BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA
AND THE CALIFORNIA ENERGY COMMISSION

Order Instituting Rulemaking to Implement the Commission's Procurement Incentive Framework and to Examine the Integration of Greenhouse Gas Emissions Standards into Procurement Policies	R.06-04-009
AB 32 Implementation	07-OIIP-01

REPLY COMMENTS OF THE ENERGY PRODUCERS AND USERS COALITION AND THE COGENERATION ASSOCIATION OF CALIFORNIA ON TYPE AND POINT OF REGULATION ISSUES

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The Energy Producers and Users Coalition[1] and the Cogeneration Association of California[2] (jointly, EPUC/CAC) submit the following reply comments on type and point of regulation issues pursuant to the November 9, 2007 Administrative Law Judge's Ruling (Ruling).

I. OVERVIEW AND SUMMARY OF RECOMMENDATIONS

Through these comments, the Commission sought more extensive feedback on

[1] EPUC is an ad hoc group representing the electric end use and customer generation interests of the following companies: Aera Energy LLC, BP West Coast Products LLC, Chevron U.S.A. Inc., ConocoPhillips Company, ExxonMobil Power and Gas Services Inc., Shell Oil Products US, THUMS Long Beach Company, Occidental Elk Hills, Inc., and Valero Refining Company – California.

[2] CAC represents the power generation, power marketing and cogeneration operation interests of the following entities: Coalinga Cogeneration Company, Mid-Set Cogeneration Company, Kern River Cogeneration Company, Sycamore Cogeneration Company, Sargent Canyon Cogeneration Company, Salinas River Cogeneration Company, Midway Sunset Cogeneration Company and Watson Cogeneration Company.

four regulatory approaches. The comments highlight the difficulty involved with incorporating imports into California's regulatory scheme. Parties note that application of the Load-Based (LB) approach to imports is incompatible with MRTU's least cost dispatch, the First Seller (FS) approach may conflict with the Federal Power Act, and the Pure Source (PS) based approach fails to address imports in conflict with AB 32. In short, none of the approaches are ideal. Despite differences in the specific approaches, however, the comments evidence a growing alignment of positions.

Consensus exists on several issues. First, stakeholders value a source-based regulatory approach that regulates sources at the point of emission. Second, they agree that a cap-and-trade program is needed to allow cost-effective emission reductions. Finally, stakeholders recognize that programmatic measures will be an important way for the state to achieve targeted emission reductions.

In addition to highlighting consensus, these reply comments examine the issues raised by hybrid models. They acknowledge the potential for market distortion arising from a source based/load based hybrid under the MRTU. They also observe that while the hybrid proposed by Constellation (source based/first seller) may avoid this distortion, it would also be more susceptible to legal challenge under the Dormant Commence Clause and the Federal Power Act. Finally, they urge further consideration of the Constellation hybrid.

II. PARTIES AGREE THAT USE OF SOURCE-BASED REGULATIONS SHOULD BE MAXIMIZED

Comments advocate three approaches that aim to maximize regulation of in-state sources at the point of emission: First Seller, Hybrid and the Constellation Hybrid. Regardless of the specific program advocated, the comments reflect widespread support for a source-based approach for good reason.

A. Goal of the Hybrid Proposal Was to Maximize Source-Based Regulations

EPUC/CAC proposed the Hybrid approach in an effort to maximize source-based regulations and minimize the legal conflict raised by the FS approach. Under the Hybrid approach, in-state sources would be regulated at the stacks while imports would be regulated once the power is assigned to an LSE.[3] As a result of the different points of regulations, in the MRTU market, in-state power prices reflect compliance costs unlike imported power prices. Given the MRTU market's reliance on economic dispatch, as noted in the comments, in-state sources may be disadvantaged.[4]

The shortcoming of the Hybrid approach demonstrates how difficult it is to incorporate imports into California's regulatory scheme with accuracy and without legal conflict. EPUC/CAC thus acknowledge that maximizing in-state source-based regulation in coordination with a workable import model, should be the focal point of the Commission's efforts.

[3] EPUC/CAC Comments on MAC Report, at 4-5.
[4] PG&E Comments, at 23; SCE Comments, at 12.

B. Comments Reflect Widespread Support for a Source-Based Regulatory Approach

The comments largely recommend a source-based regulatory approach for California.[5] As reflected in the comments, a source-based approach:

- best aligns the incentives to reduce emissions with the source of those emissions;[6]
- allows for greater accuracy in the tracking of emissions, increasing the likelihood that California can reach its target by 2020;[7]
- allows expandability to future federal and regional regulatory efforts;[8] and
- minimizes leakage.[9]

The observations in favor of a source-based regulatory approach are not only reflected in the comments of stakeholders, they are also included in the MAC Report and in the reports of experts.[10] Finally, a source-based approach rests on experience.[11] In contrast, parties note that a pure load-based approach is not expandable to federal and regional efforts, will allow leakage, requires increased reliance on default emission values, is incompatible with MRTU, and may result in

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5 *See, e.g.*, AReM Comments, at 13-14; Calpine Comments, at 17; Constellation Comments, at 19; DRA Comments, at 2; ED Comments, at 10-11; EPUC/CAC Comments, at 3-9; Morgan Stanley Comments, at 12; Powerex Comments, at 7; WPTF Comments, at 17.

6 *See, e.g.*, EPUC/CAC Comments, at 3-4; PG&E Comments, at 41; Morgan Stanley Comments, at 12; Van Horn Consulting Comments, at 3-4.

7 *See, e.g.*, Constellation Comments, at 6; EPUC/CAC Comments, at 5-6; SCE Comments, at 18-19; PG&E Comments, at 30-44; Van Horn Consulting Comments, at 3-4.

8 *See, e.g.*, EPUC/CAC Comments, at 6; PG&E Comments, at 39-41; SCE Comments, at ; AReM Comments, at 5-7; Van Horn Consulting Comments, at 3-4.

9 *See, e.g.*, PG&E Comments, at 33; SCE Comments, at 4; Van Horn Consulting Comments, at 3-4.

10 MAC Report, at iv; Wolak, et al., Opinion on "Load-Based and Source-Based Trading of Carbon Dioxide in California," at 2-3; Dallas Burtraw, *State Efforts to Cap the Commons: Regulating Sources or Consumers?*, November 2007, at 23; Van Horn Consulting Comments, at 3-5.

11 As noted by several parties the EU-ETS and RGGI both utilize source-based regulations.

higher compliance costs.[12] In short, regardless of the specific regulatory approach adopted by the Commission, source-based regulations carry benefits that are unmatched by a load-based system.

III. PARTIES AGREE THAT A CAP-AND-TRADE PROGRAM INCLUDING ELECTRICITY SECTOR IS REQUIRED AT THE OUTSET TO ALLOW EMISSION REDUCTIONS AT LEAST COST

The comments demonstrate that parties overwhelmingly recognize the benefits of a cap-and-trade program to provide cost-effective emission reductions for the electricity sector.[13] As Dallas Burtraw observes, while the electricity sector may not be the largest emitting sector, it *"is typically identified as the source of most potential greenhouse gas reductions in the near term."*[14] In fact, Dr. Burtraw observes that modeling at the national level indicates the electricity sector, while responsible for approximately 40% of all emissions, will account for nearly two-thirds or three-quarters of emissions reductions.[15] As the source of the most potential emission reductions, it is particularly important to include the electricity sector in a cap-and-trade program which affords continuing incentives to reduce emissions.[16]

Also important, is the immediate implementation of a cap-and-trade program. Several parties emphasize that use of a cap-and trade program is required by AB 32's

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12 See examples PG&E Comments, at 31-34; Van Horn Consulting Comments, at 4-5.

13 AReM Comments, at 2-3; Calpine Comment, at 14; Constellation Comments, at 16; Environmental Defense Comments, at 2-3; EPUC/CAC Comments, at 10; IEP Comments, at 2-3; NRDC/UCS Comments, at 3; PG&E Comments, at 23-24, SCE Comments, at 2; SCPPA Comments, at 2;.SMUD Comments, at 11; Western Power Trading Forum (WPTF) Comments, at 14-15.

14 Dallas Burtraw, *State Efforts to Cap the Commons: Regulating Sources or Consumers?*, November 2007, at 1; SoCalGas/SDG&E Comments, at 2.

15 *Id*, at 2.

16 *See* MAC Report, at 7.

mandate to facilitate emission reductions at least cost.[17] Others note that the adoption of a cap-and-trade program is an integral part of California taking a leadership role in lowering emissions.[18] In short, given the value of a cap-and-trade program, the Commission should not defer its implementation and should ensure that any cap-and-trade program adopted includes electricity sector emissions.

IV. REGARDLESS OF REGULATORY APPROACH ADOPTED, PARTIES AGREE THAT PROGRAMMATIC MEASURES CAN PROVIDE MATERIAL EMISSION REDUCTIONS

While a cap-and-trade program can provide emission reductions at least cost, the comments remind the Commission that programmatic measures will be an important part of the emission reductions effort. In particular, NRDC/UCS note that expanded reliance on renewable power, energy efficiency and combined heat and power can provide significant emissions reductions.[19] Similarly, DRA notes that the encouragement of energy appliance and building standards can provide material reductions.[20] Finally, PG&E observes that programmatic measures alone, while not as preferable as market mechanisms, "*may reasonably transition California well for the coming national source-based market.*" [21] As noted in EPUC/CAC's opening comments, expanded reliance on renewables, energy efficiency, solar resources and combined heat and power can allow the state to achieve nearly 40MMTCO_2/year in emissions reductions.[22] The reductions from these programs constitute over a fifth of

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17 Constellation Comments, at 16; EPUC/CAC Comments, at 9-10; Morgan Stanley Comments, at 3; PG&E Comments, at 2.

18 Calpine Comments, at 14; NRDC/UCS Comments, at 19.

19 NRDC/UCS Comments, at 13-14.

20 DRA Comments, at 11.

21 PG&E Comments, at 41.

22 EPUC/CAC Comments, at 10-11.

the emission reductions required by AB 32.[23] If these programmatic measures are used by publicly owned utilities (POUs), the reductions will be even greater.[24] The MAC Report notes that the average emissions rate for in-state sources is 700 lbs/MWh while the emissions rate for imports is 930lbs/MWh.[25] This demonstrates that California has already undertaken significant efforts to lower emissions in the electric sector. To ensure *additional* in-state reductions will take place, it is critical that the Commission consider all potential sources of emission reductions.

As discussed in the opening comments, further development of the state's CHP policy is required to maximize potential reductions. To allow California to realize the full scope of emission reductions from CHP, several changes to the existing policy framework must be considered:

- portfolio set-aside for CHP power purchases by the utilities, similar to the RPS;
- reasonable pricing provisions for power purchases from CHP facilities;
- removal of deployment barriers, including eliminating departing load charges; and
- regulatory incentives for utilities to procure from CHP resources.

The Intergovernmental Panel on Climate Change, in its recently issued report, emphasizes that there continues to be a large emission reduction potential that can be realized by expanding reliance on cogeneration technology.[26] In fact, the report indicates that the mitigation potential for industrial cogeneration is almost

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23 *Id.*
24 *Id.*
25 MAC Report, at 41.
26 Intergovernmental Panel on Climate Change, *Climate Change 2007 Mitigation*, at 459.

$150MMTCO_2$ for the United States.[27] The policy changes listed above, therefore, are crucial to the state's efforts to lower emissions.

V. THE CONSTELLATION HYBRID MERITS FURTHER CONSIDERATION

In its comments, Constellation proposes a new hybrid that regulates in-state sources at the stacks and imports using the FS approach.[28] The Constellation Hybrid appears to overcome the potential MRTU distortion that could result from the Hybrid. Like other regulatory approaches, however, the Constellation approach's regulation of imports provides grounds for challenge under the Dormant Commerce Clause (DCC) and the Federal Power Act (FPA).

A. Constellation Hybrid May Overcome the Market Distortion That Could Arise from a Source-Based/Load-Based Hybrid.

To avoid market distortion in the face of MRTU implementation, any adopted regulatory approach must ensure that all MWh – imported or in-state power – come to the market similarly situated. Both must either include or exclude carbon costs. The Constellation Hybrid appears to achieve this objective, while maximizing explicit source-based regulation.

The Constellation Hybrid places the point of regulation for in-state sources at the stack; for imports, regulation occurs on a First Seller basis. Under this approach, all MWh enter the MRTU market with a carbon allowance cost. Moreover, by expressly addressing in-state resources with source-based regulation, the Constellation Hybrid would avoid the unnecessary complexity of regulating in-state sources on a transactional, First Seller basis.

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27 *Id.*

28 Constellation Comments, at 19.

B. The Constellation Hybrid Would Be Subject to Legal Challenge

1. Constellation Hybrid Treats In-State and Out-of-State Interests Differently

The DCC focuses on differential treatment that favors in-state interests and burdens out-of-state interests.[29] The Constellation hybrid would track emissions for in-state sources at the stacks and emissions for imports based on transactions.[30] Since the differential impact would be evident from the language of the implementing regulations, the regulations would be facially discriminatory.[31] A facially discriminatory regulation is subject to the scrutiny test.[32] Such a regulation fails the strict scrutiny test unless "*the discrimination is demonstrably justified by a valid factor unrelated to economic protectionism.*"[33] A state must also demonstrate that "'*nondiscriminatory alternatives adequate to preserve the local interests at stake*" do not exist.[34] In short, to overcome challenge, California would be required to demonstrate that nondiscriminatory alternatives are insufficient to protect its interest in reducing GHG emissions.

2. Constellation Hybrid Is as Susceptible to Challenge Under the FPA as FS Approach

The focus of an FPA challenge would be on whether state regulations interfere

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29 *Oregon Waste Systems, Inc. v. Dept. of Environmental Quality of the State of Oregon, et al.*, 511 U.S. 93, 99 (1994).

30 Constellation Comments, at 19.

31 *See Oregon Waste Systems, Inc.*, 511 U.S. at 93 (invalidating facially discriminatory statute); *National Solid Waste Mgmt. v. Pine Belt Regional Solid Waste Mgmt Auth'y*, 389 F.3d 491, 497 (5th Cir. 2004) ("'[s]tate laws discriminating on their face are virtually *per se* invalid.'")

32 *Maine v. Taylor*, 477 U.S. 131, at 138 (1986); *Alliant Energy Corp. v. Bie*, 336 F.3d 545, 546 (7th Cir. 2003)

33 *Wyoming v. Oklahoma*, 502 U.S. 437, 454 (1992); *Oregon Waste Systems, Inc.*, 511 U.S. at 93; *Maine*, 477 U.S. at 131.

34 *Chemical Waste Mgmt Inc. v. Hunt*, 504 U.S. 334, 342 (1992) (*quoting Hunt v. Washington Apple Advertising Comm'n*, 432 U.S. 333, 353 (1992).

with FERC's regulation of wholesale transactions.[35] Like the FS approach, Constellation's hybrid approach would directly regulate wholesale transactions. As explained in EPUC/CAC's opening comments on the MAC Report, there are strong grounds to conclude that a state's authority to regulate carbon emissions is drawn from its police powers and can coexist with FERC's authority to regulate wholesale transactions. First, "*[w]hen Congress legislates in a field traditionally occupied by the States, 'we start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress.*'" [36] AB 32 regulations would be an exercise of California's police powers given that it is directed to promoting the health and safety of its citizens.[37] Second, a recent FERC case categorizes a state regulation that creates and allocates environmental attributes to be a matter of state law.[38] Despite the fact that GHG regulations would be an exercise of state police powers, however, the Constellation hybrid could be challenged on the grounds that it directly impacts FERC's authority to regulate wholesale transactions. In short, even though an FPA challenge could be overcome, the Constellation approach is vulnerable to such a legal claim.

VI. CONCLUSION

Assembly Bill 32's mandate to include imports in the scope of electricity sector regulation presents regulators with a true predicament. As evidenced in the comments, none of the proposed regulatory approaches for imports are immune to

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35 Nantahala Power and Light Co. v. Thornburg, 476 U.S. 953, at 956 (1986); *Hillsborough County v. Automated Medical Laboratories, Inc.*, 471 U.S. 707, 712 (1985).

36 *California v. ARC America Corp.*, 490 U.S. 93, 101 (1989).

37 California Health & Safety Code §38501(a).

38 Federal Energy Regulatory Commission, 105 FERC ¶ 61,004, 2003 WL 22255784 (2003).

challenge. What can be gleaned from the comments, however, is that: (i) a source-based regulatory approach should be adopted; (ii) a cap-and-trade program including the electricity sector is important to keep compliance costs low; and (iii) programmatic measures will be a critical part of the state's effort to reduce emissions. In addition, the most promising approach may be the Constellation Hybrid, which merits additional development.

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Respectfully submitted,

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