purpose, the state law is not preempted. *See e.g., Huron Portland Cement Co. v. City of Detroit*, 362 U.S. 440 (1960). Compliance with both the FPA and the first-seller approach is possible, because there is no federal provision impeding dual compliance. Indeed, there is no federal legislation regarding greenhouse gas emissions.

The FPA empowers FERC to regulate "the transmission of electric energy in interstate commerce" and "the sale of electric energy at wholesale in interstate commerce." 16 U.S.C. § 824(b); *New York v. F.E.R.C.*, 535 U.S. 1 (2002); *see also Gulf States Util. Co. v. FPC*, 411 U.S. 747, 758 (1973). The FPA gives FERC "jurisdiction over all facilities for such transmission or sale of electric energy ...." 16 U.S.C. § 824(b)(1). The jurisdiction includes the authority to order interconnection to the grid and to specify the terms of the interconnection. 16 U.S.C. §§ 824i, 824k. **There is no FPA provision concerning the regulation of emissions from electric power generation**.

Further, the mere existence of FERC's regulatory scheme over interstate transmission of electricity does not by itself preempt state law on the subject of emissions from power generation. *English v. General Electric Co.*, 496 U.S. 72, 87 (1990) (explaining that the existence of a federal regulatory or enforcement scheme does not by itself imply pre-emption of state remedies: "Undoubtedly, every subject that merits congressional legislation is, by definition, a subject of national concern. That cannot mean, however, that every federal statute ousts all related state law ... instead, we must look for special features warranting preemption.")

If there is no analogous federal provision, so long as the purpose of a state law is <u>plausibly related</u> to matters of legitimate state concern, no conflict will be found. *See Northwest Central Pipeline Corp. v. State Corp. Com'n of Kansas,* 489 U.S. 493, 518-19 (1989) (emphasis added). There is no irreconcilable conflict between the first-seller approach and the federal regulation largely because there is no federal regulation in this area. Moreover, the first-seller approach is clearly related to the legitimate state concern of protecting the citizens of its state from the adverse effects of global warming. The FPA only preempts state authority to regulate in matters of transmission and wholesale power sales. See 16 U.S.C. § 824(b).

The first-seller proposal may alter incentives for sellers in relation to the sources of electricity that they provide across state lines by virtue of new market considerations relating to emissions allowances. However, this does not by itself conflict with FERC's regulatory authority over transmission and wholesale power sales. Even if the first-seller approach does cause an incidental effect on electricity rates or the types of electricity generation used to produce electricity for California consumers, **an indirect effect is insufficient to conflict with and frustrate the purposes of the federal scheme**. *Schneidewind v. ANR Pipeline Co.,* 485 U.S. 293, 308 (1988) ("Of course, every state statute that has some indirect effect on rates and facilities ... is not preempted."). In sum, any incidental effect on prices the first-seller model may create does not threaten FERC's jurisdiction over the transmission and wholesale market and thus should not cause preemption to raise its ugly head.

Congress designed the FPA in part to "prevent the expansion of Federal authority over State matters." *Jersey Cent. Power & Light Co. v. FPC*, 129 F.2d 183, 193 (3d Cir. 1942). Regulation by the state to protect the health, safety and welfare of its citizens is within the traditional police powers of the state. *See e.g., Williams v. Arkansas*, 217 U.S. 79 (1910). Furthermore, **the U.S. Supreme Court has stated a presumption against preemption in cases concerning whether a state law conflicts with, and thus has been displaced by, the existence of Federal Government authority**. See, e.g., *Hillsborough County v. Automated Medical Laboratories, Inc.*, 471 U.S. 707, 715 (1985) (citing cases); see also *Medtronic, Inc. v. Lohr*, 518 U.S. 470, 485 (1996). In such a situation, the Court starts with the assumption that the police powers of the States are not to be superseded. *Hillsborough County*, 471 U.S., at 715. Here, the mere fact that there is a general federal scheme that regulates transmission and wholesale sale of power does not overcome the assumption that California's historic police power to regulate emissions harmful to its citizens is preempted.

Implied preemption will also be found if the state law impairs the achievement of federal objectives set forth in federal statute. *Hill v. Florida*, 325 U.S. 538 (1945). The first-seller approach should not be found to impede the objective of the FPA, which is to encourage the orderly development of plentiful supplies of electricity at reasonable prices. *See Wabash Valley Power Ass'n, Inc., supra*, 268 F.3d 1105. Instead, the first-seller program encourages California's energy suppliers to compose their energy portfolios with an eye to limiting the emissions associated with those sources. The central purpose is to limit GHG emissions, rather than wholesale power sales. The first-seller approach may incentivize first-sellers to obtain their out of state power supplies from low emission sources, but should not frustrate the purposes of the FPA, i.e., orderly development of plentiful supplies of electricity at reasonable prices. *Id.* The first-seller approach would limit the quantity of GHG emissions associated with a given quantity of electricity, but would not impair the free flow of electricity in commerce. It would not in any manner alter FERC's delineated powers to regulate the transmission and wholesale sale of electricity in interstate commerce. For these reasons, the first-seller approach should not result in preemption for impairment of the federal objectives reflected within the FPA.

Some parties will surely argue that a first-seller cap and trade system will impede the FPA's objectives of orderly development of plentiful supplies of electricity at reasonable prices due to the cost impacts of greenhouse gas regulation. The Council will flesh out the cost considerations from the proposed greenhouse gas regulation in California in reply comments, but will offer a few comments here.

First, there are many ways in which cost impacts to consumers could be minimized or eliminated. For example, if allowances are auctioned, revenues from the auction could be re-distributed to ratepayers to offset any electricity price increases. Alternatively, revenues could be used for rebates or tax credits for renewable energy technologies such as wind, geothermal or solar power – expanding existing state and federal programs. With expanded rebates and/or tax credits in place, the cost of low-carbon electricity generation could be mitigated partially or fully.

A recent draft report from the California Energy Commission found that the actual cost of fossil fuel generation has risen in recent years such that a number of low-carbon renewable energy technologies are now cheaper than fossil fuel sources, including wind, geothermal, and various forms of biomass (*see* Figure 1).[4] Energy efficiency will also be incentivized through a cap and trade system because regulated entities will do their best to reduce demand as a low-cost

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[4] California Energy Commission, 2007 Integrated Energy Policy Report levelized cost analysis, p. 7, CEC-200-2007-011-SD ("CEC Levelized Cost Analysis"). We show only the investor-owned utility cost; merchant-owned generation and publicly-owned generation costs are slightly different.

means of reducing emissions. Similarly, a report commissioned by the Council from Prof. Dan Kammen at UC Berkeley and Prof. Peter Schwartz at CalPoly, San Luis Obispo, found that shifting from fossil fuels and nuclear power in Santa Barbara County to energy efficiency and renewable energy would result in over $600 million in savings for our county by 2030 (in constant 2007 dollars). Last, a report from UC Berkeley's David Roland-Holst, based on a detailed energy and economics model, found that California as a whole would save $74 billion by 2020 by reducing greenhouse gas emissions back to 1990 levels, as required by AB 32.

Accordingly, there should not be any negative economic impact from GHG regulation on ratepayers in California. To the contrary, such regulation will speed the rate at which utilities develop renewable energy portfolios – on top of the RPS 20% by 2010 mandate and 33% by 2020 goal – thus bringing fossil fuel generation costs down further while also reducing the volatility in the natural gas market.

Figure 1. *Cost comparisons for various electricity generation technologies. (California Energy Commission).*

Technology	**2003 (¢/kWh)**	**2007 (¢/kWh)**	**% increase**
Natural gas combined cycle	6.0	10.3	72
Natural gas simple cycle	18.3	58.6	220
Geothermal (binary)	8.3	9.2	11
Geothermal (flash)	5.2	8.9	71
Solar parabolic trough	24.6	29.5	20
Solar Stirling dish	17.6	54.4	209
Solar PV	48.9	60.6	24
Wind	5.3	9.9	87

ii. The FPA Does Not Occupy The Entire Field on the Subject of Electric Power Emissions

"Field preemption" occurs where it appears from the federal statute that Congress intended for the federal law to "occupy the field," or stated differently, where there is "no room" left for state regulation. *Pennsylvania v. Nelson*, 350 U.S. 497 (1956). Courts look to the pervasiveness of the federal scheme of regulation, the federal interest at stake, and the danger of frustration of federal goals in determining whether a challenged state law can stand. *Id; Pennsylvania R. Co. v. Public Service Commission*, 250 U.S. 566, 569 (1919); *Cloverleaf Butter Co. v. Patterson*, 315 U.S. 148, 786 (1942). **The FPA does not occupy the field of regulation of electricity, but rather envisions a system where states have a significant role in regulating aspects of the generation and sale of electricity.** 16 U.S.C. § 824(a) (FERC jurisdiction extends only "to those matters which are not subject to regulation by the States.") Thus, Congress chose not to occupy the entire field of electricity regulation by federal law and acknowledged the existence of state regulation in matters other than transmission and wholesale sales. Thus, there is no field preemption in this context.

Since the FPA does not fully occupy the field, the state can incidentally affect the choice of power transmitted into the state through incentives created by the cap and trade program to advance public health, safety and welfare. *See California Oregon Power Co. v. Superior Court of Cal.*, 45 Cal.2d 858, 868 (1956) (holding that hydropower regulation was not exclusively occupied for all purposes by FERC, and that a California regulation designed to prevent nuisance and harm to fish from dam operation may stand.) The opinion in *California Oregon Power Co.* explained that since nothing in the FPA dealt with nuisances or danger to the public, state regulation to address such issues was not improper. *Id.* at 868-869.

While *California Oregon Power Co.* dealt with laws to prevent a public nuisance, California's first-seller approach addresses the public health, safety and welfare relating to GHG emissions. Just as public nuisance is traditionally a matter of state law, so is the protection of public health, safety and welfare. See *Mugler v. Kansas*, 123 U.S. 623 (1887). **Since nothing in the FPA deals with the regulation of GHG emissions from the electricity industry for public health or any other reason, and the FPA specifically left room for state regulations in the electricity market, the first-seller approach is not preempted by the FPA under a field preemption analysis.**

In sum, the first-seller approach is not expressly preempted, and is not impliedly preempted as conflict, impairment, or field preemption under the FPA.

44. For purposes of your legal analysis of the previous question, would your opinion differ if the deliverer/first-seller were the reporting entity only and not also the point of regulation? Why or why not?

The Council's conclusion that the FPA would not preempt the implementation of a program in which the first seller is the regulated entity would not change if the first seller were merely a reporting entity, depending on what parties become the regulated entities. However, in the event of a finding of implied preemption of the proposed cap and trade system, a cap and trade system featuring the first seller as a reporting entity should not be subject to a finding of preemption, based on the following Federal Power Act provision:

> [N]othing in this chapter shall relieve any public utility from keeping any accounts, memoranda, or records which such public utility may be required to keep by or under authority of the laws of any State.

16 U.S.C. 825(a).

45. Could the deliverer/first-seller approach be designed or implemented in a way that would avoid or lessen problems under the Federal Power Act? If so, how?

The first-seller approach should not be preempted for the reasons stated above in our answer to question 43. However, to ensure that a court would not find preemption, the Commission should stress in its decision(s) the likely cost savings to ratepayers from GHG regulation – or, at the worst, cost neutrality, through 2020 and later. There is certainly a thriving debate about the likely cost impacts to ratepayers from GHG regulation but it seems the better scholarship, as well as recent energy prices, strongly support the view that a significant and sustained shift to low- or zero-carbon sources of electricity will lead to cost savings for ratepayers. Oil prices reached an all-time high just last week and gasoline prices reached their all-time high a few months ago. Natural gas and electricity prices have not been as peaky in 2007, but the costs for fossil fuel generation – natural gas-fired electricity in particular – have risen remarkably in recent years.

A 2006 Edison Foundation report[5] found the following price increases:

- Natural gas prices jumped by 300 percent since 1999.
- Coal prices are up 20 percent since 2004.
- Uranium ore costs 40 percent more than it did in 2001.

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[5] Edison Foundation, "Why Are Electricity Prices Increasing? An Industry-Wide Perspective" (June 2006), page 2. Available at: http://www.eei.org/industry_issues/electricity_policy/state_and_local_policies/rising_electricity_costs/Brattle_Report.pdf.

Costs have continued to rise in 2007. With a global peak in conventional oil production reached in May of 2005, according to the Energy Information Administration, it is the opinion of many experts that oil prices will remain high for the foreseeable future and will likely rise further. In fact, the International Energy Agency recently projected that oil supplies will be very tight through at least 2012.

Additionally, the spot market price for uranium has risen literally 1200% since 2000, according to www.uxc.com. Nuclear power is a low-carbon power source, but it is not clear that it should be part of the debate in California as a means for meeting AB 32's requirements. Southern California Edison has recently proposed building a new round of power plants in the state despite the existing moratorium, but the Council does not support such a change due in part to the unfavorable economics of nuclear power versus renewables such as wind, geothermal and biomass (the latter two also baseload power sources, thus reasonable compared to nuclear power), as well as increased energy efficiency as an alternative to new supplies.

The Commission should include an extensive discussion of these issues in its decision(s) in order to create an administrative record of the cost impacts to ratepayers from GHG regulation.

46. Compare Federal Power Act issues under a deliverer/first-seller approach and a load-based approach.

The Federal Power Act preemption analysis should be the same for a load-based approach and a first seller approach. This is the case because it is quite clear that states have significant regulatory authority in addition to the federal authority wielded under the Federal Power Act.

47. If you conclude that Federal Power Act preemption would be a problem, could FERC action (e.g., approval of a CAISO tariff rule) ameliorate this problem? If so, what specifically could FERC do? Could FERC ameliorate any Federal Power Act concerns related to publicly-owned utilities?

As described above, a first seller cap and trade program would probably not be preempted by the FPA's jurisdictional grant or the FERC regulations promulgated thereunder. However, the FERC could remove any doubt by adopting regulations explaining its position as to its jurisdictional limits under the Federal Power Act and what type of cap-and-trade programs it would not consider to infringe upon its jurisdiction. *See,* e.g. *Consolidated Edison Co. of New York, Inc. v. Public Service Comm. of State of New York,* 63 N.Y.2d 424, 436 (1984) ["As the administrative agency charged by Congress with implementation of [the statute] FERC's interpretation should ordinarily be deferred to unless it is arbitrary, capricious or an abuse of discretion" (internal citations omitted)].; *see* generally *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.,* 467 U.S. 837 (1984).

48. Does the deliverer/first-seller approach raise problems under the dormant Commerce Clause?

The first-seller approach would not violate the "dormant" aspect of the Commerce Clause. The dormant Commerce Clause prohibits state or local laws or regulations that improperly burden interstate commerce. Laws that discriminate against interstate commerce are rarely upheld. By contrast, laws that incidentally burden interstate commerce as an ancillary effect of state or local laws directed at legitimate policy goals, are upheld unless either (a) the burden upon interstate commerce is disproportionate to the benefit of the law or regulation, or (b) there are alternative means to accomplish those policy goals with less burden upon interstate commerce. **The proposed first-seller cap-and-trade approach should not be found to violate the dormant Commerce Clause**

because: (a) it does not discriminate against interstate commerce; (b) the benefits of the first-seller approach would substantially outweigh any incidental burden upon interstate commerce; and (c) there are not less burdensome alternatives available that could accomplish the same benefits.

A. The Supreme Court's Dormant Commerce Clause Test

1. Part One: Discrimination

A two-part test is used to determine whether a state law violates the dormant commerce clause. *Oregon Waste Systems,* 511 U.S. at 5-6; *Pike v. Bruce Church, Inc.* (1970) 397 U.S. 137. "The first step in analyzing any law subject to judicial scrutiny under the negative [dormant] Commerce clause is to determine whether it 'regulates evenhandedly with only 'incidental' effects on interstate commerce, or discriminates against interstate commerce.'" *Oregon Waste Systems,* 511 U.S. at 6.

If a restriction on commerce is discriminatory, either on its face or in practical effect – i.e., the regulation treats in-state and out-of-state economic interests differently, to the benefit of the in-state interests - it is "virtually *per se* invalid." *Hughes v. Oklahoma,* 441 U.S. 337, 321 (1979).*].* Under such circumstances, the regulation will only be upheld if it is found to achieve a legitimate local purpose that cannot be adequately served by non-discriminatory alternatives. The Court will apply the "strictest scrutiny" in its determination of these facts. *Hughes,* 441 U.S. 337. Applying this strict scrutiny, the Court will thoroughly and independently consider the regulation's purpose, and will not consider itself bound by the characterization of purpose given by the legislature, but instead will consider *de novo* the "practical impact of the law." *Id.* at 336.

To establish a discriminatory effect, it must be shown that the challenged regulation "burdens out-of-state companies while providing in state companies with some advantage." *Pete's Brewing Co. v. Whitehead,* 19 F. Supp. 2d. 1004, 1011 (W.D. Mo. 1998). **Here, the state can assert a strong argument that the burdens and advantages are applied evenly to in-state and out-of-state entities because the first-seller approach is not facially discriminatory**. The primary issue is whether this approach treats in-state and out-of-state electricity in a similar way. Under the first-seller approach, the responsible entity or point of regulation is either the California power plant or the importing contractual party, depending on whether the electricity involves in-state or out-of-state generation. Under the first-seller approach, the in-state generators and initial sellers of out-of-state power are the entities that must hold allowances. In other words, **the first seller approach regulates the entity that first sells power into California's electricity system, no matter where the power originated**. More stringent regulations are not imposed on first-sellers who import electricity from out-of-state; in fact, they will be provided with allowances under the same mechanism as in-state generators of electricity.

This approach evenhandedly regulates *all* first-sellers and does not facially discriminate against first-sellers that purchase electricity from out-of-state providers. All first-sellers will have a cap on their own emissions and thus will use this cap to make sourcing decisions. Both in-state generators, and out-of-state generators that source to first-sellers in California will face similar incentives to reduce electricity-related emissions, such as implementing lower carbon technologies. It is true that a first-seller, such as an LSE, may choose to alter its current sourcing decisions under this new approach. The LSE will face a higher price if purchasing from an out-of-state generator with high carbon emissions and a lower price if purchasing from a generator with low emissions (all else being equal). Nonetheless, there is nothing in this approach that directly encourages the first-sellers to stop sourcing from out-of-state suppliers. For example, an LSE may choose to purchase electricity from less carbon-intensive out-of-state generators, such as hydro-power providers, and cease sourcing from out-of-state coal-generators. This business decision, however, is only an incidental effect of the approach, and is not *per se* discrimination against out-of-state generators of electricity. **Both in-state coal generators and out-of-state coal generators face the same incentives to install new, cleaner technology.**

Under a first-seller approach, both in-state and out-of-state generators may pass the cost of compliance onto consumers when selling electricity. Moreover, the actual effect on out-of-state electricity generators is unknown as this time. The extent to which in-state-generators will enjoy a competitive advantage over out-of-state generators is unclear. However, **on its face, the first-seller approach burdens first-sellers equally**.

This approach can be distinguished from a regulation that facially discriminates against interstate commerce, such as would be the case if California were to prohibit first-sellers from importing electricity from out-of-state. Another example of a facially discriminatory approach is where a state uses a fee structure to discourage out-of-state imports, such as a discriminatory tax. In these types of cases, the regulations have been overturned for violation of the Commerce Clause. *See Chemical Waste Management Inc. v. Hunt,* 504 U.S. 334 (1992); *Fort Gratiot Sanitary Landfill, Inc. v. Michigan Dept. of Natural Resources,* 504 U.S. 353 (1992).

In sum, the proposed first-seller approach is not discriminatory (facially or otherwise) because it even-handedly regulates first-sellers without regard to their geographic source. The first-seller approach, therefore, should not be found to violate the dormant Commerce Clause under the first part of the

Commerce Clause analysis.

Because the proposed first-seller approach is non-discriminatory, the dormant Commerce Clause analysis proceeds to the second step, the *Pike balancing test*, which evaluates whether the burden on interstate commerce from the first-seller approach is excessive in relation to the benefits arising from it. As we discuss below, the proposed first-seller approach is not unduly burdensome upon interstate commerce and, therefore, should not be found to violate the dormant Commerce Clause.

a. Similarly Situated Entities

Courts acknowledge a rationale for differential treatment where market participants are not similarly situated. Discrimination under the Commerce Clause presupposes a comparison between similarly situated entities. *General Motors Corporation v. Tracy*, 519 U.S. 278 (1997) [the Court found that there was no Commerce Clause violation because the favored and disfavored natural gas entities were not similarly situated]. Opponents of a first-seller cap-and-trade approach will likely contend that both in-state and out-of-state electricity generation facility owners are similarly situated, for purposes of showing discrimination against out-of-state coal-fired plants. This is not the case. The first-seller approach is in fact regulating all first-sellers that purchase electricity from many different sources. Even if out-of-state generators are incidentally burdened over in-state generators that are competing for the same market, the burden is not clearly excessive in light of the state interest in reducing greenhouse gases because the burden is incidental and the benefits are clear and substantial. *Minnesota v. Clover Leaf Creamery*, 449 U.S. 456 (1981).

b. Part Two: *Pike* Balancing

If a restriction is found to be non-discriminatory, and it "regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits." *Pike v. Bruce Church, Inc.* (1970) 397 U.S. 137, 142 (hereinafter "*Pike*"). This is referred to as the *Pike balancing test* (hereinafter "*Pike* Test"). The balancing test weighs the legitimate local public interest against the burden imposed on interstate commerce. If the burden is clearly excessive to the benefit, the law or regulation will be struck down. *Id.*

In *Pike*, an Arizona state order, issued pursuant to a state statute, required Bruce Church, Inc. to package the cantaloupes it grew in Arizona within the state, and would not allow it to truck the unpackaged cantaloupes to its California packaging facility. The court found the Arizona act unconstitutional because, though its goal to protect and enhance the reputation of growers within the state was legitimate, the requirement that Bruce Church, Inc. construct a packing house within Arizona impermissibly burdened interstate commerce, outweighing the legitimate state interest. *Id.*

Under the *Pike* test, a law that is non-discriminatory and effectuates a legitimate local public interest will be upheld unless the burden on interstate commerce is disproportionate to the local benefits:

> If a legitimate local purpose is found, then the question becomes one of degree. And the extent of the burden that will be tolerated will of course depend on the nature of the local interest involved, and on whether it could be promoted as well with a lesser impact on interstate activities.

Pike, 397 U.S. at 142. Here, the State can show a solid public purpose in the curtailment of green house gas emissions to avoid the most adverse effects of global warming upon California. Under *Pike*, the burden of proving "excessiveness" falls on a party challenging a regulation. The benefits of the GHG cap-and-trade first seller approach should be found to outweigh any burden on interstate commerce. The Market Advisory Committee, which has endorsed the first seller approach, has experience in developing other cap-and-trade programs. A first-seller approach will help to mitigate the following significant impacts on all Californians[6]:

- Loss of Sierra snowpack (and consequent loss of drinking water and water for power generation);
- sea level rise;
- heat wave days in major urban centers;
- heat-related deaths in major urban centers;
- increase in days conducive to ozone formation;
- critically dry years;
- increase in electricity demand;
- decrease in pine forest yields; and
- increase in the expected risk of large wildfires

More specifically, as stated by the Market Advisory Committee:

> We recommend a first-seller approach in light of its relative simplicity and ease of emissions accounting. Responsibility for in-state emissions can be tracked precisely under a first-seller system,

[6] California Climate Change Center, "Our Changing Climate" (July 2006).

> but it is only approximately accounted for under the alternative load-based approach. A lesson from previous programs is that their success has been associated with public acceptance—that, in turn, has been fundamentally linked to transparent and precise monitoring and accounting. Furthermore, if the state seeks to develop a program that has strong potential to serve as a regional/national model and to link easily with an international system, a first-seller approach is preferred. This option would allow California to transition naturally to a regional or national generator-based system.

MAC Report at pg. 5. As we discussed above, the first-seller cap and trade system should also lead to significant economic benefits for ratepayers. **These benefits should be found to outweigh any incidental burden on interstate commerce arising from the first seller approach to cap and trade.**

Some commentators have expressed concern that California's cap-and-trade program will not produce local environmental benefits due to contract shuffling and leakage or that it will not result in a net GHG reduction. However, the first seller approach specifically addresses the issues of leakage and contract shuffling, finding that there is no difference between a first seller approach and a load-based approach vis a vis these problems. Moreover, the MAC report found that contract shuffling shouldn't be a significant problem because there is a relatively small amount of unclaimed coal and natural gas power outside of California that is imported into California.

Further, the Market Advisory Committee explains that a well-designed cap-and-trade program will (i) encourage advances in emission-reducing technologies and reinforce technology-promoting policies, (ii) reduce "the potential for shifting rather than reducing production and emissions ("leakage"), and (iii) "provide certainty about monitoring obligations and consequences for noncompliance. MAC Report at page 5.

The argument that California will reap the benefit of the program while out-of-state companies must deal with increased burdens is similar to a failed argument in *Minnesota v. Clover Leaf Creamery,* 449 U.S. 456 (1981). In *Clover Leaf Creamery,* the Court upheld a Minnesota statute that banned the retail sale of milk in plastic non-returnable containers, but allowed such sale in other types of non-returnable containers. 449 U.S. 456. The opponents of the statute argued that the "plastic resin ... used for making plastic non-returnable milk jugs, is produced entirely by non-Minnesota firms, while pulpwood, used for making paperboard, is a major Minnesota product." *Minnesota v. Clover Leaf Creamery,* 449 U.S. at 473. The Court responded: "[e]ven granting that the out-of-state plastics industry is burdened relatively more heavily than the Minnesota pulpwood industry, we find that this burden is not 'clearly excessive' in light of the substantial state interest in promoting conservation of energy and other natural resources." *Id.* Similarly here, the burdens of the proposed regulatory programs should not be deemed "clearly excessive" in light of the substantial benefits to the state due to the numerous benefits discuss above and the only incidental impact of the regulation on out-of-state producers.

Furthermore, the location of the regulated entity is irrelevant under both proposals. The dormant Commerce Clause does not require California to protect the pecuniary interests of out-of-state companies. *See Exxon Corp. v. Maryland,* 437 U.S. 117, 127-28 (1978). The Supreme Court has also observed that the Commerce Clause "protects the interstate market, not particular interstate firms, from prohibitive or burdensome regulations." *Id.* Here, the first seller approach may have some impact on out-of-state power producers, but such impact is not ruled out by the dormant Commerce Clause, per *Exxon Corp.* With SB 1368 and the Commission's Emissions Performance Standard already in place, it is not clear, moreover, what additional impact the proposed cap and trade system will have on coal producers. The EPS already requires that new baseload power plant contracts of five years or more duration be at least as clean as a modern natural gas plant (1,100 pounds of CO2 equivalent per megawatt hour or less). Therefore, the proposed cap and trade system will likely have no additional impact on baseload contracts of five years or more, but may have an impact on contracts of shorter duration and/or on non-baseload contracts.

A first seller approach could *in effect* further deter the construction of new coal plants outside of the state, **but it will similarly deter the construction of new coal plants within the state.** However, it is also conceivable that purchases of interstate electricity could increase if out-of-state generators provide substantial quantities of cost-competitive, low GHG emission power. For example, a number of wind power contracts for import into California have recently been signed including a contract between PPM Energy and the Los Angeles Department of Water & Power for a wind farm to be built in Wyoming. Hydro power is also imported into California on a regular basis from the Pacific Northwest. It is also conceivable that the first seller program would not even burden coal-based generators if those generators act to eliminate their GHG emissions through the emerging technology of carbon sequestration. Moreover, while the first-seller approach *may* have an adverse effect on certain out-of-state generators, the abovementioned benefits from the first seller approach should be found to outweigh any incidental adverse effects upon discrete market participants seeking to sell power generated with high GHG emissions into California.

c. Least Discriminatory or Restrictive Alternatives

As discussed above, there will be substantial local benefits from the implementation of a cap and trade program that uses the first seller approach. However, under the *Pike* test, the first seller approach could be held unconstitutional if there were alternatives that could achieve the same local benefits with less burden upon interstate commerce. *Pike, supra,* 397 U.S. at 142 ["the extent of the burden that will be tolerated will of course depend on the nature of the local interest involved, and on whether it could be promoted as well with a lesser impact on interstate activities."]. The concept of least restrictive alternatives is based upon minimizing disparate treatment of in-state and out-of-state entities within the ambit of the legislation or regulation at issue, such that the desired local benefits might still be achieved.

As discussed below, there are probably no feasible alternatives to the first seller approach that would result in less of a burden on interstate commerce. As noted in the Market Advisory Committee: "A first seller approach would take advantage of emission monitoring at every source to achieve a precise connection between regulated entities and the emissions for which they are responsible under the program." MAC Report at 41. These considerations tend to favor the first seller approach. Other alternatives such as requiring utilities to apply carbon adders, which account for any future cost of mitigating GHG emissions in the event that national legislation is adopted, or requiring new and existing power plants to offset their emissions, are unlikely to achieve the same reduction in GHG emissions. The carbon adder was expressly designed in anticipation of regulations such as the cap and trade system, so cannot be a substitute for the actual regulations. Similarly, requiring power providers to offset emissions is a more blunt policy tool because it eliminates the trade portion of cap and trade, which is its primary advantage over other policy options; moreover, the same Commerce Clause issues would arise with a "cap and no trade" system.

The most likely alternative approach that would accomplish the same goals as a first-seller cap and trade system is a revenue-neutral carbon fee assessed on first sellers of fossil fuels, discussed in Section I of these comments. However, the dormant Commerce Clause analysis of a carbon fee assessed on in-state producers of fossil fuels or on out-of-state importers of fossil fuels would likely be identical to the analysis for a first-seller cap and trade system. Accordingly, the first seller approach should not be deemed to violate the dormant Commerce Clause by virtue of not being least burdensome on the interstate electricity market.

49. Could the deliverer/first-seller approach be designed or implemented in a way that would avoid or lessen problems under the dormant Commerce Clause? If so, how?

To further ensure compliance with the dormant Commerce Clause, the Commission should create a record stressing the benefits to California ratepayers from a first-seller cap and trade system, the fact that there will only be incidental impacts on out-of-state generators, and the lack of available alternative policy tools that would lead to a different Commerce Clause analysis.

50. Are issues under the dormant Commerce Clause more or less serious under a deliverer/first-seller approach compared with a load-based approach? Explain.

The first-seller approach has fewer serious commerce clause issues than the load-based approach because the first seller approach has more local benefits. Under the first seller approach, emissions from in-state power plants could be monitored more precisely. The two approaches would differ somewhat in their treatment of emissions embodied in imported electricity. The first seller approach would require that contractors that bring power into the state identify and report their emissions. In contrast, the load-based approach would require another level of approximation in making an assignment between the contracting party identified as the first seller and the LSE that has the compliance obligation.

Under a load-based approach, greenhouse gas emissions will likely be capped based on a utility's total power load. Since the utility would have the discretion to manage its power procurement to keep emissions associated with serving the load under the capped amount, there may be less chance the law is struck down as discriminatory in effect. On the other hand, under the first seller approach, California would regulate emissions directly from in-state generating plants and emissions associated with companies that import power across state lines.

In the final analysis, it seems that the legal issues are functionally identical whether the utility is the entity managing emissions or whether regulators are one-step closer to the regulated emitter, as is the case with the first-seller approach.

51. The Market Advisory Committee report suggests that the value of GHG emission allowances "can be used to fund innovative emission reduction technologies and to focus pollution-reduction efforts in low-income and minority communities" or "can be utilized to provide transition assistance for workers and industries subject to strong market pressures from competitors operating in jurisdictions that lack similar caps on greenhouse gas emissions" (Market Advisory Committee report, at iv - v) or "should be directed to investments in end-use efficiency improvements" (*Id.*, at 54). Would these uses raise problems under the dormant Commerce Clause? Would these problems be more or less serious under a deliverer/first-seller approach compared with a load-based approach?

These issues should not raise problems under the dormant Commerce Clause. The fact that the allowances could be used to fund innovation emission re-education technologies is further proof that the first-seller approach has a legitimate purpose and will advance its purpose of reducing carbon emissions. By using GHG emission allowances to fund new emission reduction technologies, the cap and trade program offers yet more benefits to California's ratepayers, including the promotion of economic growth in the emerging field of emission reducing technologies. Likewise, market transition assistance would benefit the state's economy as it moves away from carbon-intensive power supplies.

These benefits supplement the other strong policy rationales for reducing greenhouse gas emissions: protecting the Sierra Nevada snow pack and California's high-value oceanfront communities, and pollution-reduction efforts to benefit the health of low-income and minority residents. The Supreme Court has held that the protection of the health of citizens and the integrity of natural resources constitutes a legitimate state interest. *See Maine v. Taylor*, 477 U.S. 131 (1986). Thus, the proposed uses should bolster arguments against preemption under the dormant Commerce Clause, rather than weaken them.

It is unlikely that the use of auction revenues under a load-based approach will lead to a different legal result than under a first-seller approach because the use of auction funds will no be impacted at all by the choice between a first-seller or a load-based approach.

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Dated: August 6, 2007

CERTIFICATE OF SERVICE

I hereby certify that I have served by electronic service a copy of the foregoing COMMENTS OF THE COMMUNITY ENVIRONMENTAL COUNCIL ON MARKET ADVISORY COMMITTEE REPORT on all known interested parties of record in R.06-04-009 included on the service list appended to the original document filed with this Commission. Service by first class U.S. mail has also been provided to those who have not provided an email address.

Dated at Santa Barbara, California, August 6, 2007.

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[1] California Environmental Protection Agency, Climate Action Team Report to Governor Schwarzenegger and the Legislature, March 2006 p.82 A "Fee-Based Option" is explored by only two short paragraphs of the entire report. The report finds that "Fee-based options exist and merit further evaluation but have not been fully explored at this point." After briefly noting the administration and emission coverage advantages of such programs the section simply concludes "at this time the CAT would not recommend this option as it cannot guarantee emission reductions," and "the extensive consultation with industry and other stakeholders necessary also has not been completed."
Online at: http://www.climatechange.ca.gov/climate_action_team/reports/2006-04-03_FINAL_CAT_REPORT.PDF

[2] Wall Street Journal, "Is it Time for a New Tax on Energy?" By Phil Izzo, February, 9 2007, http://online.wsj.com/article/SB117086898234001121-search.html?KEYWORDS=Phil+Izzo%2C+Is+it+time+for+a+new+tax+on+energy%3F&COLLECTION=wsjie/6month

[3]- Los Angeles Times, Editorial; "A Warming World; Cool and Collected; A carbon tax is the best, cheapest and most efficient way to combat cataclysmic climate change. May 28, 2007.
- Washington Post, Editorial, "Some Positive Energy; Now Start Talking About a Carbon Tax", Monday, June 25, 2007, http://www.washingtonpost.com/wp-dyn/content/article/2007/06/24/AR2007062401331.html?sub=new
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[4] - The Australian, Business Section, "Exxon Advocates Tax Over Carbon Trading", by Andrew Trounson, March, 21 2007, http://theaustralian.news.com.au/story/0,20867,21418225-643,00.html?from=public_rss
- American Enterprise Institute for Public Policy Research, Environmental Policy Outlook, "Climate Change: Caps vs. Taxes", by Kenneth P. Green, Steven F. Hayward, and Kevin A. Hassett, June 2007, p.11, In concluding the report asserts "if aggressive actions are to be taken to control GHG emissions, carbon-centered tax reform - not GHG emission trading - is the superior policy option."
- Carbon Tax Center, "supporters", available at http://www.carbontax.org/who-supports/ eomments from Al Gore's remarks to U.S. Congress in March 2007.