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)

California Energy Commission Docket #07-OIIP-01

LEGAL BRIEF OF THE NATURAL RESOURCES DEFENSE COUNCIL (NRDC) AND ENVIRONMENTAL DEFENSE (ED) ON THE "FIRST SELLER" APPROACH

August 6, 2007

Kristin Grenfell
Natural Resources Defense Council
111 Sutter St., 20th Floor
San Francisco, CA 94104
415-875-6100
kgrenfell@nrdc.org

Virgil Welch
Environmental Defense
1107 9th Street, Suite 540
Sacramento, CA 95814
916-492-7078
vwelch@environmentaldefense.org

TABLE OF CONTENTS

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)

California Energy Commission Docket #07-OIIP-01

LEGAL BRIEF OF THE NATURAL RESOURCES DEFENSE COUNCIL (NRDC) AND ENVIRONMENTAL DEFENSE (ED) ON THE "FIRST SELLER" APPROACH

I. INTRODUCTION AND SUMMARY

The Natural Resources Defense Council (NRDC) and Environmental Defense (ED) respectfully submit this legal brief in accordance with the "Administrative Law Judges' Ruling Requesting Comments and Legal Briefs on Market Advisory Committee Report and Notice of En Banc Hearing" (ALJ Ruling), dated July 19, 2007, and in accordance with Rules 1.9 and 1.10 of the California Public Utilities Commission's (CPUC) Rules of Practice and Procedure. We also concurrently submit these comments to the California Energy Commission (CEC) in Docket #07-OIIP-01, the CEC's sister proceeding to this CPUC proceeding.

NRDC is a non-profit membership organization with a long-standing interest in minimizing the societal costs of the reliable energy services that a healthy California economy needs. In this proceeding, we represent our more than 124,000 California members' interest in receiving affordable energy services and reducing the environmental impact of California's energy consumption. ED is a leading national environmental nonprofit organization representing more than 500,000 members. Since 1967, we have linked science, economics and law to create innovative, equitable, and cost-effective solutions to society's most urgent environmental problems.

Under separate cover, NRDC and ED are each filing responses to the Commissions' policy-related questions about the "first-seller" regulatory approach for an electricity cap and trade program and other aspects of the Market Advisory Committee (MAC) report recommendations. In this filing, we respond to the legal questions in the ALJ ruling. The answers to the ALJ Ruling's questions about the Federal Power Act represent NRDC's views. The answers to the ALJ Ruling's questions about the Dormant Commerce Clause and the authority to auction represent both NRDC and ED's views. NRDC and ED look forward to discussing this legal brief and our other comments with other parties at the August 21, 2007 en banc hearing.

In summary:

- NRDC believes that the deliverer / first-seller (hereinafter "first-seller") approach to a cap and trade program is more vulnerable to preemption under the Federal Power Act than is the load-based approach.

- NRDC believes that it is possible for the first-seller approach to avoid preemption by the Federal Power Act, if it is structured carefully to avoid interfering with FERC's authority to license and set rates for wholesale sellers of power.

- Based on initial analysis, ED does not believe that the Federal Power Act would preempt adoption of the first-seller approach.

- NRDC and ED believe that the first-seller approach should be able to overcome any possible problems under the dormant Commerce Clause problems.

- NRDC and ED believe that AB 32 gives ARB the authority to auction allowances.

II. FEDERAL POWER ACT

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?

A: The Federal Power Act (FPA) would not necessarily preempt adoption of the first seller approach.

Because the first-seller approach would regulate wholesale sellers of power, it faces potential preemption by the FPA, which gives the Federal Energy Regulatory Commission (FERC) the authority to regulate wholesale power transactions. The load-based approach, which regulates only retail sellers, does not face the same potential preemption problem. However, if the first-seller approach to a greenhouse gas (GHG) cap and trade program is implemented as an environmental regulation that does not interfere with FERC's ability to license wholesale power sellers and set their rates, it will not be preempted. On the other hand, if it purports to determine wholesale rates or supersede FERC's rate-making process, then it would most likely be preempted by FERC's authority to regulate wholesale sales and determine wholesale rates.

In order to answer this question more thoroughly, we must first give a brief background on the Federal Power Act and on federal preemption law, then apply the law to the facts at hand.

A. Background on the Federal Power Act

Prior to 1935, States had broad authority to regulate electric utilities, which were mostly local monopolies providing both generation and distribution services to consumers. *New York v. Fed. Energy Reg. Comm'n*, 535 U.S. 1, 5 (2002). States' regulatory authority over electricity was limited only by the dormant Commerce Clause. *Id.* When Rhode Island attempted to regulate rates for electricity generated in Rhode Island but ultimately sold in Attleboro, Massachusetts, the Supreme Court struck down the regulation, holding that it imposed a "direct burden on interstate commerce." *Public Util. Comm'n of R.I. v. Attleboro Steam & Elec. Co.*, 273 U.S. 83, 89 (1927). This created the so-called "Attleboro gap," because states did not have authority over interstate sales of electricity, but Congress had not yet exerted authority. In response, Congress passed the Federal Power Act (FPA) in 1935. 16 U.S.C. § 824 *et seq.*

Congress gave the Federal Power Commission (FPC), the predecessor to the Federal Energy Regulatory Commission (FERC), jurisdiction over "transmission of electric energy in interstate commerce" and "the sale of electric energy at wholesale in interstate commerce." 16 U.S.C. § 824(b). One of FERC's main duties with regard to transmission and wholesale sales of electricity is to ensure that rates are "just and reasonable." 16. U.S.C. §824d(a). FERC has the "exclusive authority to determine the reasonableness of wholesale rates." *Mississippi Power & Light v. Mississippi ex rel. Moore*, 487 U.S. 354, 371 (1988). To allow FERC to ensure the reasonableness of rates, wholesale sellers are required to file a rate schedule to be approved by FERC. 16 U.S.C. § 824d(c); 18 C.F.R. § 385.205. While FERC has exclusive jurisdiction over wholesale sales and rates of wholesale power, FERC's authority extends only to those matters that are not subject to regulation by the states. 16 U.S.C. § 824(a). Thus, states retain authority over issues not addressed by the FPA. With the exception of hydropower projects, for which the FPA expressly provides that FERC must consider effects on fish and wildlife (16 U.S.C. §§ 797(e), 803(a)(1)), the FPA does not address environmental concerns. The FPA does not address GHG emissions associated with wholesale power at all. This area of regulation remains open to the states.

B. Overview of Federal Preemption Doctrine

The Supremacy Clause states that the U.S. Constitution and federal laws are the "supreme law of the land." U.S. CONST. ART. VI. Federal law preempts state law if: 1) a federal law expressly preempts state or local law; 2) a federal law so completely occupies the field of regulation that it must be inferred that Congress left no room for state or local government to regulate; or 3) state law conflicts with federal law so that it is impossible to comply with both. *Gade v. Nat'l Solid Waste Management Ass'n*, 505 U.S. 88, 98 (1992).

1) Express Preemption

The FPA does not expressly preempt a state's authority to regulate greenhouse gas (GHG) emissions associated with interstate sales of electricity. Therefore, the express preemption doctrine is not applicable here.

2) Field Preemption

Even where a statute does not expressly state its intent to preempt state law, "Congress's intent to supersede state law altogether may be found from a scheme of federal regulation so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it." *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947) (holding that states could not regulate grain elevators that were licensed by the federal government). Where there is a comprehensive federal scheme and a state law is attempting to regulate in the same field, for the same purpose, in a manner that might undermine the federal scheme, it is likely to be preempted. *City of Burbank v. Lockheed Air Terminal*, 411 U.S. 624, 633 (1973) (holding that a city ordinance prohibiting jet flights at a local airport between 11:00 pm and 7:00 am was preempted by the Federal Aviation Act and the Noise Control Amendments to it because a multiplicity of curfews might undermine the Federal Aviation Administration's ability to regulate airspace in a safe and efficient manner.) ("It is the pervasive nature of the scheme of federal regulation of aircraft noise that leads us to conclude that there is preemption.")

Where there is a federal scheme and a state law "stands as an obstacle to the accomplishment and execution of the full purposes or objectives of Congress," the state law may be preempted. *Hines v. Davdowitz*, 312 U.S. 52, 67 (1941). However, where the intent of a state law is different than Congress's intent, a court may find that the state law is not preempted. *Pacific Gas & Electric v. State Energy Resources Conservation & Dev. Comm'n*, 461 U.S. 190 (1983) (upholding a state law that imposed a moratorium on the construction of nuclear power plants until the State Energy Commission determined that there was a safe means of disposing of high-level nuclear wastes that had been approved by a federal agency, because the state's goal was economic whereas Congress's goal in regulating nuclear power was to ensure safety). In *Pacific Gas & Electric*, the court rejected the argument that the federal government occupied the field of nuclear regulation, saying that Congress has the exclusive authority to regulate safety, "but that the States retain their traditional responsibility in the field of regulating electrical utilities for determining questions of need, reliability, cost, and other related state concerns." *Pacific Gas & Electric v. State Energy Resources Conservation & Dev. Comm'n*, 461 U.S. 190, 205 (1983). Even though the law itself stated that it prevented construction of nuclear plants unless the *safety* of disposal was ensured, the Court accepted California's assertion that the law was "aimed at economic problems, not radiation hazards." Accordingly, the Court held that California's regulation fell outside the field of nuclear safety regulation, which was occupied by the federal government. *Pacific Gas & Electric v. State Energy Resources Conservation & Dev. Comm'n*, 461 U.S. 190, 216 (1983).

In *Pacific Gas & Electric*, the utilities also argued that the state law interfered with the federal objective of encouraging the development of nuclear power. While the Court acknowledged that "a primary purpose of the Atomic Energy Act was, and continues to be, the promotion of nuclear power," it characterized that purpose as only encouraging nuclear power to the extent that it was economically feasible, thus leaving to states the authority to slow or stop development of nuclear power for economic reasons. *Pacific Gas & Electric v. State Energy Resources Conservation & Dev. Comm'n*, 461 U.S. 190, 221-23 (1983). The Court avoided preemption by narrowly characterizing the federal and state goals so that they occupied separate spheres and did not conflict.

In the case at hand, the federal scheme concerns the reasonableness of interstate power rates and nondiscriminatory access to interstate power. *See* 16 U.S.C. § 824d(a). California's intent in enacting AB 32 was clearly to "reduce emissions of greenhouse gases." CAL. HEALTH & SAFETY § 38501(c). The intent of California GHG regulation is completely different from the objectives of the FPA, and California's cap and trade program would be imposing regulations in a field separate from that occupied by the FPA. In order to avoid preemption, California should: 1) ensure that the cost of complying with California's GHG regulations for wholesale electricity sellers is included in the usual FERC rate-making process and that California's requirements do not purport to supersede or interfere with that process; 2) ensure that California's program does not stand as an obstacle to Congress's goal of ensuring just and reasonable rates for wholesale power (California can do this by ensuring that the costs of participating in the cap and trade program are accounted for in wholesale sellers' FERC rate-making process in the usual manner); 3) making clear that the intent of California's cap and trade program is to reduce GHG emissions, and is completely different from Congress's intent in enacting the FPA.

Traditional State or Local Interest – Presumption against preemption

When there is a question as to whether a state law is preempted, the Court "start[s] with the assumption that the historic police powers of the States were not to be superseded ... unless that was the clear and manifest purpose of Congress." *New York v. Fed. Energy Regulatory Comm'n*, 535 U.S. 1, 17-18 (2002) (quoting *Hillsborough*, 471 U.S., at 715 (quoting *Jones v.* Rath *Packing Co.*, 430 U.S. 519, 525 (1977)); *see also Medtronic, Inc. v. Lohn*, 518 U.S. 470, 485 (1996); *Pacific Gas & Electric v. California*, 350 F.3d 932, 943 (9th Cir. 2003).

Where there is clearly a traditional state interest involved, a court may find that a local regulation is not preempted even where there is a comprehensive federal scheme.[1] The Court held in *Maurer v. Hamilton*, 309 U.S. 598 (1940) that States have a traditional and important interest in regulating highway safety, so a state law preventing the carrying of cars over the cabs of auto transport trucks was not preempted, even though there was extensive regulation by the Interstate Commerce Commission. In *Hillsborough County, Fla. v. Automated Med. Laboratories, Inc.*, 471 U.S. 707 (1985), the Court concluded that a local ordinance requiring that donors be tested for hepatitis and be given a blood alcohol test was not preempted even though although the Food and Drug Administration had adopted many regulations governing paid donations to blood banks. The Court emphasized that "the regulation of health and safety matters is primarily, and historically, a matter of local concern." *Id.* at 719. The Court also stated that it was "even more reluctant to infer preemption from the comprehensiveness of regulations than from the comprehensiveness of statutes" because agency regulations are often very comprehensive, and to conclude that this means they are exclusive "would be inconsistent with the federal-state balance embodied in our supremacy clause jurisprudence." *Hillsborough County, Fla. v. Automated Med. Laboratories, Inc.*, 471

[1] In contrast, where the federal government traditionally has an exclusive role, a state law is not likely to survive. In immigration cases, courts have found that state laws regulated aliens are preempted by federal law, even though that preemption is not explicit. State laws requiring aliens to register with the state, precluding aliens from receiving commercial fishing licenses, and denying in-state tuition to aliens were found to be preempted and struck down. "The federal government has broad constitutional powers to in determining what aliens shall be admitted to the United States, the period they may remain, regulation of their conduct before naturalization, and the terms and conditions of their naturalization. Under the constitution, the states are granted no such powers. . . . State laws which impose discriminatory burdens upon the entrance or residence of aliens lawfully within the United States conflict with this constitutionally derived federal power to regulate immigration." *Takahashi v. Fish and Game Comm'n*, 334 U.S. 410, 419 (1948)

U.S. 707, 717 (1985); *see also Florida Lime & Avocado Growers Inc. v. Paul*, 373 U.S. 132, 146 (1963) (emphasizing the traditional role of the state in regulating the marketing of food products.)

FERC has recognized that environmental regulation is a traditional state role. Order No. 888, Stats & Regs., Regs. Preambles Jan 1991–June 1996, ¶ 31,036, p.31,762 (1996) ("State regulatory commissions and state legislatures have traditionally developed social and environmental programs suited to the circumstances of their states"). California's attempt to limit GHG emissions is an exercise of this traditional authority to protect the health, safety, and environment of its citizens from the effects of global warming. This purpose should receive deference, so long as California is not stepping into a federally occupied field in a way that would conflict with or undermine federal regulations. Here, the FPA makes no attempt to regulate GHG emissions associated with wholesale power. It only addresses rates and access. 16 U.S.C. §824d(a). So long as California makes clear that its cap and trade scheme will only impose an environmental requirement, not a sales or rate requirement, it should not be preempted.

3) Conflict Preemption

If it is impossible to comply with both state law and federal law, then the state law is preempted. *Gade v. Nat'l Solid Waste Management Ass'n*, 505 U.S. 88, 108 (1992) (holding that unapproved state regulation of occupational safety and health issues is preempted by OSHA) ("under the Supremacy Clause, from which our pre-emption doctrine is derived, 'any state law, however clearly within the State's acknowledged power, which interferes with or is contrary to federal law, must yield.'" (quoting *Felder v. Casey*, 487 U.S. 131, 138 (1988) (quoting *Free v. Bland*, 369 U.S. 663, 666 (1962)); *Florida Lime & Avocado Growers Inc. v. Paul*, 373 U.S. 132, 142-43 (1963) (ultimately holding that California law setting stricter standard for avocadoes was not preempted because federal law was meant to be a minimum requirement); *McDermott v. Wisconsin*, 228 U.S. 115 (1913) (Wisconsin law prohibiting maple syrup labeling in a manner that was required by federal law was preempted); *Hisquierdo v. Hisquierdo*, 439 U.S. 572 (1979) (federal law prohibiting attachment of railroad retirement income preempted a state community property law that divided railroad retirement income in the case of divorce).

Where a federal agency has authority to issue a license, but a state agency imposes conflicting requirements on the licensee, the state agency will be preempted. *California v. Fed. Energy Reg. Comm'n*, 495 U.S. 490 (1990). In *California*, FERC had issued a license for a hydropower generating facility imposing minimum flow requirements, and the California State Water Resources Control Board attempted to impose different minimum flow requirements. The Court held that FERC had exclusive jurisdiction to determine minimum flow requirements, in keeping with sections 797 and 803 of the FPA, and that the state could not issue conflicting requirements. *California*, at 496; *see also First Iowa Hydro-Electric Cooperative v. Fed. Power Comm'n*, 328 U.S. 152 (1946).[2]

However, where there is merely a *potential* for conflict between a FERC order and an environmental operating limitation imposed by another governmental authority, FERC is likely to accommodate the need to comply with both. 96 FERC ¶ 61,117, Docket No. EL00-95-031 (2001). In April 2001, FERC issued an order requiring power generators to offer all their available capacity into the wholesale spot market (this was called the "must offer" requirement). Several power plants that were restricted to a limited number of operating hours per year by the terms of their air permits, issued by the Bay Area Air Quality Management District (BAAQMD), requested clarification that the "must offer" requirement did not require them to violate the terms of their air permits. FERC responded that a generator could be exempt from the "must offer" requirement if it could show that running its unit would result in violation of a permit, including an environmental operating limitation. *Id.*

Under the first-seller approach, there will not be a direct conflict between state and federal law. Wholesale sellers will be able to incorporate the cost of complying with California's GHG regulations into their rates, and FERC will be able to exercise its authority to determine whether those rates are just and reasonable. California is not attempting to regulate wholesale rates in conflict with FERC. Rather, it is imposing an

---

[2] However, where the federal law is setting a minimum requirement, a state law may set a stricter requirement without being preempted. *Wisconsin Public Intervenor v. Mortier*, 501 U.S. 597 (1991) (holding that Federal Insecticide, Fungicide, and Rodenticide Act set minimum standard and stricter local rule was permissible). In addition, the Court has upheld a state law that conflicted with a federal law because it decided that this was in keeping with Congress's overall intent. *Midatlantic Nat'l Bank v. New Jersey Dep't of Envtl. Prot.*, 474 U.S. 494 (1986).

environmental regulation on entities selling power in California, a goal that can be accomplished in concert with FERC regulations. In fact, the FPA directs FERC to protect the "public interest" by ensuring the "proper utilization and conservation of natural resources." 16 U.S.C. § 824(a), a(a). California is not even imposing operational limitations, like those that FERC recognized in its "must offer" order, discussed above. It will only be imposing an additional environmental cost. FERC may approve wholesale power rates that incorporate the costs of complying with California's environmental regulations, including the requirement to participate in a cap and trade program for GHG emissions.

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?

A: Probably not.

If the cap and trade program is implemented as an environmental regulation that does not interfere with FERC's rate-making authority, it should not be preempted whether the first-seller is the reporting entity or the point of regulation. However, if FERC determines that the costs of complying with the cap and trade program cause wholesale rates to be unreasonable, it could deny a seller's request to include the costs in its rate, which could then prevent a seller from complying with California's program *and* with FERC's rate regulation. In that case, it could be possible for the seller to report its emissions but not to serve as the point of regulation.

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?

A: Yes.

The first-seller approach should be designed and implemented as an environmental regulation whose intent is to reduce GHG emissions, with no interference with FERC's rate-making authority.

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

A: A load-based system avoids preemption by the FPA because it regulates retail sellers, who are within state jurisdiction. States clearly have authority over retail sales of electricity. 16 U.S.C. 824(b); *New York v. FERC,* at 20, 23, 28; *see also Connecticut Light & Power Co. v. FPC*, 324 U.S. 515, 523-31 (1945). Because wholesale sales of power are within FERC's jurisdiction, and the first-seller approach would regulate some wholesale sellers, it will have to be more carefully designed and implemented to avoid preemption.

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?

A: Yes.

A wholesale seller, the CAISO, or the PUC could file a Petition for Declaratory Order with FERC, requesting approval to incorporate in wholesale rates the costs of reducing GHG emissions and acquiring allowances. FERC has already recognized the need for approval of such requests based on different states' needs and environmental goals. 119 FERC ¶ 61,061, Docket No. EL07-33-000 (2007). In April 2007, FERC granted the CAISO's proposal for a financing mechanism to connect multiple location-constrained resources (mostly renewable resources) to the grid. FERC noted that the proposed rate treatment "is not unduly preferential or discriminatory and includes protections to consumers that are just and reasonable." *Id.* at 15. The CAISO or PUC could make a similar case for a rate mechanism for wholesale sellers who will participate in the cap and trade program.

III. DORMANT COMMERCE CLAUSE

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

A: The first-seller approach should be able to overcome any possible problems under the dormant Commerce Clause.

The Commerce Clause of the U.S. Constitution gives Congress the authority to regulate commerce among the states. Courts also interpreted it to limit the power of the States to discriminate against interstate commerce. U.S. CONST. ART. I, § 8, cl. 3; *Wyoming v. Oklahoma*, 502 U.S. 437, 454 (1992). Known as the "Dormant" Commerce Clause (DCC), this implied limitation flows from the principle that states must avoid "economic isolation" in order to obey the political philosophy of the Constitution that "prosperity and salvation are in union and not division." *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 523-27 (1935). States may not exercise economic protectionism. However, the Supreme Court consistently recognizes the difference between "outright protectionism" and "more indirect burdens on the free flow of trade." *Lewis v. BT Investment Managers, Inc.*, 447 U.S. 27, 36 (1980).

In determining whether a state rule violates the DCC, courts apply the following general framework:

(1) State rules that clearly discriminate against interstate commerce will almost certainly be struck down under a "virtually per se rule of invalidity." *See, e.g.*, *City of Philadelphia v. New Jersey*, 437 U.S. 617, 624 (1978).

(2) State rules that regulate evenhandedly with a "legitimate local purpose" and only "incidental" effects on interstate commerce are upheld unless the burden imposed on such commerce is "clearly excessive" compared to the local benefits. *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970). This is known as the "*Pike* balancing test," in which the local benefits are balanced against the burdens on interstate commerce.

The first-seller approach does not facially discriminate against out-of-state power compared to in-state power. Rather, it regulates all first-sellers of electricity in an even-handed manner. The Court has defined discrimination as "differential treatment of in state and out of state economic interests that benefits the former and burdens the latter." *Oregon Waste Systems v. Dept. of Environmental Quality*, 511 U.S. 93 (1994). Therefore, it is unlikely to be struck down as facially discriminating against interstate commerce.

Because the first-seller approach is not facially discriminatory, a court would move on to the *Pike* balancing test. An evenhanded regulation designed to "effectuate a legitimate local public interest... will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits." *Pike,* at 142. In order to fail the *Pike* test, a state statute must "impose a burden on interstate commerce that is qualitatively or quantitatively different from that imposed on *intrastate* commerce." *National Electrical Manufacturers Assn v. Sorrell*, 272 F.3d 104, 107 (2001). A court will uphold an evenhanded regulation advanced to serve a "legitimate local interest" unless the burden imposed on interstate commerce is *clearly* excessive in relation to the in-state benefits. *See Pike*, *New Energy Co. v. Limbach,* 486 U.S. 269, 276 (U.S. 1988).

Here, California has a very important "legitimate local purpose" in protecting Californians from the potentially disastrous consequences of global warming and smoothing the state's transition economic into an increasingly carbon constrained future *(See California Climate Action Team: Report to Governor Schwarzenegger and the Legislature, 2006).* As the Supreme Court noted in *Maine v. Taylor*, 477 U.S. 131, 138 (1986), "the constitutional principles underlying the commerce clause cannot be read as requiring the State... to sit idly by and wait until potentially irreversible environmental damage has occurred..." The potential burdens on interstate commerce as a result of the first-seller approach would be the transactional costs of complying with California's regulation through reporting emissions and purchasing allowances. The first-seller approach would not prohibit out-of-state power from entering California, nor place undue hurdles before out-of-state power. The burden of these transactional requirements is not excessive in relation to California's important local interests.

Under the *Pike* analysis, courts will also often evaluate whether the "local purpose" could be promoted in a manner that produces fewer burdens on interstate commerce, *Pike* at 142. While there are a number of design options for regulating the electricity sector under a cap and trade program, it is not clear that any of them achieve California's goals while putting significantly less burden on interstate commerce, compared to the first-seller approach. Accurate data and emissions information for both in-state and out-of-state generation is crucial to an effective cap and trade program, particularly in the electricity sector. The first seller approach represents an efficient and even-handed way of securing this information, which measures emissions as close as possible to the source while remaining consistent with geographic limits on the state's regulatory power.

Another important point to note is that in order to run afoul of the dormant Commerce Clause, a burden resulting from state regulation must fall on *interstate commerce* as a whole, not just on some firms that participate in interstate commerce. As the Court noted in *Exxon Corp.*, "interstate commerce is not subjected to an impermissible burden simply because an otherwise valid regulation causes some business to shift from one interstate supplier to another," *See Exxon Corp. v. Governor of Maryland,* 437 U.S. 117, 127 (1978). In the case of the first-seller approach, the result very well may be that firms who are able to supply the California market with lower-emissions electricity will be advantaged. However, such a result would not advantage California firms at the expense of out-of-state ones. Rather, out-of-state firms able to supply electricity to California with lower emissions profiles would gain a potential advantage at the expense of both California-based and other out-of-state firms that were unable or unwilling to do so.

For the foregoing reasons, we believe that the first-seller approach would survive a potential dormant Commerce Clause challenge.

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?

A: Yes.

As noted in response to *Question 48*, state regulations are struck down for violating the dormant Commerce Clause when they either facially discriminate against interstate commerce or incidentally burden interstate trade in clear excess of the putative local benefits the regulations are designed to achieve, *See Maine v. Taylor,* 477 U.S. 131 (1986). In order to eliminate or lessen dormant Commerce Clause concerns, the first-seller approach should be crafted with the following considerations in mind.

As a starting point, it will be important that any regulations designed to facilitate the first-seller approach be explicit on their face that any and all regulatory requirements will be uniformly applied to *all* entities that first sell/deliver power into California electricity markets. Additionally, so as to minimize any incidental burdensome impacts, the regulations should be designed and implemented in a manner that maximizes the opportunity for *all* first-sellers to precisely identify the emissions content of the power they are supplying in California. Furthermore, whatever emission allowance allocation scheme is ultimately adopted, it will be important to ensure that *all* entities desiring to supply power to the California market are given reasonable opportunity to secure the allowances necessary to do so.

While we certainly believe the aforementioned factors must be considered in the design and implementation of a first-seller approach, we also believe it is important to reiterate a point that was raised earlier in response to *Question 48*. Namely, in order to be fatal from a dormant Commerce Clause perspective, regulations must be found to burden the "interstate market," not just "particular interstate firms," *See Exxon Corp.*, at 127, 128. Thus, simply because some firms (out-of-state or California-based) might be burdened as a result of the regulations does not mean the regulations themselves would be in violation of the law.

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.

A: Dormant Commerce Clause issues are no more serious under a first-seller approach than under a load-based approach.

Neither the first-seller nor the load-based approach facially discriminates against out-of-state power compared to in-state power. Both apply even-handed regulations which apply equally to in-state and out-of-state power. Any DCC challenge to either approach would have to show that the burdens on interstate commerce outweigh the local benefits. California's local interest is the same under both approaches: to protect California citizens from the dangerous impacts of global warming and to effectuate a smooth transition to a carbon constrained future. The potential burdens on interstate commerce are also the same under each approach. Carbon-intensive electricity providers will be burdened compared to low-carbon electricity providers. In both cases, these burdens and benefits are not defined by the state's boundary. Both in-state and out-of-state firms able to supply load-serving entities with cleaner electricity would be positioned to reap any such advantages.

A further point worth considering about the load-based approach is that California already regulates load-serving entities for a number of other (and related) purposes. Thus, in terms of regulations that are focused at the load-serving entity level, this approach has already been established as being a valid exercise of California's general police power. And, as the Supreme Court pointed out in *Lewis v. BT Investment*, "States retain authority under their general police powers to regulate matters of legitimate local concern, even though interstate commerce may be affected," *See Lewis v. BT Inv.,* at 35-36 (1980).

For the reasons state above, we believe that either the load-based approach or the first-seller approach can be designed and implemented in a way consistent with the dormant Commerce Clause.

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?

At this point we are unable to determine with any level of certainty whether the uses noted above would raise problems under the dormant Commerce Clause and whether they would be more or less serious under a deliver/first-seller or load-based approach. In order to make such a determination, we believe greater information is required in terms of what mechanisms and processes would be used to convert the "value of GHG emission allowances" into the various uses noted above and in the MAC report.

However, as noted previously, in order to pass muster under a dormant Commerce Clause analysis, any regulations (first-seller, load-based, or otherwise) designed and implemented to effectuate the recommendations of the *Market Advisory Committee* for a cap and trade system in California should neither "affirmatively discriminate" against interstate commerce nor incidentally impose excessive burdens on interstate commerce in relation to in-state benefits. *See Pike,* at 142; *Wyoming v. Oklahoma,* 502 U.S. 437 1992). While we are confident that regulations could be designed and implemented that meet these standards for either the first-seller or load-based approach as we understand them as outlined in the MAC report, at this point we are unable to provide further insight on the Commerce Clause legality of using the value of GHG allowances to fund various programs or other efforts.

IV. AUTHORITY TO AUCTION

52. Does ARB have the authority, under AB 32 or any other statute, to auction allowances to emit greenhouse gases? Explain.

Yes, ARB has the authority under AB 32 to auction allowances. Although AB 32 does not explicitly authorize ARB to auction allowances, ARB can derive that authority from Parts 3, 4, and 5 of AB 32. These sections of the statute authorize ARB to use market-based mechanisms to implement AB 32, and to distribute allowances in an equitable manner. ARB could reasonably interpret this to authorize it to use an auction to distribute allowances. Where an agency is interpreting a statute that it administers, courts will accord deference to that interpretation.

Sections 38505(k), 38561(b), 38562(c), and 38570(c) of AB 32 all explicitly authorize ARB to use "market-based" mechanisms. An auction system could reasonably be interpreted to be part of a market-based mechanism. The statute defines "market-based mechanism" as including "[g]reenhouse gas emissions exchanges, banking, credits, and other transactions, governed by rules and protocols established by the state board, that result in the same greenhouse gas emission limit or emission reduction measure adopted by the state board pursuant to this division." Under the canon of interpretation *noscitur a sociis,*[3] a court could interpret "other transactions" to include auctions, given that the surrounding components of market-based systems are similar in nature to auctions.

[3] "[T]he meaning of a word may be ascertained by reference to the meaning of other terms which the Legislature has associated with it in the statute." *Grafton Partners v. Superior Court,* 36 Cal. 4th 944, 960 (Cal. 2005).

In addition, AB 32 mandates that ARB design "regulations, including distribution of emissions allowance where appropriate, in a manner that is equitable." § 38562(b)(1). An auction could reasonably be considered the most equitable manner of allocating auctions, because every entity has an equal opportunity to bid for allowances in an open market. Therefore, ARB can derive authority to auction from this section of AB 32 also.

When an agency is "construing a controlling statute ... [t]he appropriate mode of review in such a case is one in which the judiciary, although taking ultimate responsibility for the construction of the statute, accords great weight and respect to the administrative construction." *Yamaha Corp. of America v. State Bd. of Equalization*, 19 Cal. 4th 1, 12 (Cal. 1998).

The Regional Greenhouse Gas Initiative (RGGI) also provides precedent for an agency's authority to auction where the enabling language does not explicitly grant that authority. New York, a member of RGGI, is planning to auction 100% of its emission allowances, even though neither the RGGI Model Rule nor the RGGI Memorandum of Understanding explicitly mentions auctions.[4]

In sum, ARB can reasonably interpret AB 32 as authorizing it to auction allowances. And courts will give deference to ARB's reasonable statutory interpretation.

V. CONCLUSION

NRDC and ED hope that this legal briefing will be helpful to the Commissions' evaluation of the first-seller approach. NRDC and ED look forward to continuing to work with the Commissions and other parties to develop a viable design for a cap and trade system for the electricity sector in California.

[4] Available at http://www.rggi.org/modelrule.htm

Dated: August 6, 2007

Respectfully submitted,

Kristin Grenfell

Kristin Grenfell
Project Attorney
Natural Resources Defense Council
111 Sutter St., 20th Floor
San Francisco, CA 94104
415-875-6100
kgrenfell@nrdc.org

Virgil Welch
Staff Attorney
Environmental Defense
1107 9th Street, Suite 540
Sacramento, CA 95814
916-492-7078
vwelch@environmentaldefense.org

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of the **"Legal Brief of the Natural Resources Defense Council (NRDC) and Environmental Defense (ED) on the 'First Seller' Approach" in the matter of R.06-04-009** to all known parties of record in this proceeding by delivering a copy via email or by mailing a copy properly addressed with first class postage prepaid.

Executed on August 6, 2007 at San Francisco, California.

Shari Walker

Shari Walker
Natural Resources Defense Council
111 Sutter St., 20th Floor
San Francisco, CA 94104
415-875-6100
Swalker@nrdc.org