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**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)

**ENERGY RESOURCES CONSERVATION AND DEVELOPMENT COMMISSION
OF THE STATE OF CALIFORNIA**

In the Matter of:

Order Instituting Informational Proceeding on a Greenhouse
Gas Emissions Cap

Docket 07-OIIP-01

**OPENING COMMENTS OF THE
CALIFORNIA MUNICIPAL UTILITIES ASSOCIATION
ON THE ADMINISTRATIVE LAW JUDGES' RULING REQUESTING COMMENTS AND LEGAL
BRIEFS ON MARKET ADVISORY COMMITTEE REPORT**

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In accordance with Rules 1.9 and 1.10 of the Rules of Practice and Procedure of the Public Utilities Commission ("CPUC") of the State of California, the California Municipal Utilities Association ("CMUA") hereby files these Opening Comments ("Comments") on the *Administrative Law Judges' Ruling Requesting Comments and Legal Briefs on Market Advisory Committee Report* ("ALJ Ruling") filed July 19, 2007, in Rulemaking 06-04-009. CMUA also files these Comments with the California Energy Commission ("CEC") in Docket 07-OIIP-01. In these Comments, the CPUC and CEC will collectively be called the "Joint Agencies."

INTRODUCTION

CMUA offers these Comments in a collaborative and productive manner. CMUA emphasizes its members' desires to integrate GHG goals together with providing reliable and affordable electric service and with wholesale power market functions. CMUA believes that the First-Seller concept is, at best, a work in progress. Therefore, these Comments are offered to discuss the different perceptions on what is meant by the First-Seller, raise issues with First-Seller, and to highlight different implications of First-Seller.

These Comments were requested prior to any substantive public discussion of First-Seller and the First-Seller concept is a new system presented by the Market Advisory Committee ("MAC") report to the California Air resources Board ("CARB") with minimal discussion and supported by some load serving entities ("LSE"). CMUA's comments here are offered to collaborate in the development of recommendations such that the regulations will not be subject to rejection by CARB or the Office of Administrative Law or be prone to constitutional challenge. By design, CMUA takes no positions in these Comments, believing that it is premature to take a position without the opportunity to read other parties opening and reply comments, as well as participate in the oral discussions during the upcoming Joint Agency workshop.

BASIC DEFINITIONS

As stated in the ALJ Ruling, the questions focus initially on option A but also look at option B. Option A for is where the deliverer/First-Seller is the entity that reports and is the point of regulation (the entity required to comply with AB 32). Option B is a hybrid in which the deliverer/first seller would report its GHG emissions, but the retail provider would be the point of

regulation (the entity required to comply with AB 32). The CPUC initially proposed a *Load Based* system where the retail service provider would be the reporting entity as well as the point of regulation. If a Load Based system is used, CARB will also require all in state generation to report emissions.

Q.1 Is the MAC report's description of this deliverer/First-Seller approach accurate?

The MAC Report introduces the concept of a "First-Seller" under the heading of "Two Main Alternatives for Covering Emissions from the Electricity Sector." (p. 41). However, despite the references the "First-Seller" cited on page 3 of the Ruling, the Report itself does not fully explain the concept, or define a "First-Seller." In fact, all that is really provided in the Report is a *concept* that raises more questions than answers.

The Report anticipates that the First-Seller approach can be used to control potential emissions leakage in the electricity sector, and defines the approach as placing "the legal obligation for compliance on the first seller of power into California electricity markets." (p.42) The Report does not define "the legal obligation for compliance" or "the first seller of power into California electricity markets."

As defined in the Ruling (and set forth in the Report) the First-Seller approach is a seemingly simple concept – (a) for in-state California generation, the First-Seller is the generator, in all cases; and (b) for imported power, the first seller is the entity that first delivers electricity at a point of delivery within California. However, even this simple definition raises many questions regarding an *overall AB32 implementation scheme*. While CMUA wants to provide the Commissions with more than just additional policy questions, without further policy discussions or direction regarding the myriad nuances entailed in the First-Seller concept as it pertains to sector wide implementation of AB32, CMUA is concerned that parties will be talking at cross-purposes.

The very fact that the ALJ Ruling sets forth 53 multipart questions on such a seemingly simple process demonstrates the complexity of the process, the need for clearly defined facts, and robust discussion. CMUA appreciates the Commissions' need to move forward as expeditiously as possible, given the time constraints mandated by the legislation, but urges that any recommendation be based on a complete vetting of all the possible scenarios and to that end urges the Commissions to proceed with caution.

For reporting purposes, PG&E has proposed that "the definition used by the Market Advisory Committee can be used, with slight revision for consistency with existing facility-specific reporting protocols used by the ARB, as follows: "The "first seller" is either the manager or operator of the California powerplant facility, or the importing contractual party who first sells the power for delivery

at a point in California, depending whether the electricity is from instate or out-of-state generation.” Conforming changes to the definitions and covered entities should be made to substitute the first seller or facility operator or manager as the reporting entity, instead of the retail provider.” July 2, 2007 comments on Draft Mandatory Reporting Proposal. While it makes sense to have consistent terminology, it is still not clear exactly how the “importing contractual party” will be determined, or how the regulation will reach that entity if they are an out of state supplier.

Other issues to consider include:

The first seller of power for imported power can be a power marketer or broker, or a joint action agency taking power that will be sold to its individual members. Since the Ruling assumes that the First-Seller scheme contemplated herein will be both the regulated entity and the entity that is required to report its emissions, there must be a clearly established structure for those that neither own nor control a resource to determine and verify the emissions. This is especially key in light of the potential for punitive enforcement mechanisms.

Determining who has “ownership” of the power is not a simple matter. If the power is “owned” by a broker or joint actions agency, are those the entities that will also be responsible for “emissions reductions.”

How is the broad term “legal obligation for compliance” going to be defined? Compliance under AB32 will likely entail a combination of overall emissions reductions and detailed reporting requirements.

It appears that a system for the allocation of allowances (whether free or by auction) must be addressed in parallel with any point of regulation discussion in order to fully understand the “compliance” obligations of an entity.

Q.7 How would treatment of imports differ in a deliverer/First-Seller system compared to a load-based approach?

CMUA understands the basic concepts for a First-Seller approach as described by the MAC report. Nonetheless, CMUA is looking for more clarity regarding defining the actual First-Seller due to the ramifications of the compliance obligation being placed upon the entity defined as the "First-Seller". Some have suggested using an e-tag to identify the First-Seller of imported power. We remain concerned about adding carbon content information to e-tags that could add time and requirements to the extensive confirmation process used for e-tags. We also note that the transmission path identified on an e-tag may differ significantly from the contract path due to various reasons including the efficient use of transmission resources. Nonetheless, where an e-tag correctly reflects the contractual intent of the contracting parties the e-tag does define the purchasing selling entity that

has title to the energy when it is delivered to the first point within California. Although the purchasing selling entity may be identified upon the e-tag, the source location may be very different from the contracted source and thereby provide inaccurate carbon information. Therefore, simply adopting the e-tag information as the determinate of both the responsible party and the carbon content of the energy would not be accurate in all cases. In order to avoid uncertainty, the First-Seller concept would need to address these issues and could not simply rely upon the information contained in an e-tag.

In addition, if the regulations are relying upon something like an e-tag to provide information about the First-Seller and the carbon content of the purchased energy, how will the regulations treat firmed intermittent renewable resources?

Power swaps and sales of excess energy to out-of-state entities avoid the environmental impacts of building additional power plants. They allow for sharing of the capacity and energy of existing resources in an efficient manner. How will the First-Seller approach address power swaps? Will energy delivered in a swap arrangement be netted against the energy provided to the other party in the swap? Without knowing how these aspects will be addressed by either system, it is difficult to provide a comparison between the two options.

Furthermore, since power can be sold into California and then resold to entities outside of California, the reporting and compliance system must address power sales to out-of-state entities. Will energy sales simply moving through California to other locations be netted against the original delivery into California? Some accounting would need to be in place to address energy that is brought into California and then resold to entities located out-of-state.

Will energy sales to entities outside of California be counted as part of the overall California cap? Under a First-Seller system, power generated in California but sold to out-of-state entities will be reported and require compliance. A limited cap could create a disincentive to selling California generation out-of-state. Should these regulations create a disincentive to selling power out-of-state? Should the power swaps mentioned above be treated differently?

CMUA would like to see a system that does not create a disincentive to using power swaps that reduce environmental impacts, enhance efficient deployment of resources and support regional reliability. Furthermore, CMUA supports a system that does not create a disincentive to selling power to out-of-state purchasers when that additional capacity or energy is available.

Q8. Provide a complete definition that identifies, for each way in which electricity could be delivered to the California grid, the entities that would be responsible for compliance with AB 32 regulations under a deliverer/First-Seller approach.

The First-Seller of energy in California means: (a) the owner or operator of a power plant

located in California; or (b) the entity importing energy to California where the entity is defined as the party who has ownership of the energy at the first point of entry into California. Although, this short sentence describes the two basic entities that would be First-Sellers, CMUA is not indicating that it has sufficient information to fully understand or support the First-Seller approach.

GENERAL POLICY ISSUES

Q.9a Environmental integrity of the deliverer/First-Seller approach [leakage].

As stated in its comments on the Staff Reporting Protocols, CMUA is unclear or unsure about the concept of leakage in the electric sector under AB 32. AB 32 specifically deals with imported electricity and regardless of the entity that is the point of regulation. Emissions from electricity generated outside California but that is used to serve California load is captured by the statute.

Does an “importing contractual party” have a greater likelihood of knowing the carbon content of its imports as opposed to a retail provider? What is the percentage of import transactions in which there are multiple parties from the California border to the eventual sink? Depending upon the answers to those questions, the First-Seller approach may not prevent leakage any more than a load-based approach.

AB 32 defines “leakage” as “a reduction in emissions of greenhouse gases *within the state* that is offset by an increase in emissions of greenhouse gases *outside the state*.”¹ The AB 32 definition of leakage incorporates a geographical component that is based on where the GHG emissions are actually produced. For electric utilities, the concept of leakage is approached head-on by AB 32, which provides that “statewide greenhouse gas emissions” (“Statewide GHG Emissions”) include not only the GHG emissions produced within California but also all GHG emissions “from the generation of electricity delivered to and consumed in California, . . . , whether the electricity is generated in state or imported.”² The AB 32 definition of Statewide GHG Emissions for the electric sector has a geographical component based on *where the electricity is consumed*, regardless of where the GHG emissions are produced. Therefore, a Retail Provider may not avoid AB 32 regulation merely by serving its load with imported power to supplant generation resources located in California. This is an important distinction that substantially reduces the opportunities for electric utilities to cause leakage as defined by AB 32.

¹ Cal. Health & Safety Code § 38505(j) (emphasis added).

² Cal. Health & Safety Code § 38505(m).

Q.9b Environmental integrity of the deliverer/First-Seller approach [contract shuffling].

CMUA has grave concerns about the concept of “contract shuffling” since it is not mentioned in AB 32. Rules to prevent shuffling, if they are improperly devised and implemented, will pose problem for all retail providers. It is important that the rules promote true environmental integrity and do not inhibit it. AB 32 does not provide authority for CARB to regulate generation out-of-state if the electricity is not used to serve load in California. Without understanding more about the Joint Agencies’ position on contract shuffling and a definition that comports with California law, CMUA is unable to provide comments on this question.

Q.11 Is there any advantage to applying the deliverer/first seller approach to reporting only, while having the retail providers be the point of regulation (as with load-based)?

On the presumption that the First-Seller is the furthest upstream in the flow of electricity inside California, the “line of sight” issue may make sense in regard to which entity is in the best position to know the emissions of the electricity it is selling. One advantage of the load-based entity as the point of regulation is that it will be able to reduce emissions by being selective on what it buys, but also by implementing energy efficiency, demand response, and other load-based programs.

Interaction with Energy Markets

In questions 17, 18, and 19, the ALJ Ruling seeks information regarding the First-Seller approach, and “Interaction with the Energy Markets.” This is a key issue, and one that the MAC Report does not discuss. Before California can embrace the First-Seller approach (or any emissions reduction scheme) there must be a thorough analysis of how the approach will function in the real world – meaning on a daily basis when the single most important issue driving the real time dispatch and delivery of power is reliability. The success of any emissions reduction program is closely linked with the ongoing reliable operation of the state’s electric grid. If Californians are going to be called upon to actively participate – and fund – greenhouse gas reductions, those efforts must be recognized, and in fact, rewarded, by resulting in no adverse impacts to the efficient, cost effective, and reliable provisions of electricity across the state.

The First-Seller concept has not yet been subject to open and robust discussions regarding the nuances of reconciling the emissions tracking and reporting program with real-time provisions of electricity. Thus, the following questions are addressed based on different assumptions and different perspectives in order to provide the Commission with the broadest possible range of information to aide in the discussions regarding the very real impacts that a First-Seller approach can have on the California energy markets.

Q 17 Compare and contrast the impact that a deliverer/First-Seller and a load-based system would have on the existing wholesale energy markets, both at the CAISO and outside of it.

With a First-Seller point of regulation, the cost of the carbon dioxide (CO₂) credits will be passed on to the consumer in the form of variable costs on the generation. If the costs are not included in the variable component for generation, there will be an unrealistic disconnect between supply alternatives and other alternatives (renewables and energy conservation). If the point of regulation is the retail provider, the costs of the CO₂ credits may be treated more like a fixed costs and not included in the variable component. In order for the variable costs to have any impact on the dispatch of electricity (coal vs. combined cycle), the price of CO₂ will need to be about \$50 to 60 per ton of CO₂.

Under the First-Seller approach, consumers will directly pay for CO₂ credits, rather than having the retail electric provider spending money on actually reducing emissions. The First-Seller point of regulation could have entities responsible for CO₂ compliance not directly concerned about the costs of compliance but rather the “spark spread value” between the costs and price at which the product can be sold. (Similar to what happened during deregulation in California where the merchant generators did not focus on the price of natural gas/cost of electricity but rather the spark spread value). If the credits are in short supply, it is likely that the price of the credits will be very high, and all sellers would expect to be compensated at the current price for credits, rather than for the actual cost of the credits to that seller. Some sellers will make a profit on both the “sale” of the credit and the sale of the energy.

In theory, the price of CO₂ credits would rise to the cost to replace coal plants with new natural gas plants – likely in the range of \$90 per ton of CO₂. This is very different from a scheme where the retail electric provider charges for credits at the purchase price of the credits, where the cost will then likely be included in the fixed component of costs.

From an operations standpoint, a retail electric provider will first want to optimize generation, and then optimize transmission. The First-Seller system could keep this prioritization in place. The First-Seller is either going to make the decision to operate a plant based on environmental compliance or by making the necessary economic tradeoffs (i.e., purchases credits), and those costs will be included in the sale price of electricity.

A wholesale energy market based on purchase decisions driven by emissions considerations rather than the price of energy or transmission would look very different. The investment houses will not be able to hedge their operations based on a supply/demand formula or in other words the economic system will not operate smoothly. Essentially, a higher priority is put on environmental qualifications of a resource rather than the economic viability of a resource.

From the perspective of those *outside* the ISO – bilateral contracts will provide greater

transparency of resources versus the general market contracts within the ISO.

Under a First-Seller regime, entities that desire to import power from out of state within the wholesale market (i.e. a COB purchase) may find difficulty in assessing the emissions profile of the purchase. It is also possible that sellers into California may be reluctant to participate simply due to fear of the "regulatory unknown" and/or being branded a polluting exporter. While it is likely that exporters into California will still comply with the accounting standards developed by California's regulators, this may increase the overall cost of the wholesale market, as exporters will desire a premium for those resources with smaller emissions profiles (i.e. hydro).

Under a load based program, if emissions levels are capped based upon load, the ability to generate or procure additional energy for the wholesale market will be limited by the available emissions credits. For example, if a retail electric provider is allocated 10 credits based upon load, but is able to serve that its load with only 9 credits, there is one credit left over for generating power to sell into the wholesale market. Based upon the asset optimization strategy of the utility (which varies greatly), this may significantly impact the ability to market excess energy and reduce fixed cost exposure to retail customers.

Q 18 For those entities participating in the CAISO markets, what would be the likely differential impacts of a deliverer/First-Seller versus a load-based system on the CAISO's implementation of the MRTU system, including day-ahead and real-time markets for energy, transmission, and reserves?

The foundation of this question rests upon the basis that MRTU is a functional system, with clear functional understanding by all participants and that MRTU will be fully functional by February 2008. With MRTU in its development stage, it is not clear exactly what impacts either system will have on the markets.

MRTU is designed to encourage all generators to bid their variable costs and dispatched based upon the lowest costs to meet customer load (considering both variable costs of generation and the transmission/congestion costs). However, it is not clear how MRTU will allow generation to be scheduled for anything other than costs (i.e., dispatch based upon reducing CO2 emissions) in either first seller point of regulation or retail energy provider point of regulation. Such a scenario could mean that the First-Seller approach would be more advantageous. The buyer does not know where the energy is coming from; a load-based system would hide the true costs, as they will either be lower or higher than what actually took place. In the deliverer/First-Seller approach the exact costs will be known; that price will be figured into the cost of the energy.

MRTU should produce a homogeneous product where everything going in is also coming out. Like the gas market (or Henry Hub for example) gas with different characteristics comes in and a

market price is set. The system would be confounded if homogenous power must somehow be distinguished when there are not distinguishing characteristics.

Q 19 To what extent would either approach (deliverer/First-Seller or load-based) be likely to alter the dispatch of existing generation units in the near-term? Why? If there is a difference between the approaches, how significant would it be?

In order to alter the dispatch of existing generation (i.e., coal to natural gas combined cycle) the cost of CO2 credits will need to be included in the variable component and need to reach about \$50 to 60 per ton of CO2. (Assuming variable costs of coal at approximately \$20 per MWh, 2000 lbs CO2/MWh; variable costs of combined cycle natural gas of approximately \$54/MWh, 850 lbs of CO2/mwh assuming \$7/mmbtu gas). These numbers would provide an incentive for market manipulation and for ways to make money off of the credits. Without more, there doesn't appear to be a way that the markets can be structured in a way that will prevent market manipulation. Instead, a solution will not be forthcoming until there is a way to insure that the regulation encourages changes in the generation mix not a transfer of money from customers to market players for CO2 credits. It is not clear how this will work under the First-Seller approach. Shown below is a spreadsheet for estimating the costs of credits to change the dispatch decision.

Gas Price (\$/mmbtu)		\$ 7.00			
Costs of CO2 credits (\$/ton)		\$ 57.00			
		Variable Cost of Generation	lbs CO2/MWh	\$/MWh for emissions credit	Forward going costs
Existing	Coal	\$ 20.00	2000	\$ 57.00	\$ 77.00
Existing	CCGT	\$ 53.00	850	\$ 24.225	\$ 77.225
New	CCGT	\$ 73.00	850	\$ 24.225	\$ 97.225

CO2 credits at \$57/ton CO2 would cause a natural gas plant to dispatch above a coal plant

This line estimates the costs of CO2 credits needed to shutdown a coal plant and build a new combined cycle plant

CO2 credits at \$92/ton CO2 would cause a new natural gas plant to be built to replace an existing coal plant

Under a load-based system the scheduling of transmission will have to come after the development of the supply (based on emissions). Currently, a generation schedule is developed that has been optimized, then a transmission schedule is developed that should be optimized. However, an emissions requirement will have to be met even before the optimization of generation and transmission. This will cause generators to make different decisions for environmentally based reasons; however, such an outcome is not necessarily tied to First-Seller based approach.

In either case, it is likely that (depending upon the cost of additional credits or “carbon fee”), an economic dispatch decision will be made that accounts for the cost incurred to either generate or purchase electricity based upon the emissions profile. For example, if the marginal dispatch cost of a coal unit is \$45/MWh but carries a \$10/MWh emissions adder, the real marginal cost is \$55. Therefore, a gas unit with a marginal cost of \$49 and an emissions adder of \$3 (for a total of \$52) would be the economic decision. The same is true for carbon credits, except that the carbon adder would not be reflected in \$/MWh, it would be established in terms of credits/MWh. The economic choice would be the least consumption of credits/MWh. The end result may be the famed “environmental dispatch”. This is very difficult to assess without understanding the form of fee (i.e. credit or \$) and the load based or First-Seller approach.

INTERACTION WITH EXISTING PROGRAMS AND POLICIES

Q.20 How would a deliverer/First-Seller approach affect efforts to maintain resource adequacy by the publicly-owned utilities (POUs)?

All utilities in the state, IOUs and POUs are required to meet Federal reliability standards and other resource adequacy requirements. Any scheme that limits a utility’s ability import clean energy or to export excess resources will impact the utility’s ability to meet such reliability and resource adequacy requirements. Before any scheme is adopted the impact to the economic feasibility of critical procurement options such as imports of renewable resources, must be understood.

Since POUs tend to purchase and/or acquire at least enough energy to meet projections, POUs would also sell excess energy, if not needed. Under an First-Seller system, POUs would be responsible for the carbon from their generators even if selling excess capacity. The First-Seller approach could include a disincentive to in state generation to sell excess capacity because the carbon price adder is not completely covered in the energy price or firm cap placed upon that generation does not allow for additional operating hours.

In addition, any uncertainty of, and projected volatility in carbon content and allowance costs could reduce market participation and significantly reduce import power market liquidity resulting in an increased price without a corresponding reduction in carbon. This uncertainty would potentially

impact the practical availability of power at the margins.

Q.21 How would a deliverer/First-Seller approach affect energy efficiency programs for the POUs? Under which system would the penetration of end-use efficiency likely be greater?

Many POUs have committed significant resources to energy efficiency and see continued use of these and expanded programs as a contributor to reducing demand. If a load based system is used, energy efficiency options can be compared directly against generation options in finding the best way to serve load. With a First-Seller system the reduction in load translates to reduced need to procure power but may not compete directly against the generator because the generator may not be owned by the retail service provider.

Regarding demand side management (DSM), a First-Seller system might leave DSM programs without a state backed standard value for carbon reductions associated with energy savings for every retail service area. This unlikely scenario leads to a need for a parallel mandatory “load-based” filing in addition to the First-Seller compliance obligation to provide the standard carbon value for reductions due to DSM.

Q.22 How would a deliverer/First-Seller approach interact with the State’s Renewable Portfolio Standard requirements (both existing and proposed)?

POUs are committed to meeting the State Renewable Portfolio Standard (RPS). As State RPS mandates increase and all utilities are vying for limited renewable resources in-state and out, limitations on the viability of importing renewable resources (e.g. the ability of the transmission grid to accommodate and balance these resources) will impact the ability to meet RPS. As Federal RPS mandates are enacted, the pressures on existing resources becomes even greater.

CMUA expects the increased pressure on finding RPS resources will increase the availability of those resources but it will also increase their cost. CMUA is opposed to any scheme that prohibits the use of mandated RPS procurements from factoring into the emissions values of the procuring utility (e.g. the inability to count zero carbon resources as part of an emissions portfolio). Such additionality requirements will impact the ability of the utility to meet RPS under any reporting/compliance program

Q.23 How should renewable energy generators be treated under a deliverer/First-Seller system?

Regardless of the system adopted renewable generators should be treated in a manner to maximize the extent to which existing and new renewable resources may be identified and treated as specified resources.

Q.24 Compare and contrast the impact of a deliverer/First-Seller and a load-based approach on the voluntary renewables market.

Both approaches will put a premium on low carbon resources including renewable resources. Under a First-Seller approach zero or low carbon resources will have the advantage of no or minimized need to purchase or obtain carbon allowances for their resources. This approach may reward those resources because they will not need to obtain allowances. On a load-based approach the retail service provider will be directly comparing the options and looking for the least cost, best fit resource to add to their portfolio. The renewable resource will have the advantage of no or minimal need to obtain a carbon allocation for that resource.

Q.25 Would one approach (deliverer/First-Seller or load-based) have an advantage over the other in producing the greatest amount of emissions reductions through modifications to existing power plants?

As noted above, a deliverer/First-Seller based scheme regulates the entity that controls the least cost solution for reducing emission on an individual facility, whereas a load based scheme should be designed to lead to the lowest cost reductions on a broader scale. Each approach may also have varying impacts on economic dispatch models. Ultimately, which approach would result in the least cost impact to ratepayers?

REPORTING AND TRACKING

CMUA is concerned about the accuracy of the reported information. Therefore, CMUA looked at the question of whether the accuracy of reporting be improved by First-seller? The First-seller approach creates increased accuracy of reporting emissions because the reporting entity is closer to the source of the energy and the carbon. It also places markers and others on notice that they will need to know the carbon content of the energy they sell. Nonetheless, if reporting and compliance requirements are placed on the retail service provider, they will require carbon content information from the counter party to the transaction. Therefore, under either system marketers will need to have carbon information about the energy they are selling into California.

Q.28 If a deliverer/First-Seller approach is adopted, what would be the pros and cons of requiring reporting both from deliverers/first sellers and retail providers, in order to provide ARB with multiple control data sets for comparison?

AB 32 places a reporting protocol on retail providers already. So, this is just adding a reporting requirement on the first seller. How do you reduce the burden for the reporting if you are

vertically integrated since you will be the first seller AND the retail provider?

Q.32 Would implementation of a deliverer/First-Seller approach necessitate auctioning of GHG emissions allowances?

CMUA's members are concerned about the impacts of an auction on ratepayers. The MAC Report recognized the transfer of costs to consumers when retail service providers are required to purchase allowances through an auction. If the auction costs are in addition to the costs to reduce the carbon content of the energy provided to electricity customers, the purchase cost of those allowances would simply become a cost adder to customers' utility bills. In order to avoid this additional cost burden, some portion of the allowances needed by retail service providers should be provided to retail service providers at no cost or the proceeds from the auction should be distributed back to the retail service providers to offset consumer costs.

CMUA's members are aware of the concerns expressed by independent power producers regarding inequitable treatment of carbon emissions from power plants owned by retail service providers and those owned by others. Nonetheless, CMUA's members do not want the costs of an auction to simply become an additional cost to consumers. Therefore, some accommodation to ratepayers needs to be addressed in the regulations.

Q.33 If you do not believe that an auction would be required under the deliverer/First-Seller approach, explain how an emissions allocation system would work under a deliverer/First-Seller approach. In doing so, answer the following:

Q.33a To whom would allocations be given?

As stated above, CMUA's members do not want an auction of allocations to become a direct cost increase to consumers. If the auction costs are in addition to the costs of reducing the carbon content of the energy, customers will see additional costs of electric service through the costs incurred by their retail service providers to purchase lower carbon power and these same customers will also take on the financial burden of the cost of purchasing allocations.

Q.33b If you recommend allowances be given to deliverers/First-Sellers, on what basis would allocations be given during any particular compliance period?

CMUA members support a fair and balanced approach to providing allocations to retail service providers if those auction costs are in addition to the cost of reducing the carbon content of the energy to reduce the cost burden on electricity customers for compliance with GHG regulations. As we have stated above, these same customers could be bearing the costs associated with purchasing low carbon resources.

Q.33c How would the state of California know how many allowances were needed by importers?

CMUA would like to see the comments of importers on this question prior to providing a response. CMUA reserves the right to provide comments in reply.

Q.33d How would marketers be treated?

Power marketers are an important part of the overall power market in California. CMUA would like to review marketers' views on this issue prior to providing an opinion. CMUA may provide comments in reply to the positions advocated in opening comments.

Q.33e How would electricity service providers be treated?

CMUA has no comments at this time.

Q.33f Would zero-carbon generators also receive allowances?

CMUA supports allocations that reward efficiency and renewable generation. The development of the auction or allocation system needs to be further defined in order for CMUA to provide specific comments on this issue.

Q.33g What would be the likelihood of windfall profits under such a system?

CMUA members are concerned about the cost impacts to electricity customers from an auction to the extent that the costs of compliance are above the cost of reducing the carbon content of the energy i.e. the cost of building or procuring replacement power. If the free allocation of allowances is carefully tailored to protect electricity customers the potential for windfall profits is reduced. If all of the allowances are auctioned and the auction is in addition to the costs incurred to reduce the carbon content of the power, CMUA members support a carefully tailored program to return those auction revenues to the retail service providers to reduce the cost burden to electric consumers for compliance with the GHG regulations. As electric service providers shift procurement strategies and purchase additional low carbon resources and energy, and increase energy efficiency, the cost of energy to California electricity customers will increase. Low carbon resources and efforts to reduce consumption have a higher cost than using existing high carbon resources. Thus, electric consumers will see increased costs to reduce the carbon footprint of the electricity provided by their retail service provider. CMUA does not believe customers should pay for both the increased cost of low carbon electricity and in addition, pay for that retail service provider's auction costs when those auction costs are in addition to the costs of the low carbon electricity.

Q.33h How could such a system prevent windfall profits?

A carefully crafted program could ensure that all benefits received by publicly owned utilities flow back to the customers of that utility. It is these customers that would pay the additional costs of obtaining low carbon resources and purchasing allowances. Any benefits received from allocation of allowances to publicly owned entities would flow directly back to the customers.

Q.34 If you recommend allocation of allowances to retail providers, followed by an auction to deliverers/first sellers, how would such an auction be administered?

CMUA would like to see a proposal on a modified allocation and auction. Should a proposal be presented, CMUA will provide comments in reply.

Q.35 Would GHG emissions allowances created under a deliverer/First-Seller compliance regime in the electricity sector be compatible for trading with other sectors in the California economy, assuming a multi-sector cap-and-trade system? How?

Currently, emissions credits for criteria pollutants are traded among various industries in California. The interaction and participation of other industries creates a stronger and more diverse market for credits. Limiting trading to simply the electric sector would unnecessarily thin the market for allowances and could create market power situations that would hinder the efficient operation of the electric sector.

All allowances should be in CO₂e, carbon dioxide equivalent. If all sectors use the same measure, there should not be any concerns about trading between sectors.

Q.36 Compare and contrast the ability of a deliverer/First-Seller and a load-based approach to avoid double counting of emissions between states.

Coordination between the states is essential to completely avoid double counting of energy sales between states. This coordination including agreed upon emissions levels is essential regardless of the approach used to report and regulate GHG emissions. As long as different methods are used by different states to attribute the carbon content of energy moving across state lines, there will be some level of double counting of resources creating in effect a carbon seam where carbon is lost or added.

Q.37 How should exports from California be handled under a deliverer/First-Seller approach?

As stated above, the GHG regulations in California should not hinder the ability of California generators to sell energy out-of-state. The existing sales of energy between the states provides an efficient method of serving the power needs of the region. Should California place additional

limitations on the generation of power in California for sale outside of California, California would simply be exporting those emissions to another state or region. GHG is a global issue and exporting emissions to another region does nothing to address the overall problem.

Furthermore, the GHG regulations need to address power swaps so as not to create a disincentive for these valuable transactions. There are inherent environmental benefits achieved by sharing resources with surrounding states such that California supplied energy is available when needed by other states just like energy from other states is imported to California when needed by California. These energy sales and swaps reduce the number of power plants built in each location to serve native load. Reducing the overall number of power plants built to serve the larger region is an environmental benefit.

Carbon emissions associated with energy sales to entities outside of California should be recorded and used to provide accurate emissions information to purchasers of power in other states or regions. The Commissions should evaluate whether and how to account for in state generation sold to out-of-state entities. Should these sales be deducted from the overall emission profile for serving the California electric sector? Should these sales or swaps be treated separately in addressing California's overall emission profile? CMUA would like to see a program that supports these existing transactions.

Q.38 If some states in the region adopt a source-based system (or a load-based system which also regulates exports), how would the state of California verify the true source of imports in order to avoid double-regulation of power imported from other capped states?

Electricity is used and shared regionally and can best be addressed on a larger than California basis. Given California's interest in proceeding ahead of a national system, close coordination with surrounding states and throughout the west is the only way to avoid double counting and losing carbon in the seams between state systems. Given the constraints upon California's ability to regulate entities outside of the state, California may need to use some averages for transactions that cannot be traced directly to a specific source.

Q.39 How would a deliverer/First-Seller approach function relative to an Oregon load-based system (as currently proposed by Oregon)?

CMUA believes it is important to look at both potential systems in surrounding states as well as on the national level in development of California's system. No system developed specifically for California will fit perfectly with systems developed by other states or on the national level. The key issue is working with surrounding states to understand the carbon content of the energy moving between the states so that regardless of the systems adopted by these states, California will have an accurate picture of the carbon content of the energy used to serve California load.

INTERACTION WITH FEDERAL REGULATION

Q 40 – How easily could a deliverer/First-Seller approach scale or link to multi-state, national, or international programs?

As compared to a load-based program, without further exploring the numerous variables involved, the First-Seller concept would appear to lend itself more readily to a transition to a regional program. By definition, a successful regional program would have to have an “upstream” approach to adequately capture the emissions associated with electricity generation. Accordingly, the more upstream the California program can be, the more readily the program can be integrated into a regional system. However, since the First-Seller approach still contemplates only regulation of activities within the state, the transformation to a regional program will not be facile. Linking a California system to any other system is going to be more dependent upon factors such as off-sets, price caps, and overall program integrity than merely the original point of regulation.

To date, none of the federal proposals use a First-Seller approach. Rather, the point of regulation (and corresponding allowances for emissions) are either assigned at the fuel source, or the point of emissions (e.g., generator). To date there has been no effort to include power marketers, brokers or other third-party intermediaries that might be non-generator first sellers into a federal program. Of course, if you are talking about creating a program from the federal level, it is not necessary to devise a means by which to capture out-of-state resources because legal limitations, such as those raised by the Commerce Clause, would not be implicated.

Q 41 Would one approach (deliverer/First-Seller or load-based) be easier to transition into a potential federal GHG regulatory system? If one would be superior in this respect, explain why and what assumptions you are making about the likely federal framework.

Transition to a federal program from a California program with a load-based point of regulation could be difficult. Even under a First-Seller system, it would still be necessary to track the original source, and be prepared to transition to a system that looks to generators – this is based on the assumption that a federal program will include a generator point of regulation. The federal focus on generators is based on a variety of factors, including (a) minimizing the pool of regulated entities, (b) tradition of point-source regulation, and (c) it fits with the current allocation models under discussion (e.g., based on unit electrical output or unit emissions). While some stakeholders have proposed a load-based system of allocation, that proposal has not been proposed in any legislation to date. It is also worth noting that under the stakeholder-recommended load-based system, the point of regulation would remain on generators (based on actual emissions) but the allowances would be allocated to load-serving entities based on actual retail electricity sales.

Q 42 What are the merits of the deliverer/First-Seller proposal as a model for other governments' efforts, particularly at the national level?

As noted in response to Q41, the perceived merits of a generator-based regulatory system are (a) minimizing the pool of regulated entities, (b) tradition of point-source regulation, and (c) it fits with the current allocation models under discussion (e.g., based on unit electrical output or unit emissions).

LEGAL ISSUES

Q.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?

As CMUA has stated previously, it is difficult to provide a clear answer to this question when the way in which First-Seller would be implemented remains to be determined. The Federal Power Act ("FPA") is a Congressional act that delegates authority to the Federal Energy Regulatory Commission ("FERC") to regulate the transmission and wholesale sale of electric energy in interstate commerce.³ The FPA also empowers FERC to regulate facilities and rates for transmissions and sales of energy in interstate commerce.⁴

The FPA therefore grants FERC the power to regulate two distinct aspects of the interstate energy market: (1) interstate transmission of energy, and (2) interstate wholesale sale of energy. FERC's power to regulate within these areas is exclusive.⁵ "The statutory text thus unambiguously authorizes FERC to assert jurisdiction over two separate activities – transmitting and selling."⁶ Giving FERC authority to regulate transmission and wholesale sale of energy in interstate commerce includes the facilities and rates for such transmissions and sales.⁷

Although the last sentence of § 824(a) states that the FPA extends "only to those matters which are not subject to regulation by the States," the case law has not strictly interpreted that phrase. "Born simply a statement of aims, and later reworded without any discernible purpose to substantively change its character, [section 824(a)] is not a limitation on the Commission's exercise of any authority

³ 16 U.S.C. § 824(a).

⁴ 16 U.S.C. § 824(b)(1).

⁵ See, e.g., *Schneidewind v. ANR Pipeline Co.*, 485 U.S. 293, 304 (1988); *Wisconsin-Michigan Power Co. v. Federal Power Commission*, 197 F.2d 472, 477 (7th Cir. 1952).

⁶ *New York v. FERC*, 535 U.S. 1, 19-20 (2002).

⁷ *Appalachian Power Co. v. American Electric Power Co.*, 812 F.2d 898, 902 (1987).

Congress distinctly conferred upon it.”⁸ This provision is merely a policy declaration of great generality and it cannot nullify a clear and specific grant of jurisdiction, even if the particular grant seems inconsistent with the broadly expressed purpose.⁹

In this provision, the “sale of electric energy in interstate commerce” means a sale of electric energy to any person for resale.¹⁰ The FPA considers electric energy to be “transmitted in interstate commerce” if transmitted from a state and consumed at any point outside thereof (excluding transmission outside of the United States).¹¹ In 16 U.S.C. § 824(e), the FPA defines a “public utility” as any person who owns or operates facilities subject to the jurisdiction of the Commission under 16 U.S.C. §§ 824 et seq. (other than facilities subject to such jurisdiction solely by reason of section 824e(e), 824e(f), 824i, 824j, 824j-1, 824k, 824o, 824p, 824q, 824r, 824s, 824t, 824u, and 824v).

If California’s emissions regulations would affect the interstate sale or transmission of electricity to the level of “regulating” interstate sale or transmission of electricity, then they would intrude on FERC’s exclusive authority to regulate all aspects of the interstate transmission or sale of energy. If the regulation of greenhouse gas in California under the First-Seller system is seen simply as another environmental regulation like those under the California Clean Air Act, the courts may find such regulation does not violate the FPA. If regulations developed under the First-Seller system do not violate the FPA, the FPA does not serve as a determinant of the regulatory system adopted by California. Therefore, we pose a couple of questions where we think further analysis or discussion would help to clarify whether the First-Seller system would violate the FPA.

The issue is whether requiring First-Sellers of power in California to comply with a California GHG requirement would impact the sale of energy at wholesale. “[I]t is clear that Congress intended the FPA to preempt state law claims in the field of interstate wholesale electricity rate-setting, including practices affecting such rates.”¹² Would a statewide cap on emissions in effect eliminate sales of electricity to out-of-state entities? Would the GHG regulations place a burden on these transactions that goes beyond that posed by other California environmental regulations? Would the additional costs of the allocations sufficiently burden sales of electricity into California as to impact wholesale sales of electricity?

In 2005, section 824o, entitled “Electric reliability” was added to the FPA. The new reliability

⁸ *Duke Power Co. v. Federal Power Commission*, 401 F.2d 930, 938 (1968).

⁹ *Id.* (citing *Federal Power Commission v. Southern California Edison*, 376 U.S. 205, 215 (1964).)

¹⁰ 16 U.S.C. § 824(d).

¹¹ 16 U.S.C. § 824(c).

¹² *Lockyer v. Mirant Corp.*, 266 F.Supp.2d 1046, 1059 (2003).

legislation gave FERC subject matter jurisdiction over the reliability of the bulk-power system in the United States.¹³ For purposes of reliability only, the section gives FERC jurisdiction in the U.S. over all owners, operators, and users of the bulk-power system. *Id.* The "bulk-power system" is defined as the facilities and control systems necessary for operating an interconnected electric transmission network and electric energy from generation facilities needed to maintain transmission system reliability (the term does not include facilities used in the local distribution of electric energy.)¹⁴ A FERC-approved "Electric Reliability Organization" ("ERO") determines and enforces reliability standards for the bulk-power system.¹⁵ Reliability standards include, but are not limited to, capacity and energy emergencies; communications and coordination; load shedding plans; and facility connection requirements.

A possible conflict exists between the First-Seller approach and section 824o of the FPA. The bulk-power system would include any facilities involved in the interstate sale of electricity, this would mean First-Seller generation facilities within California, as well as out-of-state facilities supplying electricity to First-Sellers in California. If the First-Seller must secure allocations for the carbon content of power brought into California and allocations are not available or only limited allocations are available such that only low carbon resources can sell into California, the First-Seller approach could at different times in the compliance period effectively eliminate high carbon facilities from supplying power to California. This limitation could run afoul of the reliability standards set forth in the FPA. A situation may arise where only a coal-fired facility, for example, is available to supply power to California in an emergency, but the First-Seller approach severely limits electricity received from coal-fired facilities. As a consequence, the state GHG requirements could be at odds with FERC/Western Electricity Coordinating Counsel reliability requirements.

Q.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?

CMUA needs additional information about the First-Seller system prior to responding to this question. However, CMUA does not see a violation of the FPA from a reporting obligation as long as the reporting obligation does not impact the reliable operation of the wholesale power system. For example, if the reporting obligation were used in conjunction with e-tags such that the process of checking the carbon information on and signing off on e-tags sufficiently encumbered the e-tag

¹³ 16 U.S.C. § 824(b).

¹⁴ 16 U.S.C. § 824(a)(1)(A)-(B).

¹⁵ 16 U.S.C. § 824(a)(2) and 18 C.F.R. § 39.5.

process and caused power scheduling problems, then the reporting obligation could violate the FPA.

Q.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?

CMUA needs more information on the First-Seller system prior to responding to this question. CMUA may provide additional information in reply comments.

Q.46 Compare Federal Power Act issues under a deliverer/First-Seller approach and a load-based approach.

CMUA needs more information on the First-Seller system prior to responding to this question. CMUA may provide additional information in reply comments.

Q.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?

CMUA needs more information on the First-Seller system prior to responding to this question. CMUA may provide additional information in reply comments.

Q.48 Does the deliverer/First-Seller approach raise problems under the dormant Commerce Clause?

There is a high probability that the proposed definition and implementation of First-Seller would raise constitutional problems. Challenges to local regulations under the dormant Commerce Clause are typically reviewed by the courts using a two-tiered approach: (1) the regulation is generally struck down without further inquiry when a state directly regulates or discriminates against interstate commerce, or when its effect is to favor in-state economic interests over out-of-state interests; and (2) the court will examine whether the State's interest is legitimate and whether the burden on interstate commerce clearly exceeds the local benefits if a regulation has only indirect effects on interstate commerce and regulates evenhandedly.¹⁶

The Commerce Clause empowers the federal government to regulate interstate commerce,

¹⁶ *Healy v. Beer Institute*, 491 U.S. 324, 337 n.14 (1989) (quoting *Brown-Forman Distillers Corp. v. New York State Liquor Auth.*, 476 U.S. 573, 579 (1986) (citations omitted in original)); *National Collegiate Athletic Ass'n v. Miller*, 10 F.3d 633, 638 (9th Cir. 1993). However, the Court has stated that there is "no clear line between these two strands of analysis." *Brown-Forman Distillers*, 476 U.S. at 579. *The Court stated that several cases that have applied the undue burden test arguably turned in whole or in part on the discriminatory character of the challenged state regulations.*

however, the Constitution does not exclude all state power to regulate commerce.¹⁷ The limits on state regulation of commerce "necessarily [involve] a sensitive consideration of the weight and nature of the state regulatory concern in light of the extent of the burden imposed on the course of interstate commerce."¹⁸ Particularly in matters of local concern, the states may regulate commerce even if there is an incidental effect on interstate commerce.¹⁹ When the regulation of "matters of local concern is local in character and effect and its impact on the national commerce does not seriously interfere with its operation . . . such regulation has generally been held to be within state authority."²⁰ On the other hand, the Supreme Court has held that "[e]ven when business activities are purely local, if 'it is interstate commerce that feels the pinch, it does not matter how local the operation which applies the squeeze.'"²¹

Tier 1 – General overview of discrimination analysis

A state discriminates against interstate commerce by treating in-state and out-of-state economic interests differently, such that the regulation benefits the former and burdens the latter.²² State laws that discriminate against interstate commerce face "a virtually *per se* rule of invalidity."²³ A state law may discriminate against interstate commerce: (1) on its face, by explicitly treating local and out-of-state interests differently; (2) in its purpose; or (3) in its effect, by providing a competitive advantage to local interests.²⁴ Where discrimination exists, the regulation is subject to strict scrutiny under which it is the state's burden to show that the discrimination is narrowly tailored to further a

¹⁷ *Southern Pacific Co. v. Arizona*, 325 U.S. 761, 766 (1945).

¹⁸ *Raymond Motor Transp., Inc. v. Rice*, 434 U.S. 429, 441 (1978).

¹⁹ *Southern Pacific Co.*, 325 U.S. at 767.

²⁰ *Id.*; The dormant Commerce Clause is inapplicable if the challenged restrictions do not affect interstate commerce. This will be true if the restrictions address purely local concerns and treat in-state and out-of-state entities in the same manner. *Nat'l Ass'n of Optometrists & Opticians v. Lockyer*, 463 F. Supp. 2d 1116, 1123 (D. Cal. 2006).

²¹ *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 573 (1997) (quoting *Heart of Atlanta Motel, Inc. v. United States*, 379 U.S. 241, 258 (1964)).

²² *Oregon Waste Systems, Inc. v. DEQ*, 511 U.S. 93, 99 (1994).

²³ *Philadelphia v. New Jersey*, 437 U.S. 617, 624 (1978).

²⁴ See *Minnesota v. Clover Leaf Creamery Company*, 449 U.S. 456, 471 n. 15 (1981) ("A court may find a state law constitutes 'economic protectionism' on proof of either discriminatory effect, or of discriminatory purpose."); See also *NCAA v. Miller*, 10 F.3d 633 (9th Cir. 1993). "Applying this test, we must first ask whether the Statute: (1) directly regulates interstate commerce; (2) discriminates against interstate commerce; or (3) favors in-state economic interests over out-of-state interests. If the Statute does any of these things, it violates the Commerce Clause *per se*, and we must strike it down without further inquiry." *Id.* at 638.

legitimate interest.²⁵ The Supreme Court's application of strict scrutiny to discriminatory burdens on interstate commerce developed out of a recognition "that when the regulation is of such a character that its burden falls principally upon those without the state, legislative action is not likely to be subjected to those political restraints which are normally exerted on legislation where it affects adversely some interests within the state."²⁶ Thus, regulations that "clearly discriminate against interstate commerce are routinely struck down . . . unless the discrimination is demonstrably justified by a valid factor unrelated to economic protectionism"²⁷ Discriminatory laws motivated by "simple economic protectionism" are subject to a "virtually *per se* rule of invalidity," which can only be overcome by a showing that *the State has no other means to advance a legitimate local purpose.*"²⁸

Tier 1 analysis – facial discrimination resulting from direct regulation

The first step in determining whether a law violates the Commerce Clause is to ask whether it discriminates on its face against interstate commerce.²⁹ A regulation would be facially invalid under the first tier if it "directly regulates interstate commerce." "Direct regulation occurs when a state law directly affects transactions that take place across state lines or entirely outside of the state's borders."³⁰ This begs the question: would the regulations use generic language to describe a First-Seller regardless of whether that entity was involved in interstate electricity sales or not, and then apply one identical standard to all First-Sellers in-state and out? Or would the regulatory language actually distinguish between First-Sellers that are involved in interstate commerce and those that are not, by specifically stating that the former are the "importing contractual parties" and the latter are in-state generators?³¹ Furthermore, will the regulations expressly provide different rules for the

²⁵ *Conservation Force v. Manning*, 301 F.3d 985, 997 (9th Cir. 2002) (citing *C&A Carbone, Inc. v. Clarkstown*, 511 U.S. 383, 392 (1994); see also *Oregon Waste Systems*, 511 U.S. at 100-01 (explaining that under strict scrutiny the regulation "must be invalidated unless [the state] can show that it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives") (internal quotation marks omitted); *Hughes v. Oklahoma*, 441 U.S. 322, 337-38 (1979) (explaining the state's burden to show, under "the strictest scrutiny," that the regulation is the "least discriminatory alternative" to advance a legitimate purpose).

²⁶ *Conservation Force*, 301 F.3d at 999. In this vein, an out-of-state First-Seller would necessarily have less political power in the legislative and rulemaking processes.

²⁷ *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 273-274 n9 (1988).

²⁸ *United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786, 1793 (2007) (emphasis added); see also *Granholm v. Heald*, 544 U.S. 460, 476 (2005).

²⁹ *United Haulers Ass'n*, 127 S. Ct. at 1793.

³⁰ *Valley Bank of Nevada v. Plus System, Inc.*, 914 F.2d 1186, 1189-90 (9th Cir. Nev. 1990) (internal quotations omitted).

³¹ See *NCAA v. Miller*, 10 F.3d 633, 638 (9th Cir. 1993).

“different” First-Sellers in terms of reporting obligations, allowance mechanisms, oversight, or enforcement? Would this be interpreted by the courts as making a facial distinction between in-state entities and those involved in interstate commerce? Would this distinction rise to the level of differential treatment in which the in-state entities benefit while the out-of-state entities are burdened? If so, California would be required to show that the discrimination was narrowly tailored to further a legitimate interest.

Substantial precedent from the U.S. Supreme Court holds that, “in all but the narrowest circumstances, state laws violate the Commerce Clause if they mandate ‘differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter.’”³² As a result, the First-Seller placing a regulatory burden on the importing contractual party would be subject to invalidation unless California can “show that it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.”³³ It would not be sufficient to argue that the burden on importers is small, because the case law “clearly establish[es] that the degree of a differential burden or charge on interstate commerce “measures only the *extent* of the discrimination” and “is of no relevance to the determination whether a State has discriminated against interstate commerce.”³⁴

Tier 1 analysis – facially neutral but discriminatory in “practical effect”

Although, CMUA expects that the Joint Agencies would not recommend regulatory language that facially attempts to regulate conduct outside of California, the First-Seller concept may have an extra-territorial effect even without the explicit language. In addition to facial discrimination, a regulation may be discriminatory “in practical effect”³⁵ and even if the regulatory language makes no reference to interstate commerce or out-of-state companies, “a facially neutral statute may be discriminatory because of its effect.”³⁶ A state regulation is per se invalid when it has an “extraterritorial reach” which has the practical effect of controlling conduct beyond the boundaries of

³² *Granholm v. Heald*, 544 U.S. 460, 472 (2005) citing *Oregon Waste Systems, Inc. v. DEQ*, 511 U.S. 93, 99 (1994).

³³ *Oregon Waste Systems, Inc.*, 511 U.S. at 101 citing *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 278 (1988). “Our cases require that justifications for discriminatory restrictions on commerce pass the “strictest scrutiny.” *Hughes v. Oklahoma*, 441 U.S. 322, 337 (1979). The State’s burden of justification is so heavy that “facial discrimination by itself may be a fatal defect.” *Id.*

³⁴ *Oregon Waste Systems, Inc.*, 511 U.S. at 100, fn 4 citing *Wyoming v. Oklahoma*, 502 U.S. 437, 455 (1992); See also, e. g., *Maryland v. Louisiana*, 451 U.S. 725, 760 (1981).

³⁵ *Hughes*, 441 U.S. at 336.

³⁶ *Minnesota v. Clover Leaf Creamery Company*, 449 U.S. 456, 471 n. 15 (1981); *Nat’l Ass’n of Optometrists & Opticians v. Lockyer*, 463 F. Supp. 2d 1116, 1123 (D. Cal. 2006).

the state.³⁷ The Commerce Clause precludes application of a state statute to commerce that takes place wholly outside of the state's borders.³⁸ If the challenged statute discriminates against interstate transactions "either on its face or in practical effect," it burdens interstate commerce directly and is subject to strict scrutiny.³⁹

Extraterritorial reach invalidates a state statute when the statute requires people or businesses to conduct their out-of-state commerce in a certain way.⁴⁰ Thus, a statute has extraterritorial reach when it necessarily requires out-of-state commerce to be conducted according to in-state terms. Will the First-Seller model, either by its terms or in practical effect, necessarily affect out-of-state commerce? Even if the regulation affects the First-Seller's participation in interstate commerce, the regulations may be indifferent to sales occurring out-of-state.

Even if the "extra-territorial effects of only one state regulatory regime are relatively minor, if California can require the [importers to acquire allowances], so can every other state, and there is no guarantee that the standards will be similar. The effect of such a patch-work regulatory scheme would be immense. [citation omitted]. As the district court found, because there is no universal standard, "subjecting plaintiffs to the extensive amount of inconsistent state regulation California's rule would necessarily permit, would undermine the need for substantial uniformity in this area and interfere with interstate commerce."⁴¹

The Court has stated that "[t]he critical inquiry is whether the practical effect of the regulation is to control conduct beyond the boundaries of the State."⁴² "Practical effect ... must be evaluated not only by considering the consequences of the statute itself, but also by considering how the challenged statute may interact with the legitimate regulatory regimes of other States"⁴³ A number of cases have invalidated state laws under the Commerce Clause that, although they did not impose disparate

³⁷ *Healy v. Beer Inst.*, 491 U.S. 324, 336 (1989).

³⁸ *Id.*

³⁹ *Maine v. Taylor*, 477 U.S. 131, 138 (1986).

⁴⁰ *Brown-Forman Distillers Corp. v. New York State Liquor Auth.*, 476 U.S. 573 (1986).

⁴¹ *Union Pac. R.R. v. California PUC*, 346 F.3d 851, 871-72 (9th Cir. 2003). "The interest in easing the administrative burden of applying the Railroads' more technical rules pales in comparison to the burden of requiring potentially conflicting state standards. Under Supreme Court precedent, such extra-territorial burden is constitutionally infirm." *Id.*

⁴² *Healy*, 491 U.S. at 332; *Brown-Forman Distillers Corp.*, 476 U.S. at 573. Will non-California entities be required to adjust their behavior to comply with California law in a discriminatory manner?

⁴³ *Healy*, 491 U.S. at 336; *see also NCAA*, 10 F.3d at 639-40.

treatment on similarly situated in-state and out-of-state interests, undermined a compelling need for national uniformity in regulation.⁴⁴

California seems to be on the leading edge of GHG regulation amongst the western states, however, other states in the western interconnect have demonstrated their intent to consider GHG emissions.⁴⁵ This threat is real and not speculative and could present the very real possibility of a conflicting patchwork of state laws.⁴⁶

The Commerce Clause analysis may be different depending upon the point of regulation the state chooses – if the point of regulation is the California retail provider, it seems that the regulations will affect an out-of-state entity only after that entity has affirmatively chosen to subject itself to the regulations by contracting with a California retail provider. However, if the point of regulation is the actual entity engaged in interstate commerce [by virtue of being the “importing contractual party”], the First-Seller will be directly impacted by California in its regulatory capacity. This is a significant difference.⁴⁷

A statute enacted for a discriminatory purpose is likewise subject to strict scrutiny.⁴⁸ Under strict scrutiny, a state statute violates the Commerce Clause unless the state can show that the statute serves a legitimate local *purpose* unrelated to economic protectionism and that the purpose could not

⁴⁴ See *Bibb v. Navajo Freight Lines, Inc.*, 359 U.S. 520 (1959) (conflict in state laws governing truck mud flaps); *Southern Pacific Co. v. Arizona ex rel. Sullivan*, 325 U.S. 761 (1945) (train lengths); see also *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987) (“This Court’s recent Commerce Clause cases also have invalidated statutes that may adversely affect interstate commerce by subjecting activities to inconsistent regulations”).

⁴⁵ Arizona (Executive Order 2006-13, setting GHG goals for 2020 and 2040; Southwest Climate Change Initiative, Feb. 2006); Nevada (Climate Change Advisory Committee announced by Governor on April 2007); New Mexico (Executive Order 2006-69, setting GHG goals for 2012, 2020, and 2050; Southwest Climate Change Initiative, Feb. 2006); Oregon (GHG goals of Governor for 2010, 2020, and 2050; regulates CO₂ pollution by requiring new power plants to avoid, offset or mitigate at least 17% of CO₂ emissions); Washington (Executive Order 07-02, setting GHG goals for 2020, 2035, and 2050; SB 6001 becoming effective in 2008 establishing an emission performance standard for baseload generation; regulates CO₂ by requiring new and existing power plants that increase CO₂ emissions to offset those emissions 20% over 30 years). Information found at: http://www.ncel.net/news_uploads/158/StateGHGActions-chart.STAPPA.9-18-06.pdf.

⁴⁶ See *Huron Portland Cement Co. v. City of Detroit*, 362 U.S. 440, 448 (1960). In *Healy*, the Court determined that a state’s price affirmation statute was unconstitutional in part because “the practical effect of [the] affirmation law, in conjunction with the many other beer-pricing and affirmation laws that have been or might be enacted throughout the country, is to create just the kind of competing and interlocking local economic regulation that the Commerce Clause was meant to preclude.” *Healy v. Beer Inst.*, 491 U.S. 324, 337 (1989).

⁴⁷ See *Automated Salvage Transport, Inc. v. Wheelabrator Env’tl. Sys., Inc.*, 155 F.3d 59, 78 (1998). CMUA asks whether the regulatory language will explicitly or implicitly target out-of-state entities to those involved in interstate commerce? Accordingly, doesn’t the first seller concept expressly deal with transactions that occur across state lines?

⁴⁸ See *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 270 (1984).

be served as well by nondiscriminatory means.⁴⁹ At this stage, the CMUA is unsure about the purpose for this model and definition for First-Seller.

Tier 2 analysis – balancing of benefit and burden

A Commerce Clause violation may still occur even if a challenged law regulates evenhandedly and a *facially* discriminatory effect is not found.⁵⁰ In that case, a balancing test must be applied.

“Where the statute regulates evenhandedly 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.... 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.”⁵¹

- At this point, CMUA questions the benefit of the having the First-Seller as the point of regulation. There is virtually no argument to support that the First-Seller model would mitigate environmental harm to California more than a load-based approach.
- Even if the First-Seller regulation is deemed neutral on its face, the balancing test may be somewhat tenuous.⁵² What is the local legitimate purpose for placing an emission reduction requirement on the importing contractual party? Some parties have offered support for this concept using a “line of sight” argument by stating that the importing contractual party is “closer” to actual source of emissions and, therefore, more likely to know the emission connected with the electricity’s production. But, CMUA asks, in the normal course, how many different parties and transactions will ensue between the first point of delivery inside California to the eventual retail provider? In the normal course, will there be any significant difference in the ability for the importing contractual party to know the emissions any better than the very next party in the chain? Any argument that this method is a benefit must make a distinction between the first seller, which is involved in interstate commerce, and the first “buyer,” which will not.

⁴⁹ See *Hughes v. Oklahoma*, 441 U.S. 322, 336; *Cotto Waxo Co. v. Williams*, 46 F.3d 790, 793 (8th Cir. 1995).

⁵⁰ See *C&A Carbone, Inc. v. Clarkstown*, 511 U.S. 383, 390 (1994).

⁵¹ *Pike v. Bruce Church*, 397 U.S. 137, 142 (1970); *United Haulers Ass’n, Inc. v. Oneida-Herkimer Solid Waste Management Authority*, 127 S. Ct. 1786, 1792-93 (2007) (the *Pike* balancing test governs nondiscriminatory laws which are “directed to legitimate local concerns” and have incidental effects on interstate commerce).

⁵² If the First-Seller is discriminatory on its face, then it would probably not withstand the strict scrutiny analysis because there are other models using in-state entities as the point of regulation.

- CMUA does not know the motivations that initiated the development for the first seller method. If the purpose is that the first seller has a greater ability to know the emission factor, then that may be an argument to put a reporting obligation on the first seller. But, this same argument does not support making the first seller the point of regulation.
- The purported benefit of a cap and trade mechanism is to achieve the emission reductions at the lowest societal cost. A well-functioning cap and trade system implies that regulated entities have options available that include achieving the emission reduction themselves or acquiring sufficient allowances to cover their emissions. The First-Seller concept proposes that the importer is the point of regulation. If the First-Seller is a generator, then in a functioning cap and trade model, that entity must choose between reducing emissions at its out-of-state powerplant, or buy allowances from an in-state entity. In regard to the former choice, CMUA wonders whether that smacks of extraterritorial regulation. And in regard to the latter choice, the benefit from the generator's allowance purchases will inure to California and not the generator's state. This may implicate the differential treatment of in-state and out-of-state economic interests, which is anathema in Commerce Clause jurisprudence. Even more problematical, if the First-Seller is a power marketer that doesn't own any physical assets, then its *only* option is to purchase allowances. It neither owns nor controls any emissions sources and is foreclosed from choosing the option to reduce its own emissions. Its only options are to contract with lower emitting resources, reduce its sales to California, or purchase allowances from whereby the benefit runs to California. As with the generator as First-Seller, by limiting the available options for compliance, it is less likely that the most cost-effective emission reductions would be achieved. This contradicts the very purpose for establishing any market-based system.
- If the First-Seller is the point of regulation and the First-Seller is the out-of-state generator, will a problem occur if only a percentage of the powerplant's output goes to California? With the generator First-Seller as the point of regulation, will the emission reduction requirement subject the entire powerplant to California requirements even though only a portion of the energy produced is delivered to California? Again, would this have an extraterritorial effect and coerce the generator to change behavior in another state in which its activity was lawful?
- The argument for the load-based approach is that it provides the caps and allowance [and incentives to change behavior] to the entity that is in the best position to support low-carbon generation options and to invest in demand-side improvements. The load-side has the ability to select between portfolio management, and the options that are most likely to

decrease GHG emissions anywhere [statewide GHG emissions definition] rapidly and at the lowest cost. Ultimately, the only way to reduce emissions is to clean up existing plants and build more low-carbon resources. The importing contractual party *has the least control over these activities*. If the point of regulation is placed on the wrong entity, then the entire market will suffer as less effective choices are made [i.e., forced].

- As stated by the MAC report, the First-Seller will be the point of regulation and will be required to acquire GHG allowances. Arguably, this places a restriction on the imported power, merely because it is imported power. If the obligation were on the retail provider, the California entity must acquire the allowance and it will choose the seller accordingly.
- If importing contractual party is a generator and it needs to acquire allowances, could that be deemed extraterritorial regulation by effectively forcing it to change behavior in another state in which its activity was lawful?

Q.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?

In accordance with CMUA's answer to Question 48, making the First-Seller the point of regulation seems risky in terms of any Commerce Clause challenges. More importantly, the First-Seller as the point of regulation may be the least effective model to achieve statewide GHG emission reductions. Power marketers have no authority or ability to make actual changes in powerplants that would reduce emissions. They have no ability to make demand side reductions. According to the First-Seller model as proposed, the marketer is a middle party with an obligation to comply but no ability to make substantive changes.

Q.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.

In accordance with CMUA's answer to Question 48, and in the context of CMUA's understanding of the First-Seller concept, the load-based approach is less likely to implicate commerce clause issues. On the one hand, it is because the regulated activity is within California. On the second hand, should any Commerce Clause balancing analysis be implicated, a legitimate purpose may be found in that the retail provider has the capability to affect emission reductions.

CONCLUSION

CMUA looks forward to further discussions and more in-depth explorations of these important subjects.

Dated: August 6, 2007

Respectfully submitted,

A handwritten signature in black ink, appearing to be "BM", is centered below the "Respectfully submitted," text.

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