HARVARD LAW SCHOOL
Environmental Law Program
POLICY INITIATIVE

Stakeholder Comments
Regional Greenhouse Gas Initiative 2016 Program Review

Thank you for the opportunity to provide comments to inform the Regional Greenhouse Gas Initiative (RGGI)'s 2016 Program Review. During the meeting held in Boston, Massachusetts on April 29, 2016, several questions were posed about how RGGI should integrate Clean Power Plan compliance. Of those, we provide comments on the following:

- Should RGGI consider its potential influence on program design in other states?
- Should RGGI trade only with states that have a price floor?

The Environmental Policy Initiative at Harvard Law School provides robust, timely analysis of the most pressing legal issues facing energy and environmental policymakers. We have been analyzing compliance strategies for existing source performance standards since before EPA proposed the Clean Power Plan. We participate regularly in gatherings of state policymakers and stakeholders to discuss implementation issues, and we have published a number of Clean Power Plan white papers, to assist states in crafting approvable plans. Our white papers may be found http://environment.law.harvard.edu/CPPResources .

We are finalizing a new white paper about the dormant Commerce Clause implications for different plans designs under the Clean Power Plan. In the interest of submitting timely input, we are providing a discussion draft under cover of these comments.

The dormant Commerce Clause is a court-made doctrine that reads a *constraint* on state power into the Commerce Clause, which empowers Congress to regulate interstate commerce. Under the dormant Commerce Clause (DCC), a state generally may not:

(1) discriminate against out-of-state economic interests;
(2) regulate commerce occurring wholly outside the state ("extra-territorial" regulation); or
(3) impose burdens on interstate commerce clearly excessive relative to local benefits.

Our interest in writing this paper stemmed from questions we were hearing from states, utilities, and other stakeholders along the lines of the two questions noted above.

We conclude that states should consider the implications of the DCC so they can achieve CPP policy goals without significant risk of a constitutional challenge. Some observations which are potentially relevant for RGGI's consideration (including a few that go beyond the specific questions teed up by RGGI, Inc. at the April 29 stakeholder meeting):

- States can negotiate joint or linked plans with a subset of other states without violating the DCC. However, they likely may not isolate another state for refusing to adopt reciprocal plan elements.

- States might be able to prevent automatic linking to states with different plan elements, if they describe allowances they will accept for compliance in terms of the attributes of the state plans that create them rather than their origin, and if they can articulate non-protectionist, local health and safety benefits for the limits.

- Although the Clean Power Plan prohibits the export of allowances from states that operate an economy-wide greenhouse gas trading program, such states should be able to import allowances from states with utility-only programs.

- States can write rules to prevent leakage and resource shuffling, if those rules apply to in-state actors and place limits on imports that are equivalent to in-state requirements.

- The DCC does not likely implicate choices related to initial allowance allocation.

The attached discussion draft begins with a primer on the DCC. The draft then addresses whether the CPP and its compliance instruments are covered by the DCC. Finally, the draft offers guidance for designing state plans that limit exposure to possible DCC claims.

Our general DCC analysis, as outlined in the discussion draft, suggests some responses to RGGI's questions. In response to the first question, we believe RGGI can and should consider its potential influence on program design in other states. The Supreme Court has

> recognized that mutually beneficial objectives may be promoted by voluntary reciprocity agreements, and that the existence of such an agreement between two or more States is not a per se violation of the Commerce Clause of which citizens of non-reciprocating States who do not receive the benefits conferred by the agreement may complain.[1]

This rationale supports the filing of a joint plan by RGGI states – or separate plans referring to plans submitted by other RGGI members – for compliance with the Clean Power Plan. In either case, states are freely coming together to agree to a parallel set of actions which they will take within their own jurisdictions. This type of cooperation is fully consistent with the Constitution.

Cooperating RGGI states could accept allowances from other states that meet EPA's requirements for trading. In this way, RGGI states could lead by example in an open market. RGGI's design choices will affect the wider market, as allowance prices reach equilibrium. In addition, states hesitating to auction their allowances or cap new sources, as examples, would benefit from the lessons learned from by RGGI states and could model their own programs based on RGGI states' experiences . This is exactly the type of positive influence RGGI should wish to exert in the Clean Power Plan allowance market.

On the second point – whether RGGI should trade only with states that have a price floor – we caution that here the DCC could raise concerns. We understand that for any number of reasons, states might consider limiting the allowances their EGUs could use for compliance, based on the state of origin. This could be done in two ways: states could refuse to accept allowances for compliance generated in any state but those identified; or, states could condition linkage on reciprocal treatment by other states (acceptance of allowances or adoption of similar plan designs). Whether states can place broad, geographic limits on trading partners is questionable. In a case about state regulation of banks, the Court wrote

> [t]here can be little dispute that the dormant Commerce Clause would prohibit a group of States from establishing a system of regional banking by *excluding bank holding companies from outside the region* if Congress had remained completely silent on the subject.[2]

Elsewhere the Court said that "it is clear that no single State could [enact a policy for the entire Nation] or even impose its own policy choice on neighboring States."[3] Even where a state has a strong health and safety interest, the interest "may not be accomplished by discrimination against articles of commerce coming from outside the state unless there is some reason, apart from their origin, to treat them differently."[4]

Therefore, if states were to limit the allowances they will accept for compliance purposes, they may face DCC risk. As noted in the bullets above, states will stand on more solid ground if they describe acceptable allowances in terms of the attributes of the plans that generate those allowances instead of their origin. States should also document the non-protectionist purposes, such as public health and safety benefits, for any limitation. It may help here that restricting the use of out-of-RGGI allowances could in some instances harm in-RGGI generators by raising their allowance costs. Finally, to avoid being challenged for extra-territorial regulation or for placing an undue burden on the interstate commerce of compliance commodities, states should take care not to be seen as "us[ing] the threat of economic isolation as a weapon to force sister States to enter into even a desirable reciprocity agreement."[5]

Thank you for consideration of these comments.

Sincerely,

Kate Konschnik

Kate Konschnik, Director

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[1] *Great Atlantic & Pac. Tea Co., Inc. v. Cottrell* 424 U.S. 366, 378-79 (1976).

[2] *Northeast Bancorp, Inc. v. Governors of the Fed. Reserve Sys.*, 472 U.S. 159, 174 (1985) (emphasis added).

[3] *BMW of N. America, Inc. v. Gore*, 517 U.S. 559, 571 (1996) (citation omitted) (finding Alabama court could not set punitive damages based on acts in other states, particularly as the acts were allowed in other jurisdictions).

[4] *Philadelphia v. New Jersey*, 437 U.S. 617, 62-27 (1978).

[5] *Id.*

Dormant Commerce Clause Implications for Clean Power Plan Implementation
May 9, 2016 DISCUSSION DRAFT

I. Introduction

Our previous paper concluded states can file joint or linked plans to facilitate Clean Power Plan (CPP) compliance for affected power plants without violating the Constitution's Compact Clause. That provision prohibits expansion of state power at the federal government's expense.

For 200 years, courts have read an additional constraint on state power into the Constitution. The Commerce Clause authorizes Congress to "regulate commerce . . . among the several states." Courts interpret the provision to limit a state's power over interstate commerce. This court-made doctrine is known as the dormant Commerce Clause (DCC).

Congress may authorize state laws that would otherwise violate the DCC. But "congressional intent to authorize such laws must be either 'unmistakably clear' or 'expressly stated.'"[1] Section 111 of the Clean Air Act authorizes states to implement and enforce the Clean Power Plan within their borders. And yet, once a state contemplates trading of compliance instruments between regulated entities, this authority does not explicitly or clearly inoculate a state plan that discriminates between instruments based on origin, wholly regulate out-of-state activity, or unduly burdens interstate commerce.

This paper offers guidance for designing state plans that limit exposure to possible DCC claims.

TAKE-AWAYS

With planning, states can achieve CPP policy goals without significant risk of a DCC challenge.
States can negotiate joint or linked plans with a subset of other states without violating the DCC. However, they likely may not isolate another state for refusing to adopt reciprocal plan elements.
States might be able to prevent automatic linking to states with different plan elements, if they describe allowances they will accept for compliance in terms of their attributes rather than their origin, and if they can articulate non-protectionist, local health and safety benefits for the limits.
States should be able to create their own single-state compliance plan.
States can write rules to prevent leakage and resource shuffling, if those rules apply to in-state actors and place limits on imports that are equivalent to in-state requirements.
Trading-ready states can limit ERC eligibility based on type of generator but not on origin.
The DCC does not likely implicate choices related to initial allowance allocation.

II. Regional Approaches to the Clean Power Plan

The CPP established performance rates for coal and natural gas electric generating units (EGUs). EPA also calculated equivalent average emission rates for each state (in pounds of CO_2 per MWh) and state-wide carbon budgets. A state chooses which targets to apply and whether to enable sources to trade.

- Under a rate-based plan, each EGU must meet a specified emission rate; if trading is allowed, EGUs may purchase emission rate credits (ERCs) that are generated by lower-emitting resources to administratively adjust their rates.
- Under the mass-based option, EGUs must hold one emission allowance for each ton of carbon dioxide (CO2) emitted; if trading is allowed, allowances may be bought and sold between sources.

The CPP encourages flexible market-based compliance strategies. The CPP also encourages the creation of large trading markets, stating "there is no reason that whatever geographic limits may exist for electricity and capacity transactions by an affected EGU should also limit the EGU's transactions for validly issued rate-based emission credits or mass-based emission allowances."[2]

The Preamble describes trading as "nothing more than [a way to] commoditize compliance … [to reduce] the overall costs of controls and spread[ ] those costs among the entire category of regulated entities while providing a greater range of options for sources…."[3] Making pollution compliance a commodity creates potential markets; enabling trading between private firms and across state lines places this commodity into the stream of interstate commerce. Discrimination or barriers to the free flow through these markets could trigger DCC concerns.

Yet the preamble never mentions the dormant Commerce Clause, and the accompanying Legal Memorandum dispatches the issue quickly: "Interstate emissions trading programs that states may wish to develop under this rule similarly would not implicate the Commerce Clause."[4]

Notwithstanding EPA's confidence, this paper discusses four areas where states should consider the DCC: identifying trading partners (or inhibiting inter-state activity); preventing emissions "leakage" to other states; restricting ERC eligibility to in-state producers; and deciding how to structure initial allowance allocations.

It begins with a primer on the DCC. Then, the paper addresses whether the CPP and its compliance instruments are covered by the DCC. Finally, the paper explores areas of plan design where states should proceed with caution, to limit DCC exposure.

III. Dormant Commerce Clause

Article I, § 8, cl. 3 of the Constitution states that "Congress shall have power … to regulate commerce with foreign nations, and among the several states, and with the Indian tribes."

In 1824, Supreme Court Chief Justice Marshall suggested that this clause conferred *exclusive* authority to Congress to regulate trade "between the states".[5] Under that theory, states could not regulate or burden interstate commerce even when Congress did not act (was "dormant").

While some Justices have vigorously opposed this interpretation of the Commerce Clause – from Chief Justice Taney in the early nineteenth century to Justice Thomas on today's Court – the rule stands that states are limited to some degree in regulating interstate commerce whether or not Congress acts. Under the DCC, a state generally may not:

(1) discriminate against out-of-state economic interests;
(2) regulate commerce occurring wholly outside the state ("extra-territorial" regulation); or
(3) impose burdens on interstate commerce clearly excessive relative to local benefits.[6]

Discriminatory (1) and extraterritorial (2) laws are usually per se invalid (there are some exceptions for discrimination, discussed below). Otherwise, a court will engage in a balancing exercise between a law's local benefits and its burden on interstate commerce (3). We describe each hurdle, providing case examples. Additional energy cases are summarized in Appendix A.

Discriminatory state laws

"In all but the narrowest circumstances," courts will strike down a state law that benefits in-state economic interests at the expense of out-of-state competitors;[7] for instance, a law requiring Oklahoma utilities to purchase coal from in-state suppliers,[8] or a utility commission order barring the export of New Hampshire hydropower.[9] In recent years, challenges to in-state requirements for Renewable Portfolio Standard (RPS) eligibility have invoked this claim.[10] States have changed their RPS laws in reaction, often mooting the challenges but suggesting states understand the vulnerabilities of such laws.[11]

Courts will also strike down laws discriminatory in purpose or effect. Challengers must bring "substantial evidence of an actual discriminatory effect" to prevail.[12] The Seventh Circuit voided two laws encouraging utilities to install scrubbers to comply with the federal Clean Air Act,[13] when it was clear the intent of legislation was to favor use of local high-sulfur coal.[14]

Some discrimination is allowed if it is "demonstrably justified by a factor unrelated to economic protectionism."[15] The Supreme Court has upheld import bans to quarantine pests[16] and export restrictions on groundwater.[17] A district court found a plan to entice new in-state electricity generation did not discriminate because its intent was to relieve transmission congestion and improve reliability.[18] Other states are justifying energy deliverability requirements on reliability and local air quality grounds;[19] it is unclear whether courts will endorse these justifications.

DCC case law allows even protectionist discrimination in three limited circumstances:

1. When states discriminate between entities that do not compete with each other.[20] For instance, a district court upheld an ordinance prohibiting pet stores from selling professionally bred dogs. The court rejected arguments that Phoenix discriminated against out-of-state breeders in favor of local animal shelters, because the entities serve different purposes.[21] In the energy context, the Supreme Court upheld an Ohio tax exemption for natural gas distribution companies, concluding the local companies sold to different customers and so did not compete with the interstate wholesalers challenging

the exemption.[22] Similarly, the California PUC approved RPS eligibility rules requiring resources to be connected to a California balancing authority, finding that connected generators offer a different product – the clean energy associated with the REC – and so are not competing with more remote generators.[23]

2. When a public entity provides a "core function" such as waste disposal,[24] rules favoring its services over out-of-state companies will not violate the DCC.[25]

3. If a state acts as a "purchaser, seller, or producer,"[26] it can prefer local firms to out-of-state competitors. Under the "market participant" theory, the Supreme Court has upheld a South Dakota policy to prioritize sales from a state-owned cement plant to in-state purchasers;[27] and a local hiring requirement for city-financed construction in Boston.[28]

As we discuss in Part IV, states should take care not to appear to discriminate against out-of-state firms or interstate commerce when they name trading partners or exclude EGUs located in specified states from interstate allowance or ERC markets. Similarly, it is worth considering the discrimination prong of the DCC before requiring EGUs to purchase in-state ERCs for compliance with a rate-based plan, or allocating allowances to benefit generators serving in-state customers at the expense of those generators selling their power out-of-state.

Extraterritorial state laws

In contrast to economic discrimination, a law "that directly controls commerce occurring wholly outside the boundaries of a state" is never justified.[29] The extra-territoriality inquiry turns on whether the law directly controls conduct in another state:[30] "no state may force an out-of-state merchant to seek regulatory approval in one state before undertaking a transaction in another."[31]

Courts sometimes apply extra-territoriality as its own "per se invalidating" rule, while other times they use it as evidence of an unlawful burden on interstate commerce as described in the next section.[32] The Supreme Court does not often invoke extraterritoriality in either context,[33] and rumblings on lower appeals courts suggest the doctrine should be abandoned entirely or limited to price control laws.[34]

But the Court has not limited this line of reasoning to pricing laws;[35] rather, it has applied the principle to strike down statutes requiring reciprocity from other states before becoming effective,[36] an Illinois securities law regulating takeover offers involving firms with limited contacts in the state,[37] and waste flow rules that "attach restrictions … to control commerce in other states."[38] Other federal courts likewise "have extended the rule … to cases where the 'price' floor being imposed on another jurisdiction was not monetary, but rather a minimum standard of environmental protection."[39]

Finally, extra-territoriality is also implicated when challengers allege that multiple state laws create inconsistent obligations, making it impossible for a company engaged in the interstate market to be in compliance with all jurisdictions.[40]

The extra-territoriality claim has been raised in several recent energy lawsuits. For instance, petroleum trade groups and out of-state ethanol producers challenged California's Low Carbon Fuel Standard (LCFS), claiming among other things that the regulations controlled ethanol production occurring wholly outside of the state. California's rules cap the average carbon intensity of fuels produced in and imported to California, and scores intensity using factors such as the source of electricity used to power the refinery and the distance the product is transported. In 2014, the Ninth Circuit held the LCFS was not extra-territorial because it applies carbon standards only to in-state purchasers of fuels.[41] The court distinguished between "statutes 'that regulate out-of-state parties directly' – which are unconstitutional – from those that 'regulat[e] contractual relationships in which at least one party is located in [the regulating state]'."[42]

On the other hand, a federal district court found a law prohibiting "any person" from importing coal-powered electricity into Minnesota was extra-territorial, because Minnesota could invoke the broad language to halt coal-fired electricity sales on the regional grid between entitles in two other states.[43] The decision analogized to other voided laws, including a Michigan labeling law requiring a unique mark on bottles sold in state (and banning the sale of the bottles elsewhere),[44] and a Vermont law banning internet distribution of material deemed harmful to minors.[45]

As we discuss in Part IV, states should consider extra-territorial effects as they evaluate options to address potential "leakage." EPA requires plans to address leakage *within* a state between plants under the cap and new NGCC plants, which are not bound to an absolute emissions limit.[46] But the CPP does not require plans to limit *interstate* leakage from states that set a mass cap for their plants to states that apply rate-based standards. Should mass-based states wish to discourage interstate leakage, they must be careful to do so in a way that avoids extra-territorial regulation of their rate-based neighbors. State should also take care not to seem to be threatening isolation of states that do not set the same market rules.

State laws that place an undue burden on interstate commerce

A law that does not discriminate impermissibly or regulate extraterritorially, and is "directed to legitimate local concerns,"[47] may withstand DCC scrutiny unless "the burden imposed on commerce is clearly excessive in relation to the putative local benefits."[48] The Court established this test when it voided a law requiring in-state processing of Arizona cantaloupes. When a company that exported fruit for processing alleged the law would require it to invest in new processing facilities, the Court found this burden outweighed the stated benefit of the law.

Despite the outcome of this particular case, state laws “frequently survive” the so-called *Pike* balancing test,[49] so long as the state creates a record establishing the net benefit of the law.[50]

Applying the *Pike* analysis, the Supreme Court upheld an Arkansas Public Service Commission order regulating wholesale rates charged by an electric cooperative to its members.[51] While this regulation might affect interstate prices, that incidental effect did not outweigh the state’s interest in protecting cooperative ratepayers.[52] Similarly, the Second Circuit upheld a New York town’s ordinance banning high-speed ferry traffic into its port because the public health and safety benefits outweighed the burden on a Connecticut ferry company to select another port.[53]

IV. CPP Compliance Decisions and the Dormant Commerce Clause

This section discusses four areas where states should consider the DCC: identifying (or rejecting) trading partners; addressing leakage concerns; restricting ERC eligibility; and, allocating allowances. The section places different state decisions along a continuum of risk, and offers suggestions to states for limiting their DCC risk.

Threshold matters: Does the DCC apply to the CPP?

The DCC authorizes Congress to “confe[r] upon the States an ability to restrict the flow of interstate commerce that they would not otherwise enjoy.”[54] But as stated above, “congressional intent to authorize such laws must be either ‘unmistakably clear’ or ‘expressly stated.’”[55] The question, then, is whether Congress authorized states to submit CPP compliance plans that discriminate against compliance instruments based on origin, wholly regulate out-of-state activity, or unduly burden interstate commerce.

Congress established a state-based framework for a number of Clean Air Act programs, including Section 111, the statutory authority for the CPP. Under that section, states are entrusted with implementing and enforcing standards for existing sources within state borders.[56] The standards must be at least as stringent as EPA guidelines.[57] Moreover, states may “adopt or enforce (1) any standard or limitation respecting emissions of air pollutants, or (2) any requirement respecting control or abatement of air pollution” from stationary sources of pollution,[58] including standards or requirements more stringent than those imposed by EPA. The Court has sometimes read broad state authorizations like this one to sanction state discrimination,[59] and sometimes it has not.[60] So a savings clause alone does not settle the issue.

Here, in all probability, states could limit some aspects of their plans to in-state entities, in keeping with their obligations to deliver source-specific or local air quality results. The CPP supports this reading. However, the more a plan element looks like economic protectionism instead of support for clean air, the greater the risk will be that the Clean Air Act does not sanction it. Moreover, the further the compliance instrument gets from the regulator, the less a state can invoke the Clean Air Act as justification for restrictions.

A related question is whether these compliance products – allowances and ERCs – are "commerce". Some might argue that because allowances are state creations, designed for compliance with a regulatory program, they may be shielded from DCC scrutiny. But the Court has interpreted the word "commerce" very broadly:

> Whatever other meanings 'commerce' may have included in 1787, the dictionaries, encyclopedias, and other books of the period show that it included trade: businesses in which persons bought and sold, bargained and contracted.[61]

What's more, the things to be traded have not limited the scope of commerce. "[T]ransactions be commerce though non-commercial; they may be commerce though illegal and sporadic, and though they do not utilize common carriers or concern the flow of anything more tangible than electrons and information."[62]

The state's sale or giveaway of the right to pollute, in the form of allowances, may not be "commerce." But once that state allows trading – certainly with firms across state lines but perhaps even among in-state firms – the instruments enter the stream of commerce to be bought and sold by private entities. ERCs may become "commerce" even sooner, since they are not state-created units of permissible pollution but credits generated largely by private entities to sell to other private entities out of the gate.

In summary, states could argue that some CPP planning decisions are an exercise of the state's police powers and the authorizations Congress entrusted them under the Clean Air Act. And yet, Congress did not explicitly or clearly sanction all plan features that might interfere with interstate commerce, and the allowances and ERCs may trigger DCC scrutiny once they are traded.

Identifying (or rejecting) trading partners

The final CPP encourages multi-state compliance options. States can submit joint plans requiring EGUs to meet a total mass cap or a weighted average of each state's emission rate,[63] or stand-alone plans that name trading partners. Partners might include states that negotiated common plan elements with one another, share common utilities, or sit in the same RTO footprint.

The CPP also enables "trading ready" plans to link automatically with one another. In EPA's proposed CPP model rules, mass-based or rate-based plans can link so long as each (1) accepts allowances originating in other states for compliance purposes, (2) uses identical compliance instruments (allowances of carbon dioxide or ERCs representing zero-emitting generation), and (3) relies on an EPA-run or EPA-approved tracking system.[64] The only other condition for linking is the nature of the compliance regime – all linked states must implement a mass-based cap, or a rate-based standard applicable to all EGUs.[65]

Because EPA proposes to require uniformity for so few elements, states can make different design choices and still enable their EGUs to participate in interstate markets. For instance, a mass-based state could set a price floor or reserve a small percentage of allowances as a cost containment reserve; auction or freely allocate allowances; or include new sources under the cap. Such features would not bar a state from linking with states imposing different requirements.

The Supreme Court has

> recognized that mutually beneficial objectives may be promoted by voluntary reciprocity agreements, and that the existence of such an agreement between two or more States is not a per se violation of the Commerce Clause of which citizens of non-reciprocating States who do not receive the benefits conferred by the agreement may complain.[66]

Thus, the DCC does not prevent states from negotiating common plan elements; for instance, to include new sources under the cap or limit types of ERC generators. The member states in these agreements could still accept allowances from every state that meets EPA's minimum linking requirements. In this way, a bloc of states could lead by example in an open market.

However, states might want to take this a step farther, and limit the allowances or ERCs their EGUs could use for compliance, based on the state of origin. This could be done in two ways: participating states could refuse to accept allowances or ERCs for compliance generated in any state but those identified; or, states could condition linkage on reciprocal treatment by other states (acceptance of allowances or adoption of similar plan designs). Whether states can place these limits on trading partners is questionable. In a financial services case, the Court wrote

> [t]here can be little dispute that the dormant Commerce Clause would prohibit a group of States from establishing a system of regional banking by *excluding bank holding companies from outside the region* if Congress had remained completely silent on the subject.[67]

Moreover, "it is clear that no single State could [enact a policy for the entire Nation] or even impose its own policy choice on neighboring States."[68] Even where a state has a strong health and safety interest, the interest "may not be accomplished by discrimination against articles of commerce coming from outside the state unless there is some reason, apart from their origin, to treat them differently."[69]

Therefore, if states were to limit the allowances they will accept for compliance purposes (or discount allowances from certain states), they may face DCC risk. They will stand on more solid ground if they describe acceptable allowances in terms of the attributes of those allowances rather than their origin. States should also document the non-protectionist purposes, such as public health and safety benefits, for any limitation. Finally, to avoid being challenged for extra-territorial regulation or for placing an undue burden on the interstate commerce of compliance commodities, states should take care not to be seen as "us[ing] the threat of economic isolation as a weapon to force sister States to enter into even a desirable reciprocity agreement."[70]

Going it alone: single-state compliance

A state might want to implement a single-state compliance plan. Some state plan design choices isolate a state automatically from a larger market; for instance, the CPP prohibits interstate trading with any rate-based state that applies blended, custom rates to steam and gas EGUs. Under EPA's rules, EGUs in such a state may use only ERCs registered in that state for compliance. Similarly, if a state establishes its own trading platform and only accepts allowances issued on that platform, it would cut off its EGUs from the interstate allowance market.

A twist on this scenario is the California issue. California issues allowances for an economy-wide greenhouse gas (GHG) emissions trading program that is unrelated to the CPP.[71] Unless California carves out its EGUs from the rest of the program, EPA will prohibit the state from exporting its allowances to CPP mass-based trading programs (because California's economy-wide cap exceeds its CPP budget.[72] In similar fashion, Washington State is contemplating an economy-wide GHG trading program.[73] Depending on how the CPP is implemented by such states, some might challenge these programs as discriminatory.

If a state has a strong local health interest in adopting a plan that will cut off the state from interstate trading, it could overcome a DCC challenge. For instance, a state might adopt "custom" rates for each of its EGUs, to induce particularly dirty units or units located in environmental justice communities to retire. A court might find the state is not discriminating against out-of-state interests; if anything, the in-state EGUs are disadvantaged in not being able to tap into a broader ERC market. A state would be more likely to prevail in this scenario if it allowed in-state ERC generators to sell ERCs to interstate EGUs, and out-of-state ERC generators to register in the state.

If the court applied the *Pike* balancing test, it might determine that the local interests of protecting the health of vulnerable populations outweigh any burden imposed on EGUs in other states who could not access the defendant state's ERC market.

States might also seek to cut off use of their allowances in certain states. For instance, Washington State's initial economy-wide GHG trading proposal would have accepted allowances from other states, including those participating in the northeast Regional Greenhouse Gas Inventory (RGGI) program. Since the CPP prohibits *export* of allowances from economy-wide programs, this proposal could result in a one-way flow of allowances into Washington.

This should not make Washington's scheme vulnerable to DCC challenge. However, states that bar the export of their allowances to Washington could face DCC scrutiny. Of particular concern would be a plan that prohibits the sale of allowances to EGUs in another state until that state changes its domestic law to allow the export of *its* allowances, or changes some plan design element. This again looks like states forcing sister states to behave in a particular way to gain access to a market.

Reducing leakage to new plants or other activity across state lines

The CPP's primary leakage concern[74] is whether new units that are not covered by the rule will shift production from existing units operating under a cap to new units that are not.[75] While new coal and natural gas units are subject to carbon intensity standards, those standards do not cap total emissions. If a state chooses a mass-based program and does not cap emissions from new units, production could shift to new units and undermine the CPP's emission reduction goals.

The CPP suggests two methods to address leakage to new sources:

1. Including new sources under the cap (the CPP provides an "existing + new" cap for each state); or
2. Allocating additional allowances to existing gas units that increase utilization, and setting aside allowances for renewable energy, to make both cost-competitive with new EGUs.[76]

Alternatively, states may explain why they do not believe leakage to new sources will occur.

Scholars and practitioners are debating whether set aside programs can undercut a shift in generation to new gas plants. [77] Ignoring the efficacy of these set-asides, the in-state nature of the renewable energy set-asides and existing natural gas allocations could implicate the DCC.

But despite its appearance as discriminatory, an in-state set-aside should survive DCC scrutiny. As noted above, allocation of pollution allowances is not a market-based, competitive process, but the granting of permits to pollute provided by the state, to sources within that state. (A counterargument is that the natural gas plant set-aside is based on production, and might affect those generators' bids into competitive markets.) Moreover, the DCC generally does not prohibit states from providing subsidies to in-state actors.[78] Of course, nothing in the CPP would prohibit states from regionalizing these set-asides.

A second type of leakage could also occur – production could shift from EGUs under a mass-based plan to EGUs subject to a rate-based CPP plan in another state. In the past, California and the RGGI states[79] have considered rules to discourage a shift in production from their controlled markets to other parts of the country. California promulgated rules to prevent leakage[80] as required by statute.[81] RGGI states have not adopted leakage rules.[82]

EPA acknowledges interstate leakage could be a problem but adopts a "wait and see" attitude:

> [W]ithout a better understanding of the different mechanisms that states may ultimately choose to meet the emission guidelines, and how different requirements in different states may interact, the EPA cannot project every potential differential incentive that could lead to a loss of CO2 emission reductions. Therefore, once program implementation begins, the EPA will assess how emission performance across states may be affected by the interaction of different regulatory structures implemented through state plans.[83]

Still, states may want to be proactive in this area, to ensure that reductions from their capped EGUs actually result in carbon emission reductions. For instance, a state could require that an entity importing power from neighboring states retire emission allowances associated with that power. To avoid a discrimination claim, the allowance requirement must be no more stringent than allowance requirements for in-state EGUs. Requiring that the in-state importer, and not the exporting EGU, retire allowances is consistent with recent cases about extraterritoriality.

Moreover, a state may want to discourage "resource shuffling" as a reaction to its regulation of imports. A resource shuffle involves a deal between an buyer in a capped state and a seller that sells to the capped state *and* uncapped states. Prior to the cap, the seller might have sold some fossil-fuel fired electricity to the buyer. Following the cap, the seller would sell electricity from renewable generators to the buyer in the capped state, and shift its sales of fossil-fuel fired electricity to buyers in uncapped states. The scheme would not achieve actual emission reductions.

A law in the importing state prohibiting all resource shuffling could be struck down as extra-territorial, to the extent it is interpreted to prevent wholly out-of-state sales of higher-emitting sources of electricity.[84] However, something like California's rule, which allows lower- or no-emitting generation sources to use their actual emissions profile upon import only *if* they are historic importers or represent new generation, might survive a DCC challenge.[85] This scheme regulates in-state actors (importers) and a transaction to which they are a party.[86]

Limiting ERC eligibility in a rate-based plan

The CPP sets minimum eligibility requirements for ERCs used to adjust an EGU's emission rate. Some of the requirements are meant to ensure that each ERC in the system "represents one megawatt hour of actual energy generated or saved with zero associated emissions" – for instance, each ERC must carry a unique serial number and trade on EPA-administered or approved tracking systems.[87] Other requirements pertain to the type of resources that can generate ERCs – natural gas-fired EGUs,[88] renewable sources like wind, solar, geothermal, and hydro, nuclear, combined heat-and-power, demand side energy efficiency,[89] and with additional documentation, qualified biomass, waste-to-energy, and carbon capture and sequestration (CCS).[90] The only geographic limitation EPA places on resource eligibility is that to generate ERCs, resources must be located in or have a contract to provide power to a rate-based state.[91]

Beyond this federal floor, states might limit ERC eligibility further. For instance, some states may choose not to accept ERCs from biomass or waste-to-energy generators. If a state can articulate a reason that is tied to its police powers – a concern, for example, about local environmental impacts of supporting this type of generation – and if the state applies this limit in a non-discriminatory manner, then it should prevail in any DCC challenge. On the other hand, if a state makes clear that it wants to develop an in-state wind industry and so submits a plan that will only accept ERCs from in-state wind generators, it could face a charge that it is discriminating against competing out-of-state sources of ERCs.[92]

Allocating allowances to EGUs in a mass-based plan

The CPP requires mass-based state plans to provide for "allocations of allowances for each compliance period."[93] EPA gives states significant flexibility in initial allowance allocation. Even where EPA issues a federal plan, EPA proposed that a state could still file a partial plan that is focused on allocation while leaving the rest of the plan's administration to EPA.[94] At the outset, states can decide to auction the allowances or distribute them for free. A state need only worry about how to allocate allowances if they are distributed for free.

From an economic efficiency perspective, initial allocation should not have an effect on allowance price or market function.[95] In addition, one could argue that at this stage of the process, the allowances are not “commerce” and so actions related to their allocation are shielded from DCC scrutiny. Therefore, states may use this part of the planning process to achieve local air quality and other goals. For instance, a state might allocate allowances to non-emitters such as new renewable energy projects or distribution companies. Because those entities do not need to hold allowances for compliance, they could sell the allowances and use the revenue to fund new zero-emitting generation or provide rate relief.

Even as between affected EGUs, states might consider allocating allowances using different factors – historical or updated levels of production, age, proximity to environmental justice communities, or service territory. An allocation scheme that gives preference to EGUs serving in-state retail customers poses the most potential DCC risk, but ultimately may be allowed.

Conclusion: Lessons/Suggestions for Minimizing Risk

With some consideration, states should be able to achieve their policy goals without running afoul of the dormant Commerce Clause. Specifically:

- States can negotiate joint or linked plans with a subset of other states without violating the DCC. However, they likely may not isolate another state for refusing to adopt reciprocal plan elements.
- States might be able to prevent automatic linking to states with different plan elements, if they describe acceptable allowances by their attributes rather than by their origin, and if they can articulate non-protectionist, local health and safety benefits for the limits.
- States should be able to create their own single-state compliance plan.
- States can write rules to prevent leakage and resource shuffling, if those rules apply to in-state actors and place limits on imports that are equivalent to in-state requirements.
- Trading-ready states can limit ERC eligibility based on generator type but not on origin.
- The DCC does not likely implicate choices related to initial allowance allocation.

[1] *Hillside Dairy, Inc. v. Lyons*, 539 U.S. 59, 66 (2003); *South-Central Timber Dev., Inc. v. Wunnicke*, 467 U.S. 82, 91-92 (1984); *New England Power Co. v. New Hampshire*, 455 U.S. 331, 343 (1982).
[2] CPP Preamble, 80 Fed. Reg. 64,662, 64,741.
[3] CPP Preamble, 80 Fed. Reg. 64,734.
[4] EPA Legal Memo, at http://www.epa.gov/sites/production/files/2015-11/documents/cpp-legal-memo.pdf, p. 54.
[5] *Gibbons v. Ogden*, 22 U.S. 1 (1824).
[6] Some of this discussion is taken from Kate Konschnik and Ari Peskoe, *Minimizing Constitutional Risk: Crafting State Energy Policies that Can Withstand Constitutional Scrutiny*, available at https://statepowerproject.org/mcr/.
[7] *Granholm v. Heald*, 544 U.S. 460 (2005).
[8] *Wyoming v. Oklahoma*, 502 U.S. 437.
[9] *New England Power Co*, 455 U.S. 331.
[10] *See* MA, CO, OH; MO case; see also 7th circuit wind case.

[11] Cite CO example of changes to the law.
[12] *Black Star Farms, LLC v. Oliver*, 600 F.3d 1225, 1230 (9th Cir. 2010); *see also Puppies 'N Love v. City of Phoenix*, 2015 WL 4532586, *10-12 (D. Ariz. 2015).
[13] *Alliance for Clean Coal v. Miller*, 44 F.3d 591 (7th Cir. 1995); *Alliance for Clean Coal v. Bayh*, 72 F.3d 556 (7th Cir. 1995).
[14] See, e.g., *Miller*, 44 F.3d at 595 (calling Illinois' law a "none-too-subtle attempt" to drive use of Illinois coal).
[15] *McBurney v. Young*, 667 F.3d 454, 468-69, *aff'd*, 133 S. Ct. 1709 (2013) (*discussed* in *PPL Energyplus, LLC v. Nazarian*, 974 F. 2d 790, 841-42 (4th Cir. 2012)).
[16] *Taylor*, 477 U.S. at 148; *Oregon-Washington R. & Nav. Co. v. Washington*, 270 U.S. 87, 96 (1926).
[17] *See, e.g.*, *Sporhase v. Nebraska*, 458 U.S. 941, 956 (observing that "a State that imposes severe withdrawal and use restrictions on its own citizens is not discriminating against interstate commerce when it seeks to prevent the uncontrolled transfer of water out of the State," but striking a law that banned water export unless the receiving state granted reciprocal privileges).
[18] *PPL Energyplus, LLC v. Hanna*, *977 F.Supp.3d 372, 411-412 (D.N.J. 2013); see also PPL Energyplus, LLC v. Nazarian*, 974 F. Supp.2d 790, 853 (D. Md. 2012) (finding no discrimination in a similar scheme because the mere siting of a plant did not benefit that source in the wholesale market at the expense of out-of-state competitors*)*.
[19] Cite.
[20] *Gen. Motors Corp. v. Tracy*, 519 U.S. 278 (upholding taxation of interstate natural gas suppliers making bulk sales to large industrial customers but exempting distribution companies selling to small retail customers; *see also Alaska v. Arctic Maid*, 366 U.S. 199 (1961).
[21] *Puppies 'N Love*, 2015 WL 4532586, at *10 (D. Ariz. 2015).
[22] *GM v. Tracy*, 519 U.S. 278 (1997).
[23] CPUC Decision 11-12-052 (citing *Tracy*, 519 U.S. at 298–299).
[24] *See United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Mgmnt. Auth.*, 550 U.S. 330, 344-45 (2007).
[25] The Court "never intended to cut the States off from legislating on all subjects relating to the health, life, and safety of their citizens, though the legislation might indirectly affect the commerce of the country." *Huron Portland Cement Co. v. Detroit*, 362 U.S. 440, 443-44 (1960) (*quoting Sherlock v. Alling*, 93 U.S. 99, 103 (1876)).
[26] *Atlantic Coast Demolition & Recycling, Inc. v. Bd. of Chosen Freeholders of Atlantic County*, 48 F.3d 701 (3d Cir. 1995).
[27] *Reeves, Inc. v. Stake*, 447 U.S. 429 (1980).
[28] *White v. Massachusetts Council of Construction Employees, Inc*., 460 U.S. 204 (1983). *See also McCarthy v. Philadelphia Civil Serv. Comm'n*, 424 U.S. 645 (1976) (upholding a residency requirement for public employment); *Brooks v. Vassar*, 462 F.3d 341, 357 (4th Cir. 2006) (finding state-owned liquor store can choose not to sell out-of-state wines).
[29] *Healy v. Beer Inst.*, 491 U.S. 324, 336 (1989).
[30] *Brown-Forman Distillers Corp. v. NY State Liquor Auth*., 476 U.S. 573, 581 (1986).
[31] Healy, 491 U.S. at 336 (citing *Brown-Forman*).
[32] *SPGGC, LLC v. Blum*, 505 F.3d 183, cite (2d Cir. 2007).
[33] *Rocky Mountain Farmers Union v. Corey*, 730 F.3d 1070, 1101 (2013) ("In the modern era, the Supreme Court has rarely held that statutes violate the extraterritoriality doctrine.").
[34] CITE to 6th circuit, 10th circuit RPS.
[35] *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 521 (1935); *Brown-Forman Distillers Corp.*, 476 U.S. 573 (requiring the in-state price to be the lower price for the next 30 days); *Healy* 491 U.S. 324 (requiring the in-state price to be the lower price at the moment).
[36] *Sporhase*, 458 U.S. at 957; *The Great Atlantic and Pacific Tea Co., Inc.*, 424 U.S. 366 (1976).
[37] *Edgar v. MITE Corp*., 457 U.S. 624, 642 (1982).
[38] *C&A Carbone, Inc. v. Town of Clarkstown*, 511 U.S. 383, 393 (1994).
[39] *Rocky Mountain Farmers Union v. Corey*, 730 F.3d 1070, 1102 (9th Cir. 2013).
[40] *See, e.g., Healy*, 491 U.S. 336; *Huron Portland Cement Co. v. City of Detroit*, 362 U.S. 440, 448 (1960) *Freedom Holdings, Inc. v. Cuomo, 624 F.3d 38, 64-66 (2d Cir. 2010); S.D. Myers, Inc. v. City and County of San Francisco*, 253 F.3d 461, 469-70 (9th Cir. 2001).
[41] *Rocky Mountain Farmers Union v. Corey*, 730 F.3d 1070.

[42] *Id.*, at 1103 (citations omitted). Similarly, the Tenth Circuit upheld Kansas' regulation of internet payday loans, in part because Kansas stipulated that they would apply the regulation only to transactions involving a citizen in Kansas at the time of the transaction. *See, Quik PayDay, Inc. v. Stork*, 549 F.3d 1302 (10th Cir. 2008).
[43] *North Dakota v. Heydinger*, 15 F. Supp.3d 891, 916-917 (D. Minn. 2014). This case is pending before the Eighth Circuit Court of Appeals.
[44] *American Beverage Ass'n v. Snyder*, 735 F.3d 362, 367 (6th Cir. 2013).
[45] *American Booksellers Foundation v. Dean*, 342 F.3d 96 (2d Cir. 2003).
[46] As we noted above, EPA's proposed solution could be seen as discriminatory.
[47] *United Haulers Ass'n, Inc., v. Oneida-Herkimer Solid Waste Management Auth*., 550 U.S. 330, 346 (quoting *Philadelphia* v. *New Jersey*, 437 U. S. 617, 624).
[48] *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970).
[49] *Id.*
[50] *See, e.g., Raymond Motor Transp., Inc. v. Rich*, 434 U.S. 429 (1978) (striking a Wisconsin law restricting the length of interstate trucks to 55 feet, in part because state offered no evidence that shorter trucks were safer or provided any other permissible local benefit). The Court recently expressed discomfort at undertaking a fact-intensive inquiry to reach a *Pike* conclusion, an exercise usually reserved to lower courts. Cite.
[51] *Ark. Elec. Coop. Corp., v. Ark. Pub. Serv. Comm'n*, 461 U.S. 375 (1983).
[52] Arkansas' regulation of wholesale rates was not preempted by the Federal Power Act because the Act does not provide FERC with jurisdiction over rates charged by cooperatives.
[53] *Town of Southold v. Town of East Hampton*, 477 F.3d 38 (2d Cir. 2007).
[54] *Lewis v. BT Investment Managers, Inc.*, 447 U.S. 27, 44, (1980).
[55] *Hillside Dairy, Inc. v. Lyons*, 539 U.S. 59, 66 (2003); *South-Central Timber Dev., Inc. v. Wunnicke*, 467 U.S. 82, 91-92 (1984); *New England Power Co. v. New Hampshire*, 455 U.S. 331, 343 (1982).
[56] 42 U.S.C. § 7411.
[57] 42 U.S.C. § 7410(k); 42 U.S.C. § 7411(d); 40 C.F.R. 60.24(c).
[58] 42 U.S.C. § 7416.
[59] *Western & Southern Life Insurance Co. v. State Bd. of Equalization*, 451 U.S. 648, 653 (1981).
[60] *Lewis v. BT Investment Managers, Inc.*, 447 U.S. 27, 48-49 (1980) (non-preemption clause "does not give carte blanche to states to regulate in a way that discriminates").
[61] *US v. Southeastern Underwriters' Assn*, 322 US 533, 540 (1944) (superseded by statute).
[62] *Id.* at 549-550.
[63] 80 Fed. Reg. 64,839; 40 C.F.R. § 60.5750(a).
[64] 80 Fed. Reg. 64,976−77.
[65] 40 C.F.R. § 60.5750.
[66] *Great Atlantic & Pac. Tea Co., Inc. v. Cottrell* 424 U.S. 366, 378-79 (1976).
[67] *Northeast Bancorp, Inc. v. Governors of the Fed. Reserve Sys.*, 472 U.S. 159, 174 (1985) (emphasis added).
[68] *BMW of N. America, Inc. v. Gore*, 517 U.S. 559, 571 (1996) (citation omitted) (finding Alabama court could not set punitive damages based on acts in other states, particularly as the acts were allowed in other jurisdictions).
[69] *Philadelphia v. New Jersey*, 437 U.S. 617, 62-27 (1978).
[70] *Id.*
[71] California Global Warming Solutions Act, A.B. 32 (2006).
[72] 80 Fed. Reg. 64893-94.
[73] Washington Department of Ecology, Jan. 6, 2016 proposed clean air rule (withdrawn as of Feb. 26, 2016), http://www.ecy.wa.gov/programs/air/rules/wac173442/1510docs.html.
[74] Leakage has the potential to undermine the capped market by "'providing incentives to shift, rather than reduce, GHG emissions.'" Erin Parlar, Michael Babakitis, and Shelley Welton, "Legal Issues in Regulating Imports in State and Regional Cap and Trade Programs, Columbia Law School Policy Paper (Oct. 2012), at x (quote omitted).
[75] 80 Fed. Reg. 64,887-90; 64,914
[76] 80 Fed. Reg. 64,887-88, 90; 40 C.F.R. § 5790(a)(5).
[77] *See, e.g.*, MJ Bradley paper.
[78] *See New Energy v. Limbach*, 486 U.S. 269, 278 (1988) ("The Commerce Clause does not prohibit all state action designed to give its residents an advantage in the marketplace, but only action of that description *in connection with the State's regulation of interstate commerce*. Direct subsidization of domestic industry does not normally run afoul of that prohibition").

[79] *See* Section III of our first paper.
[80] CCR 17 § 95802.
[81] California AB 32; Cal. Health & Safety Code § 38562(b)(8) ("In adopting regulations . . . to the extent feasible and in furtherance of achieving the statewide greenhouse gas limits, the state board shall . . . minimize leakage").
[82] RGGI states considered and rejected implementing leakage rules in 2014. Cite.
[83] 80 Fed. Reg. 64,890.
[84] *See North Dakota v. Heydinger*, 15 F. Supp.3d 891 (D. Minn. 2014). California's resource shuffling rule focuses on "First Deliverers of Electricity" and so targets in-state purchasers of power. *See, e.g.*, CCR 17 § 95802(a)(147) .
[85] Some conclude this type of scheme is likely constitutional. *See* Parlar et al., at 24-37. To date, no one has challenged California's resource shuffling regulations, perhaps because the exceptions enable utilities to circumvent the prohibition, *see* Danny Cullenward, Leakage in California's Carbon Market: Preliminary Trading is Consistent with Expected Impacts of Regulatory Changes (working paper updated June 21, 2014, UC Berkeley), or because the state has not yet enforced these provisions, *see* Van Ness Feldman, New and Emerging Developments in California's Cap-and-Trade Program will have Significant Impacts on Western Power Markets, Jan. 14, 2014, *available at* http://www.vnf.com/1914.
[86] *Rocky Mountain Farmers Union v. Corey*, 730 F.3d at 1101.
[87] 40 § 60.5790(c)(2); details on tracking system at § 60.5810.
[88] 40 § 60.5795.
[89] 40 § 60.5800(a)(4).
[90] 40 § 60.5800(d).
[91] 40 § 60.5800(a)(3).
[92] *See, supra*, at 3 (noting states sued over in-state RPS requirements and preferences have amended their laws).
[93] 40 § 60.5815(b).
[94] 80 Fed. Reg. 65,026 ,65,029.
[95] Robert W. Hahn and Robert N. Stavins, "The Effect of Allowance Allocations on Cap-and-Trade System Performance," 54 J. OF LAW AND ECON. S267, Nov. 2011; Dallas Burtraw, David McLaughlin, and Sarah Jo Szamelan, Resources for the Future, "California's New Gold: A Primer on the Use of Allowance Value Created under the CO2 Cap-and-Trade Program," May 2012, available at: http://www.rff.org/files/sharepoint/WorkImages/Download/RFF-DP-12-23.pdf.