Testimony before the House Subcommittee on Energy and Power

EPA's CO_2 Regulations for New and Existing Power Plants: Legal Perspectives

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Mr. Chairman, members of the Committee, thank you for the opportunity to speak with you this afternoon about the Clean Power Plan. As you know, the Clean Power Plan (or the "Rule") represents an attempt at fundamental transformation of the nation's electric generation fleet to accomplish carbon dioxide reductions from the electric power sector.

My focus today is going to be on the state-side implementation of the Rule: what does the Rule mean for the states? How will state institutions need to be reorganized to deal with the Rule? And, what will states do in practice based on the Rule's design, and the incentives it gives to states and electric generators?

To be sure, the legal validity of the Rule that others on this panel are addressing is primary. However, I want to emphasize that the timelines of the utility industry means that states and utilities have to move now to begin compliance planning under the Rule. Therefore, I want to draw your attention to three aspects of the final Rule, and what it means for states:

First, the traditional state institutional arrangements for the electricity sector will need to be changed to comply with this Rule. Traditional state regulatory aims of least cost resource planning will need to be replaced with carbon resource planning. Municipal and cooperative electric associations that in many states are not regulated by utility commissions will need to be brought under the state air regulatory umbrella, and carbon reduction planning will override existing state institutional arrangements.

Second, the Rule will gain prescriptive authority while the legal challenge is pending. Absent a stay of the Rule, states and utilities must move forward with workshops and resource planning that incorporates the carbon reduction scenarios of the Rule. Even if the Rule is vacated by the courts some years down the line, large changes to the resource mixes of the various states will already be planned. Much like the Mercury and Air Toxics Standards

(MATS) rule vacated by the Supreme Court last summer, the bulk of compliance occurs before the legality of the Rule is determined.

Third, the design of the Rule inexorably leads states toward adopting a plan of mass-based trading. Because of the relative superiority of mass-based trading compared to alternatives, state compliance plans will gravitate to mass-based trading, which is popularly known as "cap and trade." In addition, states will face strong incentives to undertake what EPA calls "state measures," meaning state legislation authorizing new renewable and energy efficiency programs will be a compelling compliance path.

Let me expand on these points to describe to the Committee how the state path toward this Rule is going to play out. The ambition of this Rule toward the electric sector is totalistic; that is, it needs to fundamentally reorder the traditional federal-state division in the power sector, and force rearrangement of the state institutions dealing with electricity. Currently, under the Federal Power Act, electric generation is a state matter, interstate transmission and wholesale markets are a federal matter. Under the Rule, all of those distinctions are subsumed by EPA's carbon resource planning. In practice, this means that prerogatives that once belonged to state utility commissions, or under the self-regulatory models of rural cooperatives or municipal utilities, give way to state unified carbon resource planning under the auspices of the state air regulator.

In practice, this means that state air regulators must have complete resource planning power over all electric generation units in a state. Further, if a state uses renewable energy or energy efficiency as a compliance tool, the air regulator will have to have ultimate authority over these programs too. Now, it becomes a matter of state law analysis whether the legislative delegation to the air regulator includes all these traditional state utility commission resource

planning tools. For instance, imagine a state with a 20% renewable energy standard and a 2% retail rate impact limit on the renewable portfolio, administered by the state public service commission. Does the administrative delegation to the air regulator by the state legislature allow the air regulator to raise that amount to 30% renewable and eliminate the rate cap? That is a state law question each state must answer. Similarly, imagine a state with a $50 million dollar energy efficiency cross-subsidy program, again administered by the PSC. Can the air regulator in that same state make the energy efficiency program a $100 million a year program as part of a Rule compliance plan? Again, that is an institutional question for each state to answer.

My second point is that states and utilities are already incorporating the assumptions and carbon rations in the Rule into their resource planning decisions. The planning horizons in the electric power industry extend out seven to ten years. That means to meet the interim goal in 2022, a utility needs to make the decision soon, if not now, whether or not to retire generation, replace coal with gas-fired generation, or begin substantial increases in renewable generating capacity. In recent months, the trade press has noted utilities submitting integrated resource plans that put them on a path toward compliance. This means retiring coal and building new gas and renewables. The Rule, therefore, is having its effect before its legality is ruled upon by the courts. Indeed, if the legality of the Rule will not be passed upon by the Supreme Court until the 2018 term (or later), then many generators will already have made decisions to close facilities, and the costs for new infrastructure for gas plant and supply will also have to be committed. The recently vacated MATS rule provides a roadmap to how the Clean Power Plan can at least partially complete its renovation of the electric power sector before the courts decide on its legality. MATS forced 40-50 GW of coal-fired electric generation capacity to retire before the

Supreme Court ruled it illegal. Like MATS, the decisions on retiring plants and building new ones to comply with the Clean Power Plan must be made before the legal process plays out.

Finally, I want to point the Committee to where the Rule is headed as a matter of state compliance. When you study the Rule, its structure and the incentives it creates, the states are essentially presented with a Hobson's choice where the most palatable and achievable state plan is a mass-based trading platform, across the region or across the country. Though the term may be politically-laden, the states will inevitably gravitate to a national cap and trade platform, instituted through each state plan. A White Paper I co-authored with two colleagues, "The Clean Power Plan: Carbon Trading, State Legislation and the Political Economy Issue" attached to my testimony and just released this week makes the more detailed case about how this will come about, but let me explain the basic mechanics.

"Trading ready" state plans are being promoted across the country by environmental advocacy groups and multi-jurisdictional utilities. And, by the terms of the Rule, trading mass-based allowances across a larger area, with more generation units, gives greater optionality and lower cost than imposing a carbon rationing plan on a given state alone. For instance, if you are a utility with a newer coal plant, but the only coal plant, in one state, you will want to use allocation credits from other trading states to keep that plant open, and perhaps close another plant in another state to generate those credits.

As the Agency makes plain in the final Rule: "[T]he EPA believes that it is reasonable to anticipate that a virtually nationwide emissions trading market for compliance will emerge, and that ERCs will be effectively available to any affected EGU wherever located, as long as its state plan authorizes emissions trading among affected EGUs."[1] For those uninitiated with the rather

[1] Environmental Protection Agency, *Carbon Pollution Emission Guidelines for Existing Stationary*

ineuphonious acronym, ERC, it stands for an "emission reduction credit." EPA anticipates a nationwide ERC trading system whereby the carbon emissions are capped by the Rule, and then traded across states to achieve compliance. This is nationwide cap and trade.

However, there are reasons to believe that mass-based carbon trading will be a heavier lift than past trading programs. For one, the size of transfer payments required will be larger than ever before seen. The net effect of the Rule has to make a generator prefer to shut down or reducing output, rather than buying ERCs. Second, we can expect a great deal of special pleading to break out in the states surround ERC allocations under state plans. Coal-centric smaller utilities without much scale – say, a municipal utility or cooperative – will advocate for low cost or no cost ERC allocations under state plans. In turn, those costs not imposed on smaller utilities will have to be made up with cross-subsidies from larger utilities. Indeed, government-run markets often feature these special set asides for favored constituencies. If you think of spectrum market set asides to favored constituencies, for instance, you see that government-run markets are subject to political economy pressures, particularly when the distributive consequences will fall hard on a given set of players or in this case ratepayers.

One final inducement for state compliance will be to undertake 'state measures' through legislation. This is because emissions trading enacted through state legislation avoids the federal Clean Air Act enforcement regime.

In closing, I hope I have given the Committee a sense of the legal and policy complexity confronting the states, and want to underscore the fact that compliance with the Rule's carbon rationing by states and utilities starts now.

Sources: Electric Utility Generating Units, at 359, Docket EPA-HQ-OAR-2013-0602; FRL-XXXX-XX-OAR (Aug. 3, 2015).