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August 15, 2007

California Energy Commission
Docket Office, MS-4
Attn: Docket No. 07-OIIP-01
1516 Ninth Street
Sacramento, CA 95814-5512

Re: **Docket No. 07-OIIP-01**

Dear Docket Clerk:

Enclosed please find **REPLY COMMENTS OF PACIFIC GAS AND ELECTRIC COMPANY (U 39 E) ON MARKET ADVISORY COMMITTEE RECOMMENDATION OF "FIRST SELLER" REGULATION OF GREENHOUSE GAS EMISSIONS UNDER AB 32** being submitted in the above referenced docket.

The document has also been submitted in electronic format to the Docket Office this date.

Yours very truly,

CHRISTOPHER J. WARNER

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Enclosures

**DOCKET 07-OIIP-01**
**CALIFORNIA ENERGY COMMISSION**
**REPLY COMMENTS OF PACIFIC GAS AND ELECTRIC COMPANY (U 39 E) ON MARKET ADVISORY COMMITTEE RECOMMENDATION OF "FIRST SELLER" REGULATION OF GREENHOUSE GAS EMISSIONS UNDER AB 32**

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Dated: August 15, 2007

**TABLE OF CONTENTS**

**REPLY COMMENTS OF**
**PACIFIC GAS AND ELECTRIC COMPANY (U 39 E)**
**ON MARKET ADVISORY COMMITTEE**
**RECOMMENDATION OF "FIRST SELLER"**
**REGULATION OF GREENHOUSE GAS EMISSIONS**
**UNDER AB 32**

## I. INTRODUCTION

Pursuant to the rulings of the Administrative Law Judges dated July 12 and August 8, 2007 (ALJs' Rulings), Pacific Gas and Electric Company (PG&E) provides its reply to comments by parties on the recommendation of the Governor's Market Advisory Committee that the "first seller" approach be used for regulation of greenhouse gas emissions (GHGs) in the electric sector under AB 32. PG&E's reply comments address the following topics:

(1) Many parties agree that the first seller approach provides significant advantages over a load-based cap;

(2) The first seller approach preserves and maintains incentives, mandates and funding for development of customer energy efficiency (CEE) and renewable energy programs;

(3) A load based cap, unlike the first seller approach, is incompatible with potential regional and national GHG programs and therefore could significantly delay a transition to those programs and reduce California's ability to be a national model for climate change legislation;

(4) A load based cap, unlike the first seller approach, is incompatible with the California Independent System Operator's (CAISO's) Market Redesign and Technology Upgrade (MRTU) integrated forward market because load serving entities are unable to track GHGs associated with in-state generation bidding into the CAISO forward markets; and

(5) The parties' legal comments and the additional cases cited by the Administrative Law Judges (ALJs) confirm that both a first seller approach and a load based cap can be structured to meet legal requirements under the Commerce Clause and Federal Power Act.

## II. MOST PARTIES AGREE THAT THE FIRST SELLER APPROACH HAS SIGNIFICANT ADVANTAGES OVER A LOAD BASED CAP

Across a wide spectrum of market participants and stakeholders, parties agree that the first seller approach will provide significant advantages on key issues compared to a load based cap.[1]

For example, Environmental Defense stated: "[W]e believe that the 'first seller' approach as outlined in the *Market Advisory Committee* report is the preferable design structure [for] the California electricity sector under a cap-and-trade system." (Environmental Defense at p. 1).

The Division of Ratepayer Advocates stated:

> "…Under a 1st seller regime, more accurate stack-based emission measurements would be available. … Given that in-state generators supply about 68- 78% of the California electricity load, the opportunity for contract shuffling may be considerably less under the first-seller approach than that under the load-based approach. … A first-seller approach would likely result in an increase of wholesale power price that internalizes the cost of emissions. This has several positive consequences: (i) generators are motivated to invest in and deploy low-cost technologies to reduce emissions; (ii) LSEs in bilateral contracts will see the cost of emissions reflected in the contract prices and not have to engage in a separate permit market. (This would be the same for an inter-state bilateral contract that is unit or plant specific); (iii) sellers bidding into the CAISO (IFM and real-time) will have internalized their emissions costs such that the market clearing prices in these markets will reflect the marginal cost of emissions. In the IFM this means there is an initial feasible and least cost dispatch, or when the ISO redispatches to relieve congestion an

[1] *See, e.g.*, Environmental Defense at pp. 1, 4, 8, 10, 11; Division of Ratepayer Advocates at pp. 7- 13, 16, 18-20; Western Power Trading Forum/Alliance for Retail Energy Markets at pp. 5- 11, 14- 15; Southern California Edison (generally); California Municipal Utilities Association at pp. 6, 8, 12, 17; Natural Resources Defense Council/Union of Concerned Scientists at pp. 6- 8; Energy Producers and Users Coalition/Cogeneration Association of California at pp. 3, 5, 15- 17; Morgan Stanley Capital Group at pp. 3, 7- 13; 15- 18, 23- 25 and Attachment A; Powerex at pp. 1- 2; San Diego Gas & Electric/Southern California Gas Company at pp. 4- 5.

> efficient redispatch is assured. … To sum up some of DRA's comments, a first seller approach is preferred for the CAISO markets in most all respects."

(DRA at pp. 7, 10, 12.)

The Natural Resources Defense Council and Union of Concerned Scientists, even while expressing concern over the impact of the first seller approach on customer energy efficiency programs, also concluded that the first seller approach is superior on other grounds:

> "… [T]he first seller approach will provide more precise information about emissions attributable to the regulated entity. …NRDC/UCS believe that the first-seller approach (which uses a generator-based approach for in-state generators) is better able to serve as a model for a federal system. … [A] load-based cap dilutes the price signal that is sent to power plant owners and developers to the extent it relies on default emission values, whenever power is sold through the spot market or unspecified contracts. Therefore, a first-seller approach provides a stronger price signal for investment in supply-side GHG reduction strategies than a load-based cap."

(Natural Resources Defense Council/Union of Concerned Scientists, pp. 6- 8.)

Even representatives of major interstate power marketers and sellers, who would be directly responsible for the emissions associated with their power sales under the first seller approach, nonetheless support the first seller approach as preferable for interstate power markets in key respects. (*See e.g.*, Western Power Trading Forum/Alliance for Retail Energy Markets at p. 5 ("The first-seller approach would allow suppliers to bid energy into the spot market including both operating costs and the cost of emissions. This would result in a more efficient market with lower associated emissions.") Energy Producers and Users Coalition/Cogeneration Association of California at p. 15 ("Of the two approaches, the First Seller approach is closer to a source based model, and a GHG regulation model that is tailored as closely as possible to achieve source-based regulation of in-state resources should be preferred from a policy perspective."); Morgan Stanley Capital Group, Inc. at p. 3 ("Although not solely a source-based approach, the MAC Report's recommended 'first-

seller' standard makes the best out of a difficult situation in light of the Legislature's mandate that the State account for GHG emissions attributable to imports in a meaningful manner.")

PG&E believes these comments represent a consensus over a wide spectrum of stakeholders and market participants that the first seller approach is preferable as a matter of public policy compared to a load based cap. The only exception to this consensus is over whether the first seller approach is superior or at least as effective at preserving incentives and programs for customer energy efficiency. PG&E discusses this issue in the next section.

## III. THE FIRST SELLER APPROACH FULLY MAINTAINS AND PRESERVES EXISTING INCENTIVES AND MANDATES FOR CUSTOMER ENERGY EFFICIENCY AND RENEWABLE ENERGY PROGRAMS

As the Market Advisory Committee and the ALJs Joint Ruling notes, a central concern regarding the first seller approach is whether it maintains and preserves existing incentives and mandates for customer energy efficiency and renewable energy programs sponsored by utilities regulated by the CPUC as well as local publicly owned utilities.

In terms of existing renewable energy programs and mandates, all parties appear to agree: The first seller approach, like a load based cap, would preserve and maintain existing incentives and mandates for renewable energy, because those renewable energy policies and programs, such as the Renewable Portfolio Standard and the State's "preferred loading order" for renewables, are independent of AB 32 and the first seller vs. load based cap issue, and would continue without regard to which point of regulation is chosen.[2]

[2] *See, e.g.,* Environmental Defense, at p. 6; LADWP, at p. 27; SCPPA, at p. 27; Southern California Edison, at p. 28; Morgan Stanley Capital Group, Inc., at p.16; Energy Producers and Users Coalition/Cogeneration Association of California, at p. 45.

Moreover, many parties recognized that the first seller approach would provide the same and possibly more direct price incentives as a load based cap for development of low-emitting or zero-emitting renewable energy supplies.[3] This is because, by requiring that the costs of GHG emissions be directly internalized in energy sellers' power prices, the profitability and competitiveness of zero-emitting renewable energy producers bidding into wholesale power markets is significantly increased under the first seller approach, compared to a load based cap which does not directly internalize the costs of GHG emissions. For example, the Natural Resources Defense Council/Union of Concerned Scientists stated: "…[A] first seller approach provides a stronger price signal for investment in supply side GHG reduction strategies than a load-based cap."[4] For these reasons, PG&E believes the comments demonstrate a consensus that the first seller approach is at least as good, if not better, than the load based cap, in promoting California's renewable energy policies.

In terms of customer energy efficiency, some parties argue that the first seller approach would significantly damage and deter California's existing customer energy efficiency programs and incentives. For example, LADWP argued that:

> "…The load-based approach allows the procurement decision makers a broader opportunity to evaluate all the resource options and do longer term planning. The first seller, if it is a marketer, might end up being short-sighted chasing existing low-GHG resources and having no direct end-use relationship. Therefore, investing in efficiency might not be evaluated by a

[3] *See, e.g.,* Western Power Trading Forum, at pp. 6, 9; Environmental Defense, at p. 5; Southern California Edison, at pp. 15- 16.

[4] Natural Resources Defense Council/Union of Concerned Scientists at p. 8. NRDC/UC also cautioned that if the first seller regulation were to apply directly to zero-emitting renewable sellers, the additional regulatory burdens could burden new renewable energy sources. (NRDC/UC at pp. 19- 20.) PG&E agrees with NRDC/UC that the intent of the first seller regulation should not be to impose direct regulatory burdens on zero-emitting renewables that otherwise receive economic incentives under the first seller approach.

> first-seller/marketer in the same way as a retail service provider that serves native load."

(Los Angeles Department of Water and Power, at p. 26.)

Similarly, the Natural Resources Defense Council/Union of Concerned Scientists expressed the concern that, because many of the lowest cost investment opportunities for reducing GHG emissions exist on the demand-side, the first seller approach is worse than a load based cap: "Unfortunately, many low-cost reduction strategies – such as energy efficiency – will do nothing to lower compliance costs [for first sellers]." (Natural Resources Defense Council/Union of Concerned Scientists at pp. 8- 9.)

LADWP, NRDC and others are correct that the impact of AB 32 on incentives and funding for customer energy efficiency should be a priority consideration in implementing AB 32. As the CPUC and others know, PG&E is proud of its 30 year history of making CEE a priority for both our customers and our shareholders, and we believe we have one of the most robust, well-funded CEE programs of any public utility in the country. Moreover, during the 2006- 2008 period alone, PG&E expects to spend more than $1.0 billion of customer funded revenue for various CEE and demand reduction programs that will eliminate the need for construction of about 613 MW of new power generation facilities and save about 3063 gigawatt-hours of electricity and 47.5 million therms of natural gas.

Where PG&E disagrees with LADWP and NRDC is the facts on which they rely to draw the conclusion that public utilities like PG&E will not continue and expand their funding and commitment to customer energy efficiency unless they are made directly responsible for the emissions associated with power plants they neither own nor operate but from whom they purchase power. ***Contrary to LADWP and NRDC, California's CEE programs are independent of and will continue regardless of which point of regulation is***

***chosen for AB 32. California's energy policies, including the "preferred loading order" and resource planning mandates adopted by the CPUC and Energy Commission, already mandate and incent public utilities to make CEE a priority for funding and procurement planning – regardless of AB 32.*** As the Division of Ratepayer Advocates concluded, "a first-seller approach to regulating GHG emissions within the electricity sector does not interfere with the CPUC and CEC promotion of end-use efficiency. … The point of regulation does not influence the penetration of end-use efficiency."[5]

Just last week, the CPUC itself reaffirmed this independent commitment to CEE when it issued its proposed decision on new CEE policy goals.[6] The CPUC called its proposed decision "an innovative, new regulatory framework for achieving and exceeding the state's energy efficiency goals. This action extends California's commitment to efficiency as the highest priority energy resource in advancing policies to reduce greenhouse gas emissions. … Meeting the Commission's energy efficiency goals for just the current period alone (2006- 2008) will reduce global warming pollution by an estimated 3.4 million tons of carbon dioxide in 2008, equivalent to taking about 650,000 cars off the road."[7]

The relevance of the CPUC's proposed CEE decision is that ***the CPUC decision is totally independent of AB 32 and the choice between the first seller approach and a load based cap. The CPUC CEE programs and policies in its proposed decision will be adopted***

[5] Division of Ratepayer Advocates, at p. 14.

[6] See CPUC announcement, August 10, 2007,including letter from CPUC Assigned Commissioner, at CPUC website http://www.cpuc.ca.gov/static/energy/electric/energy+efficiency/r0604010pd.htm

[7] *Id.*

***and implemented and continue regardless of which point of regulation is chosen for AB 32. Thus, choosing the first seller approach will not disincent nor deter load serving entities from continuing CEE programs already in place.***

Local publicly owned utilities like LADWP are also spending significant amounts on CEE, independent of AB 32 compliance responsibility. In its comments in this proceeding, the Southern California Public Power Authority, representing LADWP and other Southern California public power entities, stated that its members "already have spent nearly $800 million from 1997 through 2006 on public benefits programs, with the highest percentage (34 percent or $262 million) being spent on energy efficiency. The cost of new and expanded end-use energy efficiency programs is going to be even more substantial in the future."[8]

In fact, structural changes, such as improved building codes, appliance standards and industrial process improvements, may have more of an impact on end-use energy efficiency than choosing the point of compliance for AB 32's emissions standards. This is because, under either a load based cap or the first seller approach, the costs of compliance will be passed through to end users in the form of higher electricity and gas prices, thus incenting end-use energy efficiency equally. However, changes in building codes, appliance standards and industrial processes have the direct ability to improve end use energy efficiency without regard to energy prices and without regard to actions taken by either first sellers or load serving entities.

For these reasons, PG&E believes that California's commitment to CEE and renewable energy as part of overall State energy policies will be preserved and expanded under either the first seller approach or a load based cap.

[8] Southern California Public Power Authority, at p. 39 (August 6, 2007).

## IV. A LOAD BASED CAP IS INCOMPATIBLE WITH POTENTIAL FEDERAL AND REGIONAL GHG PROGRAMS AND THEREFORE WOULD DELAY THE TRANSITION TO THOSE PROGRAMS AND REDUCE CALIFORNIA TO ACT AS A MODEL FOR NATIONAL ACTION

The last three policy questions posed by the ALJs' Ruling (Questions 40, 41 and 42) have to do with the compatibility and interaction of the first seller and load based cap proposals with potential Western regional or Federal greenhouse gas emissions programs. PG&E strongly believes that the parties' responses to these three questions demonstrate that "compatibility" with a Federal or Western regional program is not a mere after-thought in the debate, but is in fact the "Achilles heel" which renders a load based cap fatally incompatible with Federal and regional GHG programs.

Consider a sampling of the nearly unanimous comments by parties who concluded that the first seller approach is more compatible and consistent with source-based GHG programs likely to be adopted in the Western region or at the Federal level:

> "LADWP believes that a first-seller approach may provide an easier transition to a federal GHG regulatory system for in-state sources regulated under AB 32, assuming the federal program is source based."[9]

> "…[I]n terms of linkage with any eventual national program, we [Environmental Defense] agree with the MAC that such a program is likely to be closer to a generator based approach than a load-based approach. We believe a first-seller approach would facilitate easier linkage with this type of program…."[10]

> "The MAC Report has as one of its goals to establish a cap-and-trade system that could be a model for a federal GHG program. At this point, there are no load-based proposals in the major climate change bills under consideration in Congress, so a source-based or first-seller approach would better serve California's stated goal. … Given the approaches being taken by the EU and

[9] LADWP, at p. 37.

[10] Environmental Defense, at p. 11.

> RGGI, and the fact that the proposals before Congress are source-based, it seems unlikely that a load-based model would attract much emulation."[11]
>
> "California's program design choices (and not just the selection of the point of regulation) may have greater influence on the shape of a federal program if it adopts the first-seller, or another generator-based approach."[12]

PG&E believes that compatibility of AB 32 with a Federal or West-wide GHG program is rapidly becoming a very important implementation issue, particularly for the electricity sector. Governor Schwarzenegger and the California Climate Action team in recent months have made regional and international cooperation a hallmark of California's AB 32 implementation, as the State continues its long history of leading on the pressing environmental issues of the day. California already has initiated formal memoranda of understanding and programs among the Western states to establish common protocols for reporting, measuring, and regulating electric sector GHGs in the West. Regional cooperation among the Western states also is essential to avoid inaccurate reporting and double-counting of GHG emissions under AB 32.

At the national level, it is possible that federal legislation may emerge from Congress before the end of 2008 and potentially go into effect by 2012. Thus, the need for AB 32 to be implemented in a way that is compatible with Federal and regional GHG initiatives has taken on new urgency.

A load based cap throws an enormous monkey wrench into California's efforts to implement AB 32 consistent with regional and national GHG initiatives, and could complicate the State's ability to be viewed as a model for other states and Congress as the legislative process moves forward. In contrast, as the Governor's Market Advisory

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[11] Morgan Stanley Capital Group, Inc, at pp. 25- 26.

[12] Natural Resources Defense Council/Union of Concerned Scientists, at p. 27.

Committee and most parties in this proceeding recognize, the first seller approach can be fairly easily transitioned to a Federal or Western source-based GHG program, because California's regulation of in-state generation already effectively would be source-based, and there would no longer be any reason for California to regulate emissions associated with imported power.

For these reasons, a load based cap, unlike the first seller approach, is fundamentally incompatible with Federal and Western regional GHG programs likely to be enacted in the next few years, and inconsistent with what is being considered in most national and regional forums. Therefore the first seller approach should be preferred to a load based cap, and California should look to develop and implement AB 32 in a manner that can serve as a model for other states and regions as well as inform the Congressional process as climate change policies move forward.

## V. A LOAD BASED CAP IS INCOMPATIBLE WITH THE ELECTRICITY MARKET REFORMS PROPOSED BY THE CAISO UNDER ITS MARKET REDESIGN AND TECHNOLOGY UPGRADE PROPOSAL

PG&E notes that several parties concluded that a load based cap would be incompatible with the CAISO's MRTU integrated forward markets, and would create market-distorting "line of sight" problems and "leakages."[13] In contrast, the first seller approach would avoid these "leakage" and "line of sight" issues for in-state generation under the MRTU. PG&E agrees a load based cap would create these serious problems under the MRTU.

As PG&E and others have pointed out, the conflict between the MRTU and a load based cap is fairly simple to understand: The goal of the MRTU is to create more liquid,

[13] *See, e.g.,* Division of Ratepayer Advocates at pp. 12- 13; Morgan Stanley Capital Group, Inc. at p. 13; Southern California Edison at pp. 18- 26; Western Power Trading Forum at pp. 7- 8.

transparent "power pools" in California electricity markets, so that load serving entities and wholesale sellers will have more efficient sources for trading energy and capacity than existing bilateral power markets. However, one attribute of a power pool, such as the Integrated Forward Market being implemented by the CAISO under the MRTU, is that buyers of power from the pool do not know the specific units or sources of the energy they are buying from the pool, because they are buying their power from the pool, not directly from the sellers who are bidding into the pool.

As a result, if a load based cap is implemented under AB 32, then the electricity purchased from the pool will have to be assigned a default emissions rate rather than reporting its actual emissions. In contrast, under a first seller approach, all in-state generating sources and unit-specific power importers selling into the pool will report their actual emissions and will be regulated based on those actual emissions, rather than on a default emissions rate. As a result, California's emissions will be more accurately tracked and regulated under the first seller approach. However, under a load based cap, "leakage" of emissions will occur when high-emitting generators or sellers are able to avoid responsibility for their actual GHG emissions by using a lower default emissions rate assigned for purchases from the CAISO pool.

The amount of "leakage" and market inefficiency under the MRTU and a load based cap is difficult to estimate this early in the process of implementing both. However, given the large amount of in-state electricity generation that currently is operating in California, and given the CAISO's goal that the MRTU be designed to permit significant amounts of that generation to be bid, purchased and dispatched through its integrated forward markets,

the potential for a load based cap to create substantial GHG tracking and "leakage" problems must be considered as part of the first seller vs. load based cap debate.

## VI. RESPONSE TO LEGAL COMMENTS AND ADDITIONAL CASES CITED BY ALJS

### A. General Response to Comments

Several parties who addressed legal issues concluded that the first seller approach can be structured to comply with the Commerce Clause and to avoid conflict with the Federal Power Act.[14] Other parties disagreed, concluding that the first seller approach may create insurmountable legal risks under both the Commerce Clause and the Federal Power Act.[15]

PG&E believes that the CPUC and Energy Commission should evaluate these legal arguments with two overriding questions in mind:

First, are the legal arguments against either the first seller or load based cap approach a function of the unique features of the approaches themselves, or are the legal arguments a function of AB 32's overall statutory intent to regulate emissions associated with "electricity delivered" from out of state generating facilities "and consumed in California"?[16]

Second, can the legal arguments against either the first seller or load based cap approach be answered by structuring either or both to avoid conflict with the Commerce Clause and Federal Power Act?

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[14] *See, e.g.*, Natural Resources Defense Council and Environmental Defense, at p. 2; Southern California Edison at pp. 45, 47- 48; Energy Producers and Users Coalition/Cogeneration Association of California, at p. 22; Division of Ratepayer Advocates, at pp. 22- 26.

[15] *See, e.g.*, Los Angeles Department of Water and Power, at pp. 39- 49; California Municipal Utilities Association, pp. 21- 29 (Commerce Clause only); Southern California Public Power Authority, at pp. 50- 54.

[16] Health and Safety Code section 38501(m).

PG&E believes that the answer to the first question is that several of the legal arguments against the first seller approach are in reality arguments against both the first seller approach and load based cap, and therefore rise or fall based on whether AB 32's regulation of emissions associated with imported electricity itself is lawful, not whether the point of regulation under AB 32 is lawful. Regardless of whether AB 32 regulates emissions associated with imported power at the seller side of the transaction ("first seller") or at the buyer side ("load based cap"), the alleged burden on the wholesale sale of power in interstate commerce is the same. In other words: *It does not matter which side of the transaction is regulated, because the effect on the sale of FERC-regulated electricity in interstate commerce is the same* for purposes of legal analysis under the Commerce Clause and Federal Power Act. Contrary to these legal arguments against AB 32's regulation of emissions associated with electricity imports, PG&E believes that the statute can be interpreted to fully comply with the Commerce Clause and the Federal Power Act.

PG&E believes that the answer to the second question is yes, the first seller and load based cap approaches both can be structured to avoid conflict with the Commerce Clause and Federal Power Act. In this regard, almost every party who filed legal comments agreed on the legal framework that would apply under both the Commerce Clause and the Federal Power Act. The disagreement was over whether the first seller approach because of its design and factual circumstances could satisfy this legal framework. PG&E believes the facts and design of the first seller approach meet the legal test under both.

First, in Commerce Clause cases, all parties agree that the courts look at whether the regulation of interstate commerce discriminates in any way against out-of-state entities in favor of in-state entities. Under the first seller approach, there is no discrimination in favor

of in-state entities because in-state sellers and out-of-state sellers of power into the state are subject to the same regulatory standards.

Second, in Commerce Clause cases, all parties agree that the courts do not permit states to regulate transactions that occur wholly outside the state. Under both the first seller and load based cap approaches, only deliveries of power into the state for consumption in the state would be regulated, so no "extra-territorial" transaction is being regulated.

Finally, under the Commerce Clause, the relative public benefits of the regulation will be balanced against the relative burdens on interstate commerce, and in this respect the first seller approach would be evaluated in the same way as any other point of regulation under AB 32's regulation of emissions associated with imported power. PG&E believes that the courts would sustain the first seller approach under this balancing test for the same reasons a load based cap would be sustained and for the same reasons the CPUC rejected a similar Commerce Clause challenge to its SB 1368 emissions performance standard.

No parties identified any cases or courts that have interpreted the Federal Power Act's jurisdiction over wholesale sales of electricity and electric transmission to extend to regulation of environmental matters. AB 32 is an environmental statute, not a public utility statute, and therefore it does not conflict directly or indirectly with FERC's exclusive jurisdiction over the rates, terms and conditions for the wholesale sale of power and transmission of electricity.

Over four decades ago, the Supreme Court reviewed a federal preemption challenge to local environmental regulation under very similar circumstances to the arguments raised against AB 32 here. In *Huron Portland Cement Co.* v. *City of Detroit, et al*,[17] the City of

[17] 362 U.S. 440 (1960).

Detroit promulgated a "Smoke Abatement Code" that made it a crime for shipping vessels docked at its port to emit smoke above certain maximum limits. Detroit prosecuted a ship owner for violating the smoke abatement ordinance, and the shipper appealed, arguing that the local ordinance was preempted by comprehensive federal laws and regulations providing for the inspection and licensing of the ship's boilers and the ship itself. The Supreme Court held that Detroit's smoke abatement ordinance was *not* preempted by the comprehensive federal shipping and licensing regulations, because:

> "The ordinance was enacted for the manifest purpose of promoting the health and welfare of the city's inhabitants. Legislation designed to free from pollution the very air that people breathe clearly falls within the exercise of even the most traditional concept of what is compendiously known as the police power. … [T]he purpose of the federal inspection statutes is to insure the seagoing safety of vessels subject to inspection. … By contrast, the sole aim of the Detroit ordinance is the elimination of air pollution to protect the health and enhance the cleanliness of the local community. … For this reason we cannot find that the federal inspection legislation has pre-empted local action."

(362 U.S. at 442, 445- 446.)

Just as the Supreme Court found with the City of Detroit's criminal prosecution of a federally-licensed shipper for violating a local air pollution law, there is no Federal Power Act preemption of AB 32 here. AB 32 does not regulate the "licensing" or "filed rates" or other terms and conditions of wholesale power sales or electric transmission that FERC does exclusively regulate. There is no attempt by a state public utility commission to forbid the passthrough of costs to retail customers under FERC-inspected wholesale rates; AB 32 solely regulates the *emissions* associated with certain sales of power; not the *rates or tariffs* issued by FERC for those sales. In short, the first seller approach, like the load based cap, should survive any challenges under the Federal Power Act under the same rationale as the Supreme Court sustained the local air pollution law in the *Huron Cement* case.

In summary, PG&E urges the CPUC and the Energy Commission to evaluate the first seller approach and load based cap on their public policy merits, and not be swayed by legal arguments that apply equally to both approaches or which amount to an overall challenge to AB 32 itself.[18]

### B. Analysis of Cases Cited in August 8, 2007, ALJs' Ruling

The ALJs' August 8 Ruling asked parties whether three Supreme Court decisions interpreting the federal Natural Gas Act would suggest that the first seller approach is more likely than a load based cap to be preempted by the Federal Power Act.[19]

Based on the facts and holdings, the three Supreme Court decisions do *not* suggest that the first seller approach is more vulnerable to Federal Power Act preemption than a load based cap. In fact, the decisions demonstrate the contrary: that a state environmental law like AB 32 that regulates the GHG emissions of power sellers would not conflict with FERC's exclusive jurisdiction over the rates, terms and conditions of sales of power by those power sellers. Although the facts of each of the three cases are somewhat complex, the logic employed by the Supreme Court to find federal preemption in two of the cases (*Northern*

[18] In this regard, LADWP's argument that AB 32 would be preempted by federal Clean Air Act seems both puzzling and irrelevant to the first seller vs. load based cap approach. (See LADWP, p. 51 ("Thus, it may be that any scheme for implementing AB 32 with respect to limiting emissions from power generated out-of-state is preempted by the Clean Air Act.").) Coupled with other comments by LADWP opposing a cap-and-trade system and supporting allocation of emissions allowances based on historical rather than current emissions, LADWP's legal argument appears directed more at a frontal challenge to AB 32 itself, rather than an evaluation of the legal and policy merits of the first seller approach. LADWP's proposal that higher emitting utilities such as itself be allocated more allowances than they would be allocated if based on current sales or output, would effectively reward utilities who have been slow to act to reduce their GHG emissions and penalize the customers of utilities like PG&E who already have made significant investments to reduce their emissions. PG&E is prepared to address LADWP's allocation proposals in the appropriate phase of this proceeding.

[19] The three cases are *Northern Natural Gas* v. *Kansas*, 372 U.S. 84 (1963); *Transcontinental Gas Pipe Line Corp.* v. *Mississippi*, 474 U.S. 409 (1986); and *Northwest Central Pipeline Corp.* v. *Kansas*, 489 U.S. 493 (1989).

*Natural Gas* and *Transcontinental Gas Pipe Line Corp.*) but no preemption in the third case (*Northwest Central Pipeline Corp.*) is fairly simple.

First, in both *Northern Natural* and *Transcontinental Gas Pipe Line*, state regulations purported to be limited to physical and economic conservation of production from natural gas fields (a purpose expressly determined by Congress to be exempted from the scope of natural gas regulation exclusively controlled by the Natural Gas Act). However, in fact, the state regulations directly regulated the gas purchases ("ratable takes") of interstate natural gas pipelines whose transportation and sale of natural gas was clearly within the scope of regulation preempted by the Natural Gas Act. In the *Transcontinental Gas Pipe Line* case, Congress had enacted amendments to the Natural Gas Act, known as the Natural Gas Policy Act of 1978 (NGPA), that had expressly "deregulated" federal regulation of the prices at which natural gas producers could sell gas produced from the natural gas fields subject to the challenged state regulations.

The states argued that their traditional authority to regulate the physical and economic conservation of natural gas rendered the regulations outside the preemptive authority of the Natural Gas Act and the NGPA, respectively. The Supreme Court disagreed in both cases. In *Northern Natural*, the Court noted that the state's "ratable take" regulation was directed not at traditional conservation of natural gas, but at the economic purchase of gas by interstate pipelines, and held that the state regulation "fell within the limits" of the "comprehensive regulatory scheme" enacted by Congress.[20] In *Transcontinental Gas Pipe Line*, the Court held that, although NGPA deregulation meant that "FERC can no longer step in to regulate directly the prices at which pipelines purchase high-cost gas," the state's

[20] *Transcontinental Gas Pipe Line Corp.*, 474 U.S. at 419- 420, citing *Northern Natural*, 372 U.S. at 92, 94.

attempt to regulate gas purchases by natural gas pipelines "directly undermines Congress' determination that the supply, the demand, and the price of high-cost gas be determined by market forces."[21] Thus, in both cases, the state regulations purported to deal with an area of traditional regulation (conservation of natural gas) outside the preemptive field of federal regulation, but in fact directly regulated the economic decisions of interstate pipelines that were within the field preempted by Congress.

In contrast, in the third case, *Northwest Central Pipeline Corp.*, involved a different fact than the first two, and the Court reached a different result. The different fact was that the state regulation in question regulated gas producers and gas production, not interstate gas pipelines and their gas purchases. This different fact, the Court held, meant that the state regulation "regulated production rates in order to protect producers' correlative rights—a matter firmly on the States' side of that dividing line."[22] Moreover, "…the avowed purpose [of the regulation] was to protect the correlative rights of Kansas producers. The protection of correlative rights is a matter traditionally for the States, often pursued through the regulation of production."[23]

Applying these three cases to the first seller approach strengthens the conclusion that first seller regulation under AB 32 would not conflict with the Federal Power Act. All three cases reaffirmed the Supreme Court's consistent holdings that a state regulation is not preempted merely because it has an incidental effect on a matter subject to federal regulation.

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[21] *Transcontinental Gas Pipe Line Corp.*, 474 U.S. at 422.

[22] *Northwest Central Pipeline Corp.*, 489 U.S. at 514.

[23] *Id* at 518. The Court also cited another decision, *Schneidewind* v. *ANR Pipeline*, 485 U.S. 293 (1988), for the proposition that a state regulation's impact on matters within federal control that is only an "incident of efforts to achieve a proper state purpose" would not be preempted, whereas a state regulation that attempts to regulate those matters "in the mere guise" of a proper state purpose would be preempted. *Id* at 516, 518.

In all three cases, the Supreme Court took great pains to examine the true intent and subject of the state regulation, not merely the purported intent. Where the true intent of the state regulation was to regulate the purchasing practices of gas pipelines, a matter the Court concluded was squarely preempted by the Natural Gas Act and NGPA, it did not matter that the regulation purported to regulate conservation of natural gas, a matter traditionally within the authority of the states. What mattered was *what* was regulated, not *who*. On the other hand, when the state regulation had the true intent and effect of regulating the production of natural gas, and not the purchase of that gas by pipelines, the Court held that the regulation was not preempted, even though it had some incidental effects on the economic decisions of the pipelines.

Similarly, the first seller approach clearly has as its sole and true intent the regulation of environmental matters – greenhouse gas emissions – associated with the wholesale sale of power in interstate commerce. There is no stated or unstated intent in AB 32 or elsewhere to regulate the "justness and reasonableness" of the rates, terms and conditions of those wholesale sales, a matter clearly within the exclusive control of FERC. The sole intent is to regulate greenhouse gas emissions. Unlike the regulation of a gas pipeline's capital structure in *Schneidewind*, which the Court cited favorably several times in *Northwest Central Pipeline Corp.*, the first seller approach does *not* have as its "central purpose the maintenance of … rates at what the State considered a reasonable level, and their provision of reliable service."[24] The first seller approach is what it is, and no more – a method for implementing AB 32's intent that the environmental effects of greenhouse gas emissions associated with the delivery and consumption of electricity in the State be reduced. This purpose is squarely

[24] *Id.* at 513, n.10.

within the traditional authority of State regulatory authority over environmental matters affirmed by the Supreme Court in the *Huron Portland Cement Co.* case,[25] and fully consistent with the facts and holdings of the *Northern Natural*, *Transcontinental Gas Pipe Line*, and *Northwest Central Pipeline* cases.

## VII. CONCLUSION

For the reasons discussed by PG&E and numerous parties in their comments, PG&E recommends that the CPUC and the Energy Commission endorse the recommendations of the Governor's Market Advisory Committee supporting the first seller approach for the regulation of GHG emissions in the electric sector under AB 32.

Respectfully Submitted,

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[25] 362 U.S. 440 (1960).