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The Commerce Clause Implications of California's Climate Change Initiatives

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by Gordon P. Erspamer, Stacey M. Sprenkel

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Despite the growing body of scientific research regarding a potential link between increasing greenhouse gases ("GHGs") and the rise in global temperatures, the federal government has not taken the affirmative actions necessary to regulate the emissions of GHGs. This regulatory "gap" has left the states to attempt to address the issue, if at all, in a piecemeal fashion. California policy-makers have stepped in with an aggressive regulatory program to attempt to address this problem of climate change (also called global warming). Two recent initiatives addressing climate change have been passed by the California Legislature: AB 32, which aims to decrease GHG emissions to 1990 levels (which were 25% below the present levels) by 2020, and SB 1368, which prohibits any load-serving entity, and any local publicly owned electric utility, "from entering into a long-term financial commitment…unless any baseload generation… complies with a greenhouse gases emission performance standard," and calls on the California Public Utilities Commission ("CPUC") and the California Energy Commission ("CEC") to establish such emission performance standards ("EPS").

On January 25, 2007, the California Public Utilities Commission ("CPUC") issued a decision adopting regulations for Phase I implementation of an EPS for load-serving entities.[1] *See* D.0701039. Instead of pursuing facility specific standards for power plants located in California, as contemplated by AB 32, the CPUC adopted a different approach — it focused on procurement rules applicable to the *buyers* of power, recognizing that the market for procuring power in California is larger than the market for generating power. In this way state policies promoting renewable, clean technologies assume an extra-territorial dimension and address the so-called "leakage" problem, a term used to refer to power imports into California from other regions lacking GHG restrictions. The CPUC's decision prohibits California's utility companies from entering into long-term contracts with electricity sources that emit more greenhouse gases than a combined cycle gas plant. This will in effect prohibit utility companies from entering into long-term contracts to buy electricity from power plants located outside California that emit high quantities of GHGs, including most coal-burning plants (or at least those that lack carbon-sequestering systems). It is clear that California is dependent on imported power for approximately 30% of its needs,[2] that there are virtually no coal-burning plants that currently operate within California, and that approximately twenty percent of California's electricity comes from coal-burning plants located outside of California. *See* CEC, "California Gross System Power for 2005," available at www.energy.ca.gov. Therefore, a debate has arisen about whether SB 1368, and its implementing decisions, constitute an impermissible burden on interstate commerce, in violation of the Commerce Clause of the United States Constitution. This article examines the issues raised in that debate.

Discussion

The Commerce Clause's Limitations on State Action

A basic understanding of Commerce Clause principles is necessary to appreciate the constitutional issues raised by California's climate change initiatives. Article One, Section Eight of the United States Constitution states that "Congress shall have the power … to regulate Commerce among the several States." Beginning in 1824, this clause has been interpreted to prohibit states from regulating interstate commerce. As the Supreme Court set forth in *Gibbons v. Ogden*, "when a state proceeds to regulate commerce … among the several States, it is exercising the very power that is granted to Congress." 22. U.S. 1, 199 (1824). This implicit limitation is commonly known as the "dormant" Commerce Clause.

Under the dormant Commerce Clause, courts will invalidate state laws that discriminate against or unduly burden the interstate flow of commerce. *Oregon Waste Sys., Inc. v. Dept. of Env't Quality*, 511 U.S. 93, 98 (1994). "This 'negative' aspect of the Commerce Clause prohibits economic protectionism – that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors." *New Energy Co. v. Limbach,* 486 U.S. 269, 273 (1988).

To determine whether a statute violates the dormant Commerce Clause, the Supreme Court has set forth alternative analyses, depending on whether the challenged law discriminates against interstate commerce. In this context, "'discrimination' simply means differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter." *Oregon Waste Sys.*, 511 U.S. at 99. There are three different forms of discrimination: statutes candiscriminate against interstate commerce either *facially*, in *purpose*, or in *effect*. "Where discrimination exists, the regulation is subject to strict scrutiny under which it is the state's burden to show that the discrimination is narrowly tailored to further a legitimate interest." *Conservation Force, Inc. v. Manning*, 301 F.3d 985, 995 (9th. Cir. 2002). If, however, there is no discrimination, and "the state regulates evenhandedly, the regulation is valid unless the plaintiff can show that is imposes a burden on interstate commerce 'clearly excessive in relation to the putative local benefits.'" *Id.*(citing *Pike v. Bruce Church, Inc.*, 397 U.S. 137,142 (1970)). This test is known as the *Pike* balancing test. Under the *Pike* test, the Court will consider (1) the extent of the burden on interstate commerce, (2) the legitimacy of the local interests involved, and (3) whether reasonable, non-discriminatory alternatives are available to address those local interests. *Pike*, 397 U.S. at 142. If the burden on interstate commerce is found to outweigh any putative local benefits, or reasonable, non-discriminatory alternatives are available, the regulation is likely to be found to be an unconstitutional exercise of state power in violation of the Commerce Clause.

Is SB 1368 Facially Discriminatory, Discriminatory in Effect, or is the Burden on Interstate Commerce Incidental?

According to Justice Blackmun, "it is difficult to conceive of a more basic element of interstate commerce than electric energy, a product used in virtually every home and every commercial or manufacturing facility." *Fed. Energy Regulatory Comm'n v. Mississippi*, 486 U.S. 742, 757 (1982). Facially, the rules establishing the EPS appear to be geographically neutral. Load-serving entities can enter into long-term contracts with any in-state or out-of-state electricity generator, so long as the generator complies with the EPS. Notwithstanding this fact, it might be possible to fashion a facial challenge based upon the legislative history of the California statutes and implementing regulations, in conjunction with facts subject to judicial notice. However, the success of such a strategy is uncertain.

Assuming a facial challenge is foreclosed, the question, then, is whether SB 1368 and its implementing regulation are discriminatory in *effect.* Critics who suggest that SB 1368 is discriminatory in effect base their argument on the characteristics of the California energy market, which, as noted above, is both dependent on imported energy and devoid of domestic coal plants. Around twenty percent of California's electricity is imported from coal-burning plants in various Western states. The ability of these and any new coal plants to enter into long-term contracts to export electricity into California will be severely restricted or perhaps eliminated altogether. On the other hand, there are no coal-burning power plants within the State of California, and a significant percentage of California's energy comes from in-state renewable energy sources. CEC, California Gross System Power for 2005. Because there are no domestic coal plants, and there are unlikely to be any such plants in the future, critics argue that the EPS operates to reduce coal imports, placing an undue burden on that particular industry, which functions entirely out-of-state, and thus restricts the free flow of commerce. The effects on interstate commerce are arguably heightened by the fact that coal is cheaper than alternative energy sources.

The EPS, as required by SB 1368, requires emissions of GHG to be no higher than the rate of emissions of GHGs for combined-cycle natural gas baseload generation. The EPS also only applies to power sources that operate above a 60 percent capacity factor. Critics suggest that the EPS will have a materially greater impact on out-of-state energy sources, because the sources within California emit lower levels of GHG, so many will be unaffected by the establishment of the EPS, and "the 60 percent capacity factor exempts the majority of California's in-state generators from the EPS." *Center for Energy and Economic Development ("CEED") Comments on Draft Workshop Report*, Sept. 8, 2006, p. 15. CEED is a non-profit group devoted to the promotion of coal-based electricity.

According to the Attorney General, "a substantial amount of electricity generated out-of-state" complies with the EPS, and would "continue to be available for procurement" in California. (*AG Reply Brief*, Oct. 31, 2006, p. 5.) The Attorney General also noted that the CEC "estimates that more in-state than out-of-state [baseload] generation facilities would fail to meet the [EPS]" and further, "more imported electricity than locally generated electricity from facilities to which the [EPS] is to be applied may meet the [EPS]." *Id.*

To address the capacity factor issue, the CPUC explained that the regulation focuses on generators operating at a high-capacity factor, because "these plants would provide the bulk of the LSE's open procurement needs and the most significant amounts of GHG emissions." Decision at 208. Further, they found that the EPS "should not apply to generation plants that operate at a low-capacity factor to meet peaking or other reliability needs…because it could be detrimental to the reliability and performance of the transmission grid and it would not reduce a significant amount of additional CO_2 emissions." Decision at 209. The CPUC found that "the generators competing under the EPS for long-term, high capacity factor baseload contracts are not similarly situated with low-capacity factor generation plants" and on that basis, there is no legitimate claim of discrimination under the Commerce Clause.

Critics also claim that this type of regulation will have an effect on the price of electricity in the exporting state – for example – by reducing the demand for electricity from coal-burning sources — and therefore — placing a burden on out-of-state natural gas generators. *See* Yvonne Gross, Kyoto, Congress, or Bust, 28 *Thomas Jefferson L. Rev.* 205 at 226 (2005).

Another argument made to suggest that the effects of SB 1368 are discriminatory is that California is no longer a potential market for coal-burning plants, and as a result, new plants will have difficulty securing financing. The argument posits that in-state power producers will have an advantage in securing financing. There are two potential flaws with this argument. First, as pointed out in the CPUC's decision, "[u]nder the EPS, electricity generated from high-GHG emitters can still be sold to California LSEs under existing contracts, or under new or renewal contracts of less than five years." At 206. Second, plants with high GHG emissions can use technology to reduce the emissions to levels that meet the EPS. And moreover, the problem is not that in-state power producers have an advantage, but rather that "clean power" producers may have an advantage in securing financing, regardless of whether they are located in-state or out-of-state. It is certainly the case, however, that the high cost of power in California has stimulated the development of coal-based power plants located in other Western states, and the continuing development of such plants is jeopardized to the extent that California load-serving entities cannot enter into long-term contracts with these new coal-fired power plants, even if they offer the most attractive prices.

Observers should not discount the possibility that a federal court might find SB 1368 to be discriminatory in effect or, failing that, a Court would apply the *Pike* balancing test to strike down SB 1368, although in the latter case the State could assert strong arguments about the adverse effects of global warming upon California. To establish a discriminatory effect, it must be shown that the challenged regulation "burdens out-of-state companies while providing in state companies with *some* advantage." *Pete's Brewing Co. v. Whitehead,* 19 F. Supp. 2d. 1004, 1011 (W.D. Mo. 1998). Here, the state can assert a more than colorable argument that the burdens and advantages are applied evenly to in-state and out-of-state entities. The opponents of California's climate change initiatives would face a challenge in convincing a Court that the burdens of SB 1368 are not incidental, thereby avoiding application of the *Pike* balancing test. If the burden on interstate commerce imposed by SB 1368 and its implementing regulation outweigh any legitimate local interest, or if there are reasonable, non-discriminatory alternative mechanisms to address that local interest, then a Court will likely find that SB 1368 violates the Commerce Clause.

The Legitimate Local Public Interest at Stake

Critics would be hard-pressed to claim that reduction of GHG emissions does not serve a legitimate public interest, and the success of any Commerce Clause challenge may depend on reframing the public interest debate. The clear purpose behind the enactment of SB 1368 was to address the impacts of climate change. The Supreme Court has held that the protection of the health of citizens and the integrity of natural resources constitutes a legitimate state interest. *See Maine v. Taylor*, 477 U.S. 131 (1986). In addition, other legislative findings regarding the local benefits include that SB 1368 will "reduce potential exposure of California customers for future pollution-control costs," a conclusion that seems to assume that federal regulation of GHG emissions is likely. In addition, SB 1368, according to the Legislature, reduces "potential exposure of California consumers to future reliability problems in electricity supplies." The theory behind these findings is that if the citizens of California remain dependent on "dirty power," then when the future enactment of federal statutes or regulations restricting GHG emissions could negatively impact California's economy.

Opponents of the EPS argue that, as a preliminary matter, there is no consensus in the scientific community regarding whether there is actually a link between GHG emissions and climate change, although the strength of this argument has been waning as evidence substantiating the effects of global warming has accumulated. Thus, the claimed environmental benefits may never materialize. Also, the effectiveness of the EPS may be compromised or offset by increased emissions related to power used in geographic areas that are not regulated. Another concern is what is known as "contract shuffling" — where resources are simply reallocated or shifted around, so that power from sources with lower emissions would be directed to the California market, and the power generated from coal-burning plants would be shifted out of the California market. The result would be that the net share of renewable power would remain the same and emissions would not be lowered. Yvonne Gross, Kyoto, Congress, or Bust, at 213. On balance, and given the international concern about climate change and the pressing need to address it, a Court may find that SB 1368 addresses a legitimate public interest. The question would then be raised whether that interest outweighs the incidental burden on interstate commerce, or whether there are reasonable non-discriminatory alternatives.

Availability of Reasonable Non-Discriminatory Alternatives

Parties seeking to challenge the EPS argue that there are non-discriminatory alternatives to the establishment of an EPS. One such alternative would be to require the use of carbon adders. A carbon adder is an assessment that is added to a bid to account for the anticipated future costs of carbon emissions. The idea behind carbon adders is that they equalize the playing field so that "dirty power" is no longer a cheaper alternative, indirectly leading to an increase in the use of "cleaner" power sources.

Another alternative would be to require power plants to offset or mitigate their GHG emissions. Examples of methods to offset GHG emissions include reforestation, investing in energy conservation, emission reduction projects, or retrofitting diesel buses with cleaner fuel. Gross, Kyoto, Congress, or Bust, at 220.

Another alternative would be to take a more comprehensive approach to the reduction of GHG emissions, which would spread the burden more evenly among a variety of sectors (including transportation, industrial, and commercial – not just electricity). This would potentially be more effective to address climate change, and, by spreading out the burden, it could result in less restriction and burden on the electricity sector.

Conclusion

SB 1368, with its implementing regulations, will certainly have a major effect on the electricity generation industry, including power plants located in other Western states seeking to export power to meet California's swelling load. Whether a Court will find that this effect unfairly burdens out-of-state energy producers, and thus constitutes a violation of the Commerce Clause, is a separate question. While SB 1368 is facially neutral, the courts may be forced to address whether it is discriminatory in effect, and thus subject to the strict scrutiny standard of review. Alternatively, a Court may find that the burdens of SB 1368 on interstate commerce, while incidental, nonetheless outweigh the putative local interest behind the regulation. Or a Court may conclude that there are reasonable, non-discriminatory alternatives to address the local interest. Alternatively, a Court may find that the local interest in reducing GHG emissions in an attempt to reduce the effects of climate change outweighs any incidental burdens on interstate commerce as a result of implementation of SB 1368. Until a Court speaks definitively on the issue, the debate is certain to continue. Likewise, companies interested in the topic need to be vigilant in monitoring court dockets and intervening in any cases filed in order to protect their interests.

[1] On March 2, 2007, the CEC issued a Notice of Proposed Action for Adoption of Regulations Establishing and Implementing a Greenhouse Gases Emission Performance Standard for Local Publicly Owned Electric Utilities, and the public hearing is set for April 25, 2007. *See* www.energy.ca.gov/ghgstandards/documents/index.html#042507.

[2] For purposes of this article, the Intermountain and Mojave coal plants are treated as non-California resources based on their geographical locations. We note that the CEC has treated these power plants as in-state resources based upon contractual provisions committing them to serve California load.