CALIFORNIA AIR RESOURCES BOARD

RULEMAKING TO CONSIDER THE ADOPTION OF A PROPOSED CALIFORNIA CAP ON GREENHOUSE GAS EMISSIONS AND MARKET-BASED COMPLIANCE MECHANISMS REGULATION, INCLUDING COMPLIANCE OFFSET PROTOCOLS

COMMENTS OF PEABODY ENERGY COMPANY

Peabody Energy Company[1] urges the California Air Resources Board (ARB) not to adopt provisions in the proposed cap-and-trade regulations that would apply the regulations to electricity produced at generating stations located outside of California. These provisions run afoul of the Commerce Clause of the United States Constitution. Peabody understands the view of ARB Staff that these extra-territorial provisions were mandated by the legislature in A.B. 32. Nevertheless, these provisions violate the Constitution and should not be adopted.

I. The Cap-and-Trade Program Regulates Electric Generation Located Outside of California

As the ARB Staff Report states, "ARB has chosen ... to regulate emissions associated with electricity generated in another jurisdiction but consumed in California."[2] This extra-territorial regulation is accomplished by defining "Covered Entity" to which the program applies as including "First Deliverers of Electricity," which in turn is defined to include both those who generate electricity in California and "Electricity Importers."[3] As a "Covered Entity," an "Electricity Importer" which delivers electricity into California from an out-of-state facility must obtain allowances from ARB for the carbon dioxide equivalent emissions associated with that supply. For convenience, Peabody refers to this requirement for Electricity Importers to obtain allowances for the emissions from out-of-state generation as the Importation Standard.

Under § 95812(b)(2), First Deliverers of Electricity are subject to the cap-and-trade program if their emissions exceed certain thresholds. Under § 95812(b)(2)(A), the threshold for inclusion in the program for an electric generation facility located in California is 25,000 metric tons per year of carbon dioxide equivalent. Under § 95812(b)(2)(B), an importer of electricity from an identified out-of-state facility is subject to the program if that facility similarly emits at least 25,000 metric tons per year of carbon dioxide equivalent. However, under this section, the threshold for inclusion in the program for an importer of electricity from a specified source is zero. This apparently means that any electric sale into California from a facility that emits more than 25,000 metric tons per year of carbon dioxide equivalent emissions is subject to the program, even if the amount of electricity sold to California is small and would not in itself account for more than 25,000 metric tons of carbon dioxide equivalent.

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[1] Peabody Energy is the world's largest private-sector coal company. Its coal products fuel 10 percent of all U.S. electricity generation and 2 percent of worldwide electricity.
[2] Staff Report: Initial Statement of Reasons, Proposed Regulations to Implement the California Cap-and-Trade Program, Part I, Volume I at IV-8 (Oct. 28, 2010).
[3] *See* § 95811 of proposed regulations.

Under § 95812(b)(2)(C), the threshold for electricity delivered from unspecified out-of-state sources is also zero, meaning that the program will apply to any imported electric supply from unspecified sources, no matter how small those sources may be. Thus, the program could apply to out-of-state facilities that do not generate at least 25,000 metric tons per year of carbon dioxide equivalent. Staff proposes to use an emissions default factor to measure the carbon dioxide equivalent emissions of electricity delivered from unspecified sources based on average emissions associated with the available electricity generation that could be sold on the spot market and brought into California.[4]

II. Applying the Cap-and-Trade Program to Out-of-State Facilities Violates the Commerce Clause

A. Legal Background

The Commerce Clause, U.S. Const. Art. I, § 8, cl. 3, explicitly grants Congress the authority to regulate commerce among the States. The Commerce Clause has also long been understood to directly limit the power of the states to discriminate against or burden interstate commerce. *Oregon Waste Sys., Inc. v. Dep't of Envtl. Quality of the State of Oregon*, 511 U.S. 93, 98 (1994). This "negative" aspect of the Commerce Clause is often referred to as the "Dormant Commerce Clause" and is invoked to invalidate overreaching provisions of state regulation of commerce.

The Supreme Court has adopted a two-tiered approach to determining the validity of state regulation under the Commerce Clause. *Brown-Forman Distillers Corp. v. New York State Liquor Auth.*, 476 U.S. 573, 578 (1986). The first tier is often referred to as the "virtual *per se*" rule. This rule is applied when a statute "directly regulates or discriminates against interstate commerce, or when its effect is to favor in-state economic interests over out-of-state interests." *Id.* at 579. In such cases the Court has "generally struck down the statute without further inquiry." *Id.* (citation omitted.) A statute can be saved under this analysis only if the state shows that the law "advances a legitimate local purpose that cannot adequately be served by reasonable nondiscriminatory alternatives." *Oregon Waste Sys.*, 511 U.S. at 101 (internal quotations and citations omitted). But this showing must "pass the strictest scrutiny" and "[t]he State's burden of justification is so heavy that facial discrimination by itself may be a fatal defect." *Id.* (internal quotations and citations omitted).

The second tier is for cases where a statute "has only indirect effects on interstate commerce and regulates evenhandedly." *Brown-Forman*, 476 U.S. at 579. In such cases the statute will be upheld "unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits." *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970). This test has become known as the *Pike* balancing test. The Court has "recognized that there is no clear line separating the category of state regulation that is virtually *per se* invalid under the Commerce Clause, and the category subject to the *Pike v. Bruce Church* balancing approach." *Brown-Forman*, 476 U.S. at 579. As the Court noted, "[i]n either situation the critical consideration is the overall effect of the statute on both local and interstate activity." *Id.* (citation omitted.)

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[4] Staff Report at II-20.

A. The Importation Standard Violates the Dormant Commerce Clause

1. ***Per se* violation**

ARB's proposed application of its cap-and-trade program to out-of-state sources through the Importation Standard cannot withstand scrutiny under the "virtual *per se*" test for three reasons. First, the Importation Standard "directly regulates … interstate commerce." *See Brown-Forman,* 476 U.S. at 579. The standard directly penalizes and therefore restricts the importation of electricity generated at out-of-state facilities. Importers must, in essence, pay a tariff to California in order to import their product into the state, and that money goes right into the state's coffers. But, under the Commerce Clause, states cannot levy tariffs on imports. *See West Lynn Creamery, Inc. v. Healy,* 512 U.S. 186, 194-96 (1994) (holding that a Massachusetts state law requiring mill processors, including out-of-state firms, to pay a premium to a state fund that was then disbursed only to in-state producers was "effectively a tax which makes milk produced out-of-state more expensive," thus discriminating against out-of-state milk).

Second, application of the cap-and-trade program to out-of-state sources constitutes improper extra-territorial regulation. *See Healy v. Beer Institute*, 491 U.S. 324, 333 (1989)*; see also Edgar v. MITE Corp*., 457 U.S. 624, 642-43 (1982) (plurality opinion) (the "Commerce Clause …. precludes the application of a state statute to commerce that takes place wholly outside of the State's borders, whether or not the commerce has effects within the State"). As Staff admits, "ARB has chosen ... to regulate emissions associated with electricity generated in another jurisdiction but consumed in California."[5] Critically, the conduct that the Importation Standard seeks to affect is the production of greenhouse gas emissions occurring in other states and thus "wholly outside the State's borders." Although the electrons produced at these out-of-state facilities are imported into California, the state is obviously not concerned with the impact these electrons have once they enter the state.

The purpose of the Importation Standard to regulate out-of-state generation is also shown in how the thresholds for such generation are set. As noted, the threshold for an imported supply of electricity from specified generation is zero so long as the generation produces at least 25,000 metric tons per year of carbon dioxide equivalent. Had Staff for some reason been concerned that the importation of electrons into California in and of itself caused some effect, Staff would have set the threshold for the imported power supply at 25,000 metric tons in line with the threshold for in-state generation. In that way, the electrons produced in California and the electrons entering California from out-of-state would have been treated the same.

But obviously, the imported electrons do not cause any damage in California; the concern is the generation of greenhouse gases at the out-of-state facility, and that is why Staff wishes to align the threshold for out-of-state and in-state facility emissions at 25,000 metric tons. Staff's view may be logical, but the Importation Standard nevertheless is an effort to affect conduct occurring wholly outside the state, and that is something California cannot do under the Commerce Clause.

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[5] Staff Report: Initial Statement of Reasons Proposed Regulations to Implement the California Cap-and-Trade Program, Part I, Volume I at IV-8 (Oct. 28, 2010) ("Staff Report").

Similarly, as stated, the threshold for an imported supply of electricity from unspecified out-of-state generation is zero. Not knowing exactly where this power comes from and therefore the amount of the associated emissions, Staff had the option of not penalizing these imports at all in order to avoid the possibility that it would regulate emissions from generation that does not produce more than 25,000 metric tons of carbon dioxide equivalent per year. Staff chose otherwise because it wished to make sure that the program applies to out-of-state generation even where uncertainty exists as to the associated emissions and because Staff frankly wishes to encourage emissions reductions at out- of-state facilities. As Staff said, "[i]n this way, the California cap-and-trade program will encourage low-emitting generation for both in-state production and imported power."[6]

Third, application of the program to out-of-state generation is virtually *per se* invalid because such application is economically protectionist in its purpose and effect. *See Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 270 (1984) ("A finding that state legislation constitutes 'economic protectionism' may be made on the basis of either discriminatory purpose or discriminatory effect"). In order to survive a challenge based on economic protectionism, California bears the burden of showing that its justification for a discriminatory law is "unrelated to economic protectionism." *See New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 274 (1988). California cannot meet this burden.

The explicit purpose of the Importation Standard is ensure that out-of-state generation does not obtain a competitive advantage vis-à-vis in-state generation, a result that would occur if the state were to limit application of the cap-and-trade program to in-state sources. California is rightly concerned that, without the Importation Standard, California will expose itself to increased imports of lower-cost fossil-fueled power, with the result that greenhouse gas emissions out-of-state will increase. California has almost no in-state coal generation and no coal industry, but it is trying to dramatically increase in-state renewable generation, and this renewable generation is more expensive than the out-of-state fossil generation with which it competes. Such in-state renewable generation therefore is at risk if California does not penalize out-of-state fossil generation.

But California's purpose in this regard, and certainly the effect of the Importation Standard, is protectionist and therefore invalid under the Commerce Clause. As stated by the Supreme Court, a regulation addressing interstate commerce that gives regulated parties "who handle domestic articles of commerce a cost advantage over their competitors handling similar items produced elsewhere constitutes such protectionism." *Oregon Waste*, 511 U.S. at 106. Thus, California cannot force "producers or consumers in other States [to] surrender whatever competitive advantages they may possess" to "give local consumers an advantage over consumers in other states." *Brown-Forman*, 476 U.S. at 580; *see also Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 521, 527 (1935) ("New York has no power to project its legislation into Vermont by regulating the price to be paid in that state for milk acquired there," because such regulation "set[s] up what is equivalent to a rampart of customs duties designed to neutralize advantages belonging to the place of origin"). But that is exactly the effect the Importation

[6] Staff Report at 11-20.

Standard has—it penalizes the natural cost advantage of out-of-state generators who have access to and use low cost fossil-fueled electric generation. It therefore violates the Commerce Clause.

Even a concern as to "leaking" California greenhouse gas emissions to other states would not justify the protectionist effect of the Importation Standard. *See Chemical Waste Mgmt., Inc. v. Hunt*, 504 U.S. 334, 340 (1992) (even a legitimate legislative purpose cannot justify the use of invalid "legislative means"); *Philadelphia v. New Jersey*, 437 U.S. 617, 627 (1978) (a "presumably legitimate goal" does not justify "the illegitimate means of isolating the State from the national economy"). Indeed, the need for California to regulate out-of-state units to accomplish its goals—whether that goal is the openly protectionist one of promoting in-state renewable generation or simply reducing greenhouse gas emissions associated with California electricity consumption—highlights the interstate nature of the electricity market that California seeks to affect for its own ends and its improper intrusion into that market.

Finally, California's Importation Standard is economically protectionist because it helps the state to improve the competitive position of its own electricity-using industries vis-à-vis their competitors in lower cost, higher coal-using states. Because California has such a high demand for electricity compared with other states in the West, California's Importation Standard will incent non-California generators wishing to export to the large California market to switch to other, higher cost generation. This generation will serve not only California but other western states as well, as it is not economic for generators to maintain two sets of resources, one for California and one for other states. Thus, the California Importation Standard will cause a general up-lift in wholesale electric prices outside California, thus removing a competitive advantage those states have with respect to California. In this sense, California's Importation Standard is no less protectionist than the state "price affirmation" regulations condemned in *Healy*, 491 U.S. at 335-40, where beer importers were required to meet the lowest in-state posted price. *See also Brown-Forman Distillers Corp. v. New York State Liquor Auth.*, 476 U.S. 573 (1986); *United States Brewers Ass'n., Inc. v. Healy*, 692 F.2d 275 (2d Cir. 1982), *aff'd*, 464 U.S. 909 (1983).

Because its Importation Standard is a "virtual per se" violation of the Commerce Clause, California faces a heavy burden to show that the regulation "advances a legitimate local purpose that cannot adequately be served by reasonable nondiscriminatory alternatives." *See Oregon Waste Sys.*, 511 U.S. at 101 (citations omitted). But California's effort to reduce greenhouse gas emissions in order to affect the climate is no more than symbolism. *See* Staff Report at ES-1 referring to the desire to "provide a model for action that can be taken at the federal level and by other states individually and through regional action" and to "catalyz[e] action throughout the country and the world."

In terms of real-world impact, the program will have no discernible effect on the overall level of greenhouse gases in the global atmosphere nor on the global climate, given the steep trajectory of increases in international greenhouse gas emissions. Moreover, California has other alternatives for addressing the global climate change issue, such as lobbying in Congress for adoption of what could be more meaningful national or international approaches to the issue. *See C & A Carbone, Inc. v. Town of*

Clarkstown, 511 U.S. 383, 392 (1993) (a discriminatory state law will be struck down unless the defendant can "demonstrate, under rigorous scrutiny, that it has no other means to advance a legitimate local interest").

2. ***Pike* Balancing**

Even if California's Importation Standard can survive the virtual *per se* test, such standard fails under the *Pike* balancing test. As seen, the "putative local benefits" of such standard is minuscule because it will provide no discernable in-state protection against potential global climate change. On the other hand, the interstate impact is massive, because it interferes with the free flow of electricity in wholesale markets, a business that is interstate in nature.

The Supreme Court has often noted that state regulation having an interstate effect is given particular scrutiny where there is a need for uniform interstate regulations. *See Milk Control Bd. of Pennsylvania v. Eisenberg Farm Prods.*, 306 U.S. 346, 351 (1939) ("This court has repeatedly declared that the grant established the immunity of interstate commerce from the control of the states respecting all those subjects embraced within the grant which are of such a nature as to demand that, if regulated at all, their regulation must be prescribed by a single authority"); *Morgan v. Commonwealth of Virginia*, 328 U.S. 373, 377 (1946) ("Where uniformity is essential for the functioning of commerce, a state may not interpose its local regulation"); *Southern Pacific Co. v. Arizona*, 325 U.S. 761, 774 (1945) (noting the "confusion and difficulty" that would attend the "unsatisfied need for uniformity" in setting maximum limits on train lengths); *Cooley v. Board of Wardens*, 53 U.S. 299, 319 (1852) (Commerce Clause prohibits States from regulating subjects that "are in their nature national, or admit only of one uniform system, or plan of regulation").

Perhaps no industry in the United States is more interstate in nature and needing of uniform regulation than the electricity industry. Electrons flow according to the laws of physics at the speed of light and do not respect state borders. Every electric company in the country is part of a larger powerpool and interstate grid in order to achieve the benefits of diversity, reliability and coordination. As the Midwestern and Northeastern blackout of 2003 demonstrates, local events on the grid can have instantaneous and cascading effects across large sections of the country. Balkanized state control of interstate transactions across the grid, with individual states controlling interstate power flows based on their own conceptions of what is in their own best self-interest, could have catastrophic impacts.

In sum, weighing the large interstate impact of California's Importation Standard against its purely symbolic purpose leads to the inescapable conclusion that such standard cannot withstand scrutiny under the *Pike* balancing test and therefore violates the Commerce Clause.

III. Conclusion

Peabody urges ARB not to adopt the Importation Standard for the reasons discussed above. Such standard is unlawful under the Commerce Clause. Peabody appreciates the opportunity to submit these comments.

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Respectfully submitted,

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