What's Best for the States:
A Federally Imposed Competitive Solicitation Model or a Preference for the Incumbent? State Adoption of Right of First Refusal Statutes in Response to FERC Order 1000 and the Dormant Commerce Clause

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About the Author

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Executive Summary

The Federal Energy Regulatory Commission ("FERC") issued Order 1000[1] in 2011, directing electric transmission providers to participate in a regional planning process, consider transmission needs driven by public policy requirements, coordinate interregional planning with neighboring regions, adopt regional and interregional cost-allocation methodologies consistent with prescribed principles, and remove rights of first refusal from FERC-approved tariffs.

The Order directed transmission providers to replace right-of-first-refusal ("ROFR") tariffs with competitive processes by which non-incumbent transmission providers could be selected to develop an identified new regional transmission facility on a basis comparable to the incumbent. In response to this directive, certain states proposed or enacted statutes conferring ROFRs to their local incumbent transmission provider.

This paper analyzes whether ROFR statutes enacted in the states of Minnesota, North Dakota, and South Dakota and proposed in New Mexico and Oklahoma are constitutional under the dormant Commerce Clause of Article I of the U.S. Constitution. First, the paper distinguishes the ROFR at issue in Order 1000 and in the state legislation from traditional ROFRs, which seem to require holders of the right to match the terms of a competitor's offer. Neither the ROFRs addressed in Order 1000 nor the state legislation seeking to confer a ROFR appears to contain a matching condition.

Second, the paper summarizes FERC's reasons for requiring transmission providers to remove ROFRs from FERC-approved tariffs and FERC's position on the jurisdictional limits of Order 1000. FERC acknowledges that states may adopt laws limiting the ability of a non-incumbent transmission provider to construct facilities, and, in any case, FERC reiterates that Order 1000 is procedural in nature and not intended to achieve specific substantive outcomes.

Next, the paper discusses the courts' dormant Commerce Clause jurisprudence under Article I of the U.S. Constitution and analyzes whether the three enacted and two proposed state ROFR statutes noted above could survive a court challenge under two court-developed legal standards, strict scrutiny, and the *Pike* test.[2] The analysis borrows from an analogous line of cases in which state renewable energy portfolio standard statutes have been similarly challenged under the dormant Commerce Clause. The paper finds that while each of the five pieces of legislation considered are likely to receive strict scrutiny due to facial discrimination against non-incumbent transmission providers, it is possible that the local reliability interests of states may fall into a narrow line of cases in which facially discriminatory statutes overcome the strictest scrutiny.

[1] In July 2011, FERC issued a major new rule requiring transmission providers to file tariffs amending their planning and cost-allocation procedures and adopting processes for the comparable participation of competitive transmission developers in the selection process for building new transmission projects. 136 FERC ¶ 61,051 (July 21, 2011) ("Order 1000").

[2] *Pike v. Bruce Church, Inc.* 397 U.S. 137, 142 (1970).

The paper concludes by recommending that states conduct a comprehensive analysis to determine whether the competitive solicitation model, envisioned in FERC Order 1000, or conference of a preference to the incumbent yields the greatest reliability, economic and public policy benefits to their customers. If a state determines that conferring a preference to the incumbent is desirable, then the analysis can help to bolster the reliability, safety, or other factors alleged as the basis of the ROFR statute. Ultimately, the analysis can help the ROFR statute withstand a court challenge regardless of which legal standard a court applies.

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I. Introduction

In response to the Federal Energy Regulatory Commission's ("FERC" or "the Commission") Order No. 1000[1] requirement to remove from federally approved tariffs rights of first refusal ("ROFR"), certain states have enacted or proposed state laws aimed at preserving the priority status of incumbent transmission providers and conferring upon them a state-based ROFR. FERC stated unequivocally that nothing in Order 1000 is intended to limit or affect state laws with respect to the construction of transmission facilities and even tacitly acknowledged that state or local laws may continue to limit transmission development.[2] Upon determining that conferring a preference to its incumbent utility will produce greater benefits than will adopting the competitive solicitation model envisioned in the FERC Order,[3] certain states have proposed or enacted state ROFR statutes in response to FERC Order 1000.[4]

This paper analyzes whether a state's adoption of a statute conferring ROFR benefits to an incumbent, locally based transmission provider raises dormant Commerce Clause concerns in violation of Article I, §8 of the U.S. Constitution.[5] Section II of this paper distinguishes the

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[1] In July 2011, FERC issued a major new rule requiring transmission providers to file tariffs amending their planning and cost-allocation procedures and adopting processes for the comparable participation of competitive transmission developers in the selection process for building of new transmission projects. 136 FERC ¶ 61,051 (July 21, 2011) ("Order 1000").

[2] See FERC Order 1000, ¶287.

[3] See *id*., ¶258. ("Indeed, this is the fundamental nature of "bottom-up, top-down" transmission planning, in which local needs and solutions are combined within a region and analyzed to determine whether regional solutions would be more efficient or cost-effective than the local solutions identified by individual public utility transmission providers.")

[4] States with either enacted or proposed ROFR laws include: Minnesota (Minn. Stat 216B.246 (2012)), New Mexico – Proposed (Senate Bill 175/House Bill 163 (2013)), North Dakota (Century Code §49-03-02 (2011), Oklahoma - Proposed (House Bill 1932 (2013 Current Session)) and South Dakota (South Dakota Codified Laws §49-32-19 (2011)). Prior to the publication of this paper, New Mexico's proposed ROFR statute was not approved by the state legislature. A discussion of the bill is included in this paper for informational purposes.

[5] "Congress shall have the Power…To regulate Commerce with foreign Nations, and among the several States, and with Indian Tribes;" U.S. Const. Art. I, §8, cl. 3.

ROFR at issue in Order 1000 from the more traditional definition of ROFR, such as the one the Commission adopted in Order 888.[6] Section III summarizes FERC's Order 1000 requirement to remove ROFRs from Commission-approved tariffs and addresses state jurisdictional concerns with the rule. An interpretation of the plain language in the rule makes it clear that state actions implementing a ROFR do not violate FERC Order 1000. Section IV provides background on the dormant Commerce Clause, and Section V analyzes whether a state ROFR statute could withstand different levels of scrutiny under a court's analysis. Finally, Section VI provides a brief discussion of the relationship of state ROFR statutes to state protectionist policies affecting renewable-energy procurement.

This paper concludes by recommending that states conduct a comprehensive analysis to determine which transmission-project selection procedure—incumbent preference or competitive solicitation—confers the greatest benefits to it. The analysis should include valuations of the reliability, economic, and public-policy costs and benefits for each selection model. In addition to best informing the state as to which approach benefits it most, the comprehensive analysis could serve as a basis for preserving a state ROFR statute, regardless of the legal standard a court applies (Section V discusses the strict-scrutiny standard and the *Pike* test[7]). Secondly, states may want to consider developing, where possible, statutory language that achieves incumbent preference without being facially discriminatory. Statutes crafted in such a manner would be subject to a lower standard of scrutiny, the *Pike* test, and could utilize its comprehensive analysis to demonstrate that the putative local benefits outweigh incidental impacts on interstate commerce.

If a state demonstrates that there is no feasible alternative method for protecting its putative local reliability interests, then its ROFR statute may overcome the strict-scrutiny standard. Thus, while this paper concludes that the five ROFR statutes discussed herein are likely to face strict scrutiny, it does not suggest that the statutes will be held invalid. Rather, local reliability concerns deserve a degree of deference and may fall into a narrow class of cases in which discriminatory state statutes have withstood application of the strict-scrutiny standard.

This paper makes no firm recommendation on whether a state should pursue a non-discriminatory redrafting of its ROFR statute or take its chances of overcoming application of the strict-scrutiny standard. It recommends only that states conduct a comprehensive analysis of which pathway—incumbent preference or competitive solicitation—confers the greatest benefits to it. Such an analysis, if inclusive of reliability, economic, and public policy costs and benefits, will aid states if and when a state ROFR statute is challenged in court, regardless of the legal standard the court applies.

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[6] 75 FERC 61,080, 1996

[7] *Pike v. Bruce Church, Inc.* 397 U.S. 137, 142 (1970).

II. An Overview of Right of First Refusal

A right of first refusal (ROFR) is a potential buyer's contractual right to meet the terms of a third party's highest offer.[8] In a traditional property context, the owner and lessor of a property grants to the lessee a right to match the terms of and preempt any sale of the property negotiated between the owner and a potential third-party buyer during the term of the lease.[9] A ROFR is generally a small bundle of contract terms, and the applications of and variations on the right are seemingly infinite—in addition to a right to purchase, the ROFR may be used to grant a preemptive right to sell, a right to lease, a right to employ, or a right to be employed.[10] In addition, although the large majority of ROFRs are created by private contract, such rights are increasingly being granted by statute.[11]

In FERC Order 888, FERC issued a set of rules designed to create a more competitive environment in the electric utility industry by placing requirements upon utilities to (1) separate transmission from wholesale power functions and (2) take transmission under an open access transmission tariff ("OATT") that assures access to transmission service on a nondiscriminatory basis.[12] FERC issued a revised *pro forma* OATT in Order 888-A, which included §2.2 for determining priority where an *incumbent customer* seeks to renew service. Specifically, §2.2 provided an incumbent customer with a ROFR to match the duration offered by a new customer at the full OATT rate.[13] FERC stated that its policy rationale for giving an existing firm-transmission customer a reservation priority (i.e., a ROFR) when its contract expires is that it provides a mechanism for allocating transmission capacity when there is insufficient capacity to accommodate all requestors.[14]

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[8] See *Black's Law Dictionary*, Third Pocket Edition (1996).

[9] See Walker, David, *Rethinking Rights of First Refusal*, 5 Stan. J.L. Bus. & Fin. 1, 8. (1999). ("This preemption right essentially allows the lessee to step into the shoes of the potential buyer and make the purchase.")

[10] See *id.*, 5 Stan. J.L. Bus. & Fin. at 8-9.

[11] See *id.* at 54.

[12] See 75 FERC 61,080 April 24, 1996 (FERC Order 888).

[13] *Idaho Power Co. v. FERC*, 312 F.3d 454, 457 (2003). See also 78 FERC 61,220, March 4, 1997 (Order 888-A).

[14] See FERC Order 888-A at 72. FERC stated further,

> "if there are capacity limitations and both customers (existing and potential) are willing to pay for firm transmission service of the same duration, the right of first refusal provides a tie-breaking mechanism that gives priority to existing customers so that they may continue to receive transmission service."

FERC retained the matching requirements of §2.2 of the *pro forma* OATT, stating,

> [A]bsent the requirement that the customer match the contract term of a competing request, utilities could be forced to enter into shorter-term arrangements that could be detrimental from both an operational standpoint (system planning) and a financial standpoint.[15]

In *Idaho Power Co. v. FERC*,[16] FERC ordered Idaho Power Co. to continue to supply power to an incumbent customer at the end of its contract term even though a merchant customer had offered a more attractive contract term. FERC ruled that because the terms of the two offers were not "substantially the same in all respects," they were not competing bids, and thus the ROFR protected the incumbent. The U.S. Court of Appeals for the D.C. Circuit reversed the FERC order and held that Order 888-A clearly and unambiguously states that an incumbent must match a new potential customer's superior offer.[17]

Seemingly, the ROFRs at issue in Order 888 are substantially different from the ROFR at issue in Order 1000. The "right" at issue in Order 1000 is that of the incumbent transmission provider to develop and own transmission facilities deemed necessary to serve the incumbent's customers, notwithstanding the ability and willingness of non-incumbents to develop those facilities or substitute for them.[18]

For purposes of its Order 1000 rulemaking, FERC defined a ROFR as the right of an incumbent transmission owner to construct, own, and propose cost recovery for any new transmission project that is (1) located within its service territory, and (2) approved for inclusion in a transmission plan developed through the Order No. 890 planning process.[19] The idea of matching superior terms offered by a potential merchant developer, as noted in the *Black's Law* definition of ROFR and the D.C. Court of Appeal's interpretation of the Order 888-A ROFR provision, appears to be absent from the ROFR at issue in Order 1000. In fact, FERC stated that one concern it seeks to address by requiring the removal of ROFRs in Order 1000 is that it is not in the economic self-interest of incumbent transmission providers to permit new entrants to develop transmission facilities, *even if proposals submitted by new entrants would result in a more efficient or cost-effective solution to the region's needs*.[20] FERC's concern suggests that, as opposed to traditional

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[15] *Id.*

[16] 312 F.3d 454 (D.C. Cir. 2002)

[17] See *id.* at 463.

[18] See Hempling, Scott, *Order 1000 Narrows Right of First Refusal: Will Regional Processes be Cost-Effective and Nondiscriminatory?*, April 2012, p. 1.

[19] See 131 FERC ¶61,253 (June 17, 2010) (Notice of Proposed Rulemaking, Docket No. RM10-23-000, fn. 21).

[20] See FERC Order 1000 at ¶256.

ROFRs, incumbents with Commission-approved ROFRs are currently under no requirement to match the potentially superior terms of a merchant transmission provider.

III. FERC's Order 1000 ROFR Requirement

A. Deficiencies requiring removal of ROFR

As early as 2009, the Commission observed that, as a result of existing practices in some areas, a non-incumbent transmission developer may lose the opportunity to construct its proposed transmission project to the incumbent transmission owner if that owner has a federal ROFR to construct any transmission facility in its service territory.[21] FERC sought comments on whether a federal ROFR for incumbent transmission owners unreasonably impedes the development of merchant and independent transmission and, if so, how that impediment could be addressed.

Based upon comments received, FERC required incumbent transmission providers to remove ROFRs from Commission-approved tariffs in Order 1000.[22] FERC noted, among others, the following deficiencies in the current process:

- Failure to consider and evaluate non-incumbent projects violates the Order 890 planning principle of "openness."[23]

- An incumbent-held ROFR places a non-incumbent at risk of losing its investment, even if the project is proposed in a planning process and listed in a regional plan.[24]

- A ROFR can lead to practices that undermine the identification and evaluation of more efficient or cost-effective solutions to system needs, resulting in unjust rates.[25]

- It is not in the economic self-interest of incumbent transmission providers to permit new entrants to develop transmission facilities, even if proposals submitted by new entrants would result in a more efficient or cost-effective solution to the region's needs.[26]

[21] FERC Notice of Request for Comments, *Transmission Planning Process Under Order No. 890*, Docket No. AD09-8-000, October 8, 2009.

[22] FERC Order 1000 at ¶7.

[23] See *id.* at ¶229.

[24] See *id.*

[25] See *id.* at ¶253.

[26] See *id.* at ¶256.

In lieu of the ROFR, FERC required each transmission planning region to develop and file with it a framework to enable non-discriminatory participation for non-incumbent transmission providers. The framework should include procedures for project qualification, project selection, project evaluation, and cost allocation.[27]

B. Coordination with state jurisdiction

Certain stakeholders expressed concern that the Commission lacked general jurisdiction over the siting, construction, or ownership of transmission facilities;[28] that these matters Congress had intentionally left to the states; and that the proposal to adopt rules governing who can build transmission within an incumbent transmission owner's zone exceeded the authority conferred upon the Commission under the FPA to regulate the terms and conditions of service.[29]

FERC responded that eliminating a federal ROFR in Commission-jurisdictional tariffs and agreements does not result in the regulation of matters reserved to the states, such as transmission construction, ownership, or siting. Rather, the reforms are focused solely on public utility transmission provider tariffs and agreements subject to the Commission's jurisdiction.[30] The Commission also acknowledged that there may be restrictions on the construction of transmission facilities by non-incumbent transmission providers under rules or regulations enforced by other jurisdictions.[31] Here the Commission tacitly acknowledged that state and local jurisdictions may propose and adopt laws limiting non-incumbent transmission providers' rights to construct a project.

Moreover, the Commission emphasized that *nothing in the Final Rule is intended to limit, preempt, or otherwise affect state or local laws or regulations with respect to the construction of transmission facilities*, including but not limited to authority over the siting or permitting of transmission facilities.[32] FERC also defended its requirement as *procedural*, indicating that its effect is not to draw any conclusion regarding the prudence of investment decisions, nor to

[27] See *id.* at ¶¶293-338.

[28] For a list of stakeholders challenging FERC's jurisdiction over removal of ROFR tariff provisions generally and on the issue of siting construction and ownership of transmission, respectively, see Order 1000, fn. 248, 253.

[29] See Order 1000 at ¶276.

[30] See *id.* at ¶287.

[31] See *id.*

[32] See *id.* (emphasis added). In fact, FERC purposely refers to "federal rights of first refusal" because its action in the Final Rule addresses only ROFRs that are created by provisions in Commission-jurisdictional tariffs or agreements and does not require removal of references to such state or local laws or regulations from Commission-approved tariffs or agreements. See Order 1000, fn. 231.

determine which particular entity should construct any particular transmission facility, but rather to allow more types of entities to be considered for potential construction responsibility.[33]

This section of the paper summarized the Order 1000 requirement with respect to the removal of ROFR provisions from Commission-approved tariffs and discussed FERC's responses to state jurisdictional concerns. It is important to note that the rule proscribed in Order 1000 applies only to transmission facilities selected in a regional plan for purposes of cost allocation. As such, transmission facilities that are not selected in a regional plan or that do not seek regional cost allocation may continue to benefit from a federally approved ROFR tariff provision. The remainder of this paper turns to an analysis of whether adoption of state ROFR statutes raises concerns under the dormant Commerce Clause of the U.S. Constitution.[34]

IV. An Overview of the Dormant Commerce Clause [35]

The Interstate Commerce Clause of the U.S. Constitution provides that "[t]he Congress shall have Power…[t]o regulate Commerce…among the several states."[36] Though phrased as a positive grant of regulatory power to Congress, the Clause has long been understood to contain a "negative" aspect that denies the states the power unjustifiably to discriminate against or burden the interstate flow of articles of commerce.[37]

The Supreme Court (referred to herein as "the Court") has interpreted the clause as "invalidating local laws that impose commercial barriers or discriminate against an article of

[33] See *id.* at ¶290.

[34] It is also worth mentioning that this paper does not analyze whether adoption of a state ROFR violates Order 1000, as the discussion in Section III of this paper and a plain reading of FERC Order 1000 makes clear that it does not.

[35] In U.S. Constitutional law, the "dormant Commerce Clause" is so called because it forbids individual states from tinkering with even those parts of the national economy that Congress has not regulated—where federal power remains dormant. See Downes, Larry, *The Commerce Clause Wakes Up*, Harvard Business Review, September 2005.

[36] U.S. Const. Art. I, §8, cl. 3.

[37] See *Oregon Waste Systems v. Dept. of Environ. Quality*, 511 U.S. 93, 97 (1994). The concept of a dormant commerce power is derived in part from The Federalist Papers principle "that our economic unit is the Nation, which alone has the gamut of powers necessary to control of the economy…has as its corollary that the states are not separable economic units." (Citing *H.P. Hood & Sons, Inc., v. Du Mond*, 336 U.S. 525, 537-538 (1949). See also, Christine A. Klein, *The Environmental Commerce Clause*, 27 Harv. Envtl. L. Rev. 1, 2-3 (2003) ("Even if Congress has not acted, even if commerce power lies dormant, state and local governments cannot place an undue burden on interstate commerce.")

commerce by reason of its origin or destination out of state."[38] It has also recognized, on the other hand, that "there is a residuum of power in the state to make laws governing matters of local concern which nevertheless in some measure affect interstate commerce or even, to some extent, regulate it."[39]

The dormant Commerce Clause applies to laws that discriminate on their face as well as facially neutral laws that have discriminatory effects. Thus, the type of discrimination at issue is critical because courts analyze facially discriminatory laws under a strict-scrutiny standard, whereas facially neutral laws with discriminatory effects are subject to the *Pike* test, a balancing exercise that weighs the burden imposed on interstate commerce against the statute's local benefits.[40]

"Discrimination" simply means differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter.[41] If a restriction on commerce is discriminatory, it is virtually *per se* invalid.[42] In this case, the statute will be invalidated unless the discrimination is demonstrably justified by a valid factor unrelated to economic protectionism, or the state can demonstrate under rigorous scrutiny that it has no other means to advance a legitimate local interest.[43] For example, in *Alliance for Clean Coal v. Miller,*[44] the Seventh Circuit Court of Appeals struck down Illinois' 1991 Coal Act because it unlawfully discriminated against the use of out-of-state coal. Also, in *New England Power Co. v. New Hampshire*,[45] the Court overturned a New Hampshire law prohibiting hydroelectric plants from selling power out of state before offering it for sale within the state.

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[38] See *C & A Carbone, Inc. v. Clarkstown*, 511 U.S. 383, 390-393 (1994). "The Commerce Clause presumes a national market free from the local legislation that discriminates in favor of local interests."

[39] See *Selevan v. New York Thruway Authority*, 584 F.3d 82, 90 (2d Cir. 2009) (citing *Kassel v. Consol. Freightways Corp. of Del.,* 450 U.S. 662). "Accordingly, the dormant Commerce Clause does not invalidate *all* state restrictions on commerce." (Emphasis added).

[40] See *Pike v. Bruce Church, Inc.* 397 U.S. 137, 142 (1970).

[41] See *Oregon Waste Systems*, 511 U.S. 93 at 98.

[42] See *id.*

[43] See *Selevan* 584 F.3d at 94. See also Endrud, Nathan E., *State Renewable Portfolio Standards: Their Continued Validity and Relevance in Light of the Dormant Commerce Clause, the Supremacy Clause and Possible Federal Legislation*, 45 Harv. J. on Legis. 259, 265-66 (2008).

[44] 44 F.3d 591 (7th Cir. 1995).

[45] 455 U.S. 331, 334-335 (1982). Whereas state requirements to serve native load before exporting power were appropriate before New Hampshire's transition to retail choice, the hydro units at issue in this case were licensed by the FERC pursuant to Part I of the Federal Power Act, 41 Stat. 1063 (as amended, 16 U.S.C. §§ 791a-823 (1976)), and thus, in this case, such a restriction was outside the authority of the New Hampshire Public Utilities Commission.

The Court has held that in order to state a claim for discrimination in violation of the Commerce Clause, a plaintiff must "identify an in-state commercial interest that is favored, directly or indirectly, by the challenged statutes at the expense of out-of-state competitors."[46] A party challenging a state statute must therefore identify an in-state interest that is favored by the statute and an out-of-state interest that is harmed by the statute. In *Selevan v. New York Thruway Authority*,[47] non-resident motorists of Grand Island, New York, brought suit, alleging that they paid a higher toll price than Grand Island residents when traversing the Grand Island Bridge.[48] Finding that the plaintiffs had failed to identify an in-state commercial interest that was favored or point to a particular out-of-state competitor that was harmed, the court held that plaintiffs had not alleged that the toll policy discriminated against interstate commerce.[49]

By contrast, nondiscriminatory regulations that have only incidental effects on interstate commerce are valid *unless* "the burden imposed on such commerce is clearly excessive in relation to the putative local benefits."[50] In *Pike*, a grower of high-quality cantaloupes brought action against an Arizona act that prohibited the grower from transporting uncrated cantaloupes across state lines for packaging and processing. The Court announced the balancing test as follows:

> Where the statute regulates even-handedly to effectuate a legitimate local public interest, and its effect on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits…If a legitimate local purpose is found...the extent of the burden that will be tolerated will…depend on *the nature of the local interest involved*, and on whether it could be promoted as well with *a lesser impact on interstate activities*.[51]

In that case, the Court held that the burden imposed on commerce was excessive in relation to the state's interest, which it characterized as enhancing the reputation of other producers within the state.[52]

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[46] See *Selevan*, 584 F.3d at 95 (citing *Grand River Enters. Six Nations, Ltd. v. Pryor*, 425 F.3d 158, 169 (2d Cir. 2005)).

[47] *Id.*

[48] *Id.*

[49] See *id.*, at 95.

[50] See *Pike v. Bruce Church, Inc.*, *supra*, fn. 40.

[51] *Id.* at 142 (citations removed) (emphasis added).

[52] See *id*. at 146.

In another application of the *Pike* test, the Court in *Minnesota v. Clover Leaf Creamery Co.*[53] upheld a state statute that banned the sale of milk in plastic containers but permitted the sale of milk in paperboard cartons.[54] The Court found that the statute regulated evenhandedly and effectuated substantial legitimate state interests in promoting the conservation of energy and other natural resources.[55] The Court also found that the burdens on interstate commerce were relatively minor because milk products could continue to move freely across the Minnesota border and it would be easy to conform to the packaging requirements.[56]

Regarding burdens of proof, the party challenging the validity of a state statute bears the burden of showing that it discriminates against interstate commerce.[57] A showing of discrimination shifts the burden to the state to demonstrate that the local benefits of the statute outweigh its discriminatory effects, and that the state lacked a nondiscriminatory alternative that could have adequately protected the relevant local interests. If the challenging party cannot demonstrate discrimination, then it must show that the statute places a burden on interstate commerce that "is clearly excessive in relation to the putative local benefits,"[58] pursuant to the *Pike* analysis.

States have adopted or proposed ROFR statutes in response to FERC Order 1000's requirement that transmission providers remove ROFRs from federally approved tariffs. The next section of this paper examines the viability of those statutes under the dormant Commerce Clause.

V. Viability of State ROFR Statutes under the Dormant Commerce Clause

A. Overview of state ROFR statutes

1. Minnesota

Minnesota's ROFR statute defines an "incumbent electric transmission owner" as "any public utility that owns, operates, and maintains an electric transmission line in this state" and confers upon the incumbent "the right to construct, own, and maintain an electric transmission line that has been approved for construction in a federally registered planning authority

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[53] 449 U.S. 456 (1981)

[54] See *id.* at 459, 470-474. See also Endrud, Nathan E., 45 Harv. J. on Legis. at 265-66.

[55] *Id.* at 471, 473.

[56] *Id.* at 472.

[57] See *Hughes v. Oklahoma*, 441 U.S. 322, 336 (1979).

[58] See *Minnesota v. Clover Leaf Creamery Co.*, 449 U.S. at 471.

transmission plan and connects to facilities owned by that incumbent electric transmission owner."[59]

If a line is approved for construction, the incumbent must notify the state commission, within 90 days of approval, regarding its intent to construct, own, and maintain the line; if notice is given, the incumbent must file an application for a certificate of need within 18 months.[60] If the incumbent indicates that it does not intend to build the line, then the state commission may determine whether the incumbent or another entity will build the line "taking into consideration issues such as cost, efficiency, reliability, and other factors."[61]

In a report describing its ROFR statute, the Minnesota Department of Commerce, Division of Energy Resources noted significant concerns that FERC Order 1000 may discourage utilities from sharing information because another entity could step in and build any needed transmission line, and that FERC Order 1000 could lead to higher-cost transmission lines due to incentives FERC previously granted for building new lines.[62] The report states that §216B.246 was passed to ensure that transmission lines were built only when and where they were needed, in a cost-effective manner, and "to ensure that Minnesota utilities provide reliable service, at reasonable costs, in consideration of Minnesota's policy objectives."[63]

2. New Mexico

New Mexico's proposed Senate Bill 175 and House Bill 163 (not approved by legislature) included a new "Transmission Right of First Refusal" amendment to the Public Utility Act conferring the right to build a transmission line "that has been approved for construction by a federally registered regional transmission planning authority" to the public utility with which the line will interconnect "if that public utility is willing and able to construct, own and maintain the approved transmission line."[64] The bill provided a 120-day notice period, and if no notice of intent to construct, own, and maintain the approved line was received by the public utility commission within that period, the incumbent would have surrendered its ROFR.[65]

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[59] See Minn. Stat 216B.246, Subd. 2 (2012)

[60] See *id*. at Subd. 3(a).

[61] See *id*. at Subd. 3(b).

[62] See Minnesota Department of Commerce, *Report to the Minnesota Legislature on Minnesota's Electric Transmission System – Now and into the Future* (In Consultation with the Minnesota Public Utilities Commission), January 15, 2013, p. 8.

[63] *Id.*

[64] See New Mexico Senate Bill 190518.1, §1(A) (2013). While this was not approved in the legislative session, the discussion is included for informational purposes. See fn. 4, *supra.*

[65] *Id.*

An explanation of the legislation, which was attached to the proposed law, provided three justifications for enacting the ROFR.[66] These justifications included:

a. Avoidance of disruption to the New Mexico regulatory oversight structure—without the ROFR, a federal regulator will decide who builds a line at what cost. In addition, New Mexico utilities would have to rely on non-utilities to fulfill their service obligations while retaining their service obligations.

b. Maintenance of New Mexico control over transmission service quality—without the ROFR, the state commission could not be held responsible for outages caused by transmission failures, as the integrity of the system would be regulated federally rather than locally.

c. Lower costs if a New Mexico utility builds the transmission lines—without the ROFR, costs would be set at the FERC and then imposed on New Mexico customers. Federal tariffs have generally included higher rates of return than those allowed by New Mexico's Public Regulation Commission.

3. North Dakota

North Dakota conferred a ROFR to the incumbent transmission provider by requiring that an electric transmission provider cannot begin construction or operation of a transmission facility interconnecting with an existing line without first obtaining a certificate of public convenience and necessity.[67] In addition, the law prohibits North Dakota's Public Service Commission from issuing such a certificate to a transmission provider to interconnect with an existing public utility if the existing public utility "is willing and able to construct and operate a similar electric transmission line."[68]

4. Oklahoma

Proposed Oklahoma House Bill 1932 defines an "incumbent electric transmission owner" as "any Oklahoma public utility, its affiliates, electric cooperative, municipal power agency or municipal utility that owns, operates and maintains a transmission line in the state"[69] and confers on that utility the right to construct, own, and maintain a transmission line approved for

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[66] *Right of First Refusal in New Mexico*, Briefing Paper attached to Senate Bill 175/House Bill 163 (2013).

[67] North Dakota Century Code, §49-03-01 (2011).

[68] *Id.* at §49-03-02.

[69] Proposed Oklahoma House Bill 1932 Section 1(3) (2013). Bill passed out of OK House Energy and Aerospace Committee on February 26, 2013.

construction in a Southwest Power Pool ("SPP") transmission plan and that will interconnect to facilities owned by the incumbent.[70]

The bill proposes a 90-day notice period within which the incumbent must provide notice to SPP regarding its intent to construct, own and maintain the line in order to retain its ROFR.[71] If the incumbent provides notice of intent not to build the approved line, then SPP may determine whether the incumbent or another entity will build the line.[72]

5. South Dakota

South Dakota's ROFR statute defines an incumbent electric transmission owner as "an electric utility or public utility furnishing electric service in this state or wholesale rural electric cooperative whose owners furnish electric service in this state or a municipal power agency or a consumers power district"[73] and confers onto the incumbent the right to construct, own, and maintain an electric transmission line that connects to facilities owned by the incumbent and that has been approved for construction in a federally registered planning-authority transmission plan.[74] The statute also provides that the incumbent must provide notice within 90 days to the South Dakota Public Utilities Commission indicating the incumbent's intent to build before surrendering the ROFR. If notice of intent to build is provided, the incumbent must apply for a permit from the Public Utilities Commission within 18 months.[75]

B. Analysis under the dormant Commerce Clause

At the outset, it is important to note that while the transmission facilities at issue may be located within a state's borders, they are instruments of interstate commerce in that they facilitate interstate commerce.[76] In Order 888, FERC developed a seven-factor test to distinguish transmission facilities over which it exercised jurisdiction from those facilities used for local distribution.[77] The courts have held that under the commingling theory of electricity, electric

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[70] *Id.* at Section 2.

[71] *Id.* at Section 3(A).

[72] *Id.* at Section 3(B).

[73] South Dakota Codified Laws §49-32-19 (2011).

[74] *Id.* at §49-32-20 (2011).

[75] *Id.*

[76] "Congress is empowered to regulate and protect the instrumentalities of interstate commerce, or persons or things in interstate commerce, even though the threat may come only from intrastate activities." See *U.S. v. Lopez,* 514 U.S. 549, 559 (1995). (Citing *Shreveport Rate Cases,* 234 U.S. 342 (1914).

[77] The seven factors include:
(1) Local distribution facilities are normally in close proximity to retail customers.

transmissions using the interstate grid are subject to federal regulation as part of interstate commerce.[78]

1. The strict-scrutiny standard

Each of the statutes referenced in Section V.A, though written with the intent to protect local reliability and preserve local affordability, appears to be facially discriminatory. Courts have held that discrimination simply means differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter.[79] That is, a party challenging a state statute must identify an in-state interest that is favored by the state and an out-of-state interest that is harmed by the statute.[80] In this case, except for North Dakota, each state's statute confers upon an in-state incumbent transmission company the right to construct a facility identified and approved for construction in a federally approved plan, at the expense of a potential competitor (whether located within or outside of the state). While North Dakota's statute does not reference a federally approved transmission plan, it nonetheless favors the incumbent's right to build at the incumbent's discretion.

If these statutes were challenged and the courts were to apply the strict-scrutiny standard, they could be deemed *per se* invalid unless the state can justify their existence by a factor other than economic protectionism or demonstrate that it had no other means to advance a legitimate state interest.[81] While the purpose of or justification for a law has no bearing on whether it is facially discriminatory,[82] the motivations underpinning the state's efforts could be offered in attempts to overcome the rigorous legal burden.

As noted above in the Minnesota and New Mexico briefing reports, state concerns include discouragement of the sharing of information between utilities, higher-cost transmission

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(2) Local distribution facilities are primarily radial in character.
(3) Power flows into local distribution systems; it rarely, if ever, flows out.
(4) When power enters a local distribution system, it is not reconsigned or transported on to some other market.
(5) Power entering a local distribution system is consumed in a comparatively restricted geographical area.
(6) Meters are based at the transmission/local distribution interface to measure flows into the local distribution system.
(7) Local distribution systems will be of reduced voltage.
See FERC Order 888, 61 FR 21540-01, 21,621.

[78] See *Fed. Power Comm'n v. Fla. Power & Light Co*., 404 U.S. 453, 462-63 (1972).

[79] See *Oregon Waste Systems*, 511 U.S. 93, fn. 37, *supra.*

[80] See *Selevan*, 584 F.3d 82, fn. 39, *supra.*

[81] See *id*.

[82] See *Chemical Waste Management Inc. v. Hunt*, 504 U.S. 334, 340-341 (1992).

lines being built due to FERC incentive awards, disruption of the regulatory oversight structure, and maintenance of state jurisdiction or responsibility over system integrity. Many of these concerns speak to the state's responsibility in ensuring the reliability of the portion of the electric system that falls under their respective jurisdictions.

FERC itself acknowledged the many benefits that incumbent transmission providers offer, even while requiring the removal of ROFR from federally approved tariffs. These benefits include:

- unique knowledge of their own transmission systems;
- familiarity with the communities they serve;
- economies of scale;
- experience in building and maintaining transmission facilities; and,
- access to funds needed to maintain reliability.[83]

Undoubtedly, incumbents' familiarity with their own system attributes can yield numerous reliability benefits to customers by limiting the impact that integration of new facilities may have on the rest of the system.[84] Due to their unique knowledge, incumbent owners can limit the impact that new facilities have on the rest of the transmission system, increasing reliability.

Taken together, these putative system benefits, as well as reliability concerns, economies of scale and cost minimization, and the incumbents' obligation to serve its retail load could be offered as legitimate state interests and, if coupled with a demonstration that states have no alternative means to advance their local reliability interests, could potentially withstand a court's application of the strict-scrutiny standard.

Admittedly, the Court has characterized the few instances in which a state or municipality has demonstrated, under rigorous scrutiny, that it has no other means to advance a legitimate local interest as "a narrow class of cases."[85] In *C & A Carbone*, the Court held that a waste flow-control ordinance did not fit into the narrow class of cases despite its positive environmental impacts because its central purpose was a financing measure and "revenue generation is not a local interest that can justify discrimination against interstate commerce."[86] While it is unclear whether the state's reliability concerns could fit into this narrow class, the importance and

[83] See FERC Order 1000, ¶260.

[84] See generally, McGuire, Mathew R., *(Mis)understanding "Undue Discrimination": FERC's Misguided Effort to Extend the Boundaries of the Federal Power Act*, 19 Geo. Mason L. Rev. 549, 570 (2012).

[85] *C & A Carbone, Inc.,* 511 U.S. 383, 392 (citing *Maine v. Taylor,* 477 U.S. 131 (1986), upholding Maine's ban on the import of baitfish because Maine had no other way to prevent the spread of parasites and the adulteration of its native fish species).

[86] See *id.* at 393.

technical nature of reliability concerns[87] ought to afford state administrative agencies a degree of deference regarding their reliability-based findings.[88]

Compounding the rigorous burden that states would have to overcome under the strict-scrutiny standard is the framework FERC offers in Order 1000 to handle reliability matters. Where a reliability issue may transpire due to a non-incumbent's failure to keep its commitment to build, Order 1000 states:

> Given that incumbent transmission providers may rely on transmission facilities selected in a regional transmission plan for purposes of cost allocation to comply with their reliability and service obligations, delays in the development of such transmission facilities could adversely affect the ability of the incumbent transmission provider to meet its reliability needs or service obligations. To avoid this result…we require each public utility transmission provider to amend its OATT to describe the circumstances and procedures under which public utility transmission providers in the regional transmission planning process will reevaluate the regional transmission plan to determine if delays in the development of a transmission facility selected in a regional transmission plan for purposes of cost allocation require evaluation of alternative solutions, including those the incumbent transmission provider proposes, to ensure the incumbent can meet its reliability needs or service obligations.[89]

The knowledge that FERC has provided a process by which to accommodate matters of reliability may diminish the reliability-based local benefits asserted by states in the eyes of the courts. On the other hand, the FERC rule only applies to transmission lines selected in a regional plan for purposes of regional cost allocation. States may assert that local reliability concerns require enactment of a ROFR law to apply to all situations outside of FERC's jurisdiction.

It is also unclear whether there are alternative means to advance the states' local reliability benefits. The evident intent of the state ROFR statutes is to provide an advantage to in-state incumbent transmission providers at the expense of potential competitors in order to preserve the putative local benefits. This may also work in the states' favor; if the local reliability benefit is deemed legitimate and there is no feasible alternative means to protect local

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[87] See F.E.R.C. Commission Meeting Statement of Chairman Joseph T. Kelliher, February 2, 2006 ("Assuring reliability of the bulk power system is arguably the most important responsibility given the Commission by the Energy Policy Act").

[88] See *Chevron, USA, Inc. v. Natural Res. Def. Council, Inc.,* 467 U.S. 837, 844 (1984) ("We have long recognized that considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer, and the principle of deference to administrative interpretations.") See also *City of Casper v. Ultech,* 895 P.2d 449 (1995) (holding that the duty of the administrative agency to weigh evidence and determine the credibility of the evidence and witnesses supports deference of courts to findings of fact made by administrative agencies.)

[89] FERC Order 1000 at ¶263.

reliability, then it is possible that the ROFR statutes survive application of the strict-scrutiny standard.

2. Analysis under the *Pike* test

Under *Pike*, nondiscriminatory regulations that have only incidental effects on interstate commerce are valid unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.[90] It would be difficult to argue that the ROFR statutes legislate even-handedly because, as noted above, their evident intent is to benefit an in-state incumbent transmission provider at the expense of potential competitors.

Nevertheless, states should be inclined to fashion their ROFR statutes in a manner that avoids strict scrutiny, where possible. Under *Pike*, once a legitimate local purpose is identified, "the extent of the burden that will be tolerated will…depend on the nature of the local interest involved, and on whether it could be promoted as well with a lesser impact on interstate activities."[91] The *Pike* analysis presents a much safer pathway for state ROFR statutes.[92]

Specifically, the state concerns noted above—discouragement of the sharing of information between utilities, higher-cost transmission lines being built due to FERC incentive awards, disruption of the regulatory oversight structure, maintenance of state jurisdiction or responsibility over system integrity, and other reliability concerns—could each be deemed legitimate local purposes. The states would still have to show that the impacts on interstate commerce are incidental and are outweighed by the local benefits.[93]

C. The Supremacy Clause

The Supremacy Clause of the U.S. Constitution states that "this Constitution, and the Laws of the United States shall be the supreme Law of the Land."[94] State laws that directly

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[90] See *Pike*, fn. 40, *supra.*

[91] See *id*. at 142.

[92] Stiles, Trevor D., 4 Envt'l & Energy L. & Pol'y J. 33, 63 (2008). "The strict-scrutiny standard is a difficult hurdle to overcome; most statutes reviewed under strict scrutiny are declared unconstitutional."

[93] The courts have also created a narrow "market participant" exception to the dormant Commerce Clause, in which the courts differentiate between a state acting in a governmental capacity and the state acting in the capacity of a market participant, applying the dormant Commerce Clause limitations only in the former case. See *New Energy Co. of Ind. V. Limbach*, 486 U.S. 269, 277 (1988). This paper does not discuss the "market participant" exception as the act of conferring a benefit to the incumbent transmission provider is most likely a government function.

[94] U.S. Const. Art. VI, § 1, cl. 2.

conflict with federal statutes or treaties will be preempted under the Supremacy Clause.[95] The Court has recognized three types of preemption: explicit federal preemption, implicit federal preemption, and dominant federal interest preemption.[96] Federal law can implicitly preempt state law when a court finds that Congress's intent in passing a statute was to "occupy the legislative field."[97]

This paper refrains from conducting an analysis of state ROFR statutes under the Supremacy Clause of the U.S. Constitution because, despite suggestions to the contrary,[98] it appears clear that FERC has no intention of legislating traditional state functions such as transmission construction, permitting, and siting.

As noted in Section III.B above, FERC stated that nothing in the Final Rule is intended to limit, preempt, or otherwise affect state or local laws or regulations with respect to the construction of transmission facilities, including but not limited to authority over siting or permitting of transmission facilities.[99] FERC also stated that the effect of Order 1000 is not to draw any conclusion regarding the prudence of investment decisions nor to determine which particular entity should construct any particular transmission facility, *but rather to allow more types of entities to be considered for potential construction responsibility*.[100]

Thus, it seems clear that the only field FERC intended to occupy concerns planning and requires the inclusion of a process for considering transmission options, not one that determines which entities should construct any particular facility. The traditional state regulatory power of construction and siting of transmission facilities appears intact;[101] therefore, this paper does not address the Supremacy Clause further.

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[95] See McGuire, 19 Geo. Mason L. Rev. at 580 (citing *Maryland v. Louisiana*, 451 U.S. 725, 746 (1981)).

[96] See *id.* at 580-581 (citing Craig, Robin Kundis, 81 U. Colo. L. Rev. 771, 783 (2010).

[97] See *id.*

[98] See *id.*, at 592 ("If FERC is unwilling to remove itself from the transmission construction process, then the federal courts of appeals must recognize that Order No. 1000 is an attempt by FERC to regulate transmission construction.")

[99] See Order 1000 at ¶287, fn. 30, *supra*.

[100] See *id.*, ¶290, fn. 33, *supra* (emphasis added).

[101] See *Piedmont Envtl. Council v. FERC*, 558 F.3d 304, 312-313 (4th Cir. 2009).

VI. Relationship of ROFR Analysis to Renewable-Energy Procurement Analysis

Some guidance for the state ROFR dormant Commerce Clause analysis may be borrowed from the fate of renewable portfolio standard (RPS) laws that have been challenged under the same constitutional framework. Twenty-nine states have enacted mandatory renewable-energy laws, and the RPS laws in Massachusetts and Colorado have received challenges.[102]

In 2008, Massachusetts enacted the Green Communities Act adding a provision to its RPS to require electricity suppliers to purchase renewable-energy credits ("RECs") from generation units located in Massachusetts and adding a solar "carve-out" to require each electricity supplier to meet a portion of its renewable-energy quota from solar generators in Massachusetts.[103]

The challenge to the Massachusetts statute alleged that both provisions were discriminatory on their face. The requirement to purchase RECs from in-state generators prohibited a company from fulfilling a long-term contract by offering renewable energy generated outside the state.[104] In response to Massachusetts's argument that the solar "carve-out" advanced a legitimate environmental purpose, the challenging party explained that the environmental benefits of solar RECs will be experienced in every location affected by traditional power plants and that there is no reason that the solar generators must be located within the state.[105]

The challenges prompted the Massachusetts Department of Public Utilities to eliminate the requirement limiting availability of long-term contracts to in-state renewable resources[106] and the state of Massachusetts to settle the solar "carve-out" matter by enabling suppliers with contracts prior to January 1, 2010 to meet a portion of their solar-energy obligation from out-of-state resources.[107]

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[102] Havemann, Anne, *Surviving the Commerce Clause: How Maryland can Square its Renewable Energy Laws with the Federal Constitution*, 71 Md. L. Rev. 848 (2012). A lawsuit challenging Minnesota's RPS is also ongoing but it is not discussed in this paper.

[103] See *id.* at 860-861 (citing 2008 Mass. Acts 308).

[104] See *id.* (citing Complaint at P. 25-26, TransCanada Power Mktg. Ltd. v. Bowles, No. 4:10-cv-70070 (D. Mass. Apr. 16, 2010).

[105] See *id.* (citing Complaint, P. 37).

[106] See *id.* (citing Order Adopting Emergency Regulations, D.P.U. 10-58 (Mass. Dep't of Pub. Utils. June 9, 2010).

[107] See *id.*, at 862.

The Colorado RPS includes a 3 percent distributed generation (DG) requirement and defines wholesale DG as "a renewable energy resource in Colorado."[108] This statute was also challenged under the dormant Commerce Clause, in part as discriminatory against out-of-state energy resources.[109]

While the courts may address these legal challenges in the near future, a review of literature suggests that a requirement that the renewable energy used to meet a state's RPS obligation be generated within the state itself, which is the most direct means for a state to retain the economic benefits of the program, could be struck down under the dormant Commerce Clause.[110]

An alternative construct that may pass dormant Commerce Clause analysis would structure programs to track in-state consumption without regard to the location of generation, permitting out-of-state generators to transmit renewable energy generated elsewhere to the state and still meet the RPS requirement.[111] In this case, while the environmental benefits may be identical, the economic benefits to the state may be considerably diminished.

In a similar vein, states that have enacted ROFR statutes in response to FERC Order 1000 may consider refashioning their statutes, even if certain legitimate interests are diminished, in order to avoid the strict-scrutiny standard. On the other hand, reliability benefits and the infeasibility of an alternative method to protect local reliability interests may preserve the ROFR statutes despite application of the strict-scrutiny standard. While absent in the discussion of protectionist renewable-energy procurement policies, local reliability concerns could prove to be an important factor in preserving state ROFR statutes.

VII. Conclusion

This paper analyzed a series of state ROFR statutes, passed in response to federal requirements contained in FERC Order 1000 to remove ROFRs from FERC-jurisdictional tariffs, under the dormant Commerce Clause of the U.S. Constitution. It found that the five statutes identified are likely to receive strict scrutiny, as currently written, because they each discriminate on their face in favor of state-based incumbent transmission facilities to the detriment of potential competitors.

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108 See *id.*, at 863 (citing Col. Rev. State. Ann. §40-2-124(1)(a)(VI)).

109 See *id.*, at 865 (citing Amended Complaint for Declaratory Relief at Part II. A-G, Am. Tradition Inst. v. Colorado, No. 1:11-cv-00859-WJM-KLM (D. Colo. Apr., 22, 2011). (Case Pending).

110 See Endrud, Nathan E., 45 Harv. J. on Legis. 259 at 270. See also, Stiles, Trevor D., 4 Envt'l & Energy L. & Pol'y J. 33, 63 (2008) ("the RPS provisions must not appear to discriminate against out-of-state renewable energy facilities based on location. The location of the facility or the source of the renewable energy must be irrelevant to the energy requirement."). See also Havemann, Anne, 71 Md. L. Rev. at 869-872.

111 See Stiles, 4 Envt'l & Energy L. & Pol'y J. at 63.

While noting that states may consider refashioning their ROFR statutes, where possible, in a non-discriminatory manner so that they may benefit from review under the more lenient *Pike* test, this paper's main recommendation to the states is that they conduct a comprehensive analysis comparing transmission-selection procedures to determine whether incumbent preference or competitive solicitation confers more benefits to each respective state.

In other words, by undertaking an analysis of the costs and benefits of incumbent preference versus competitive solicitation, states can determine under which model they most efficiently meet the reliability, economic, and public policy needs of their customers and residents. This analysis will require states to assign values to the reliability, economic, and public policy costs and benefits derived under each scenario.

In the case that a state determines that conferring a preference upon the incumbent yields greater benefits than the competitive solicitation model, it could enact a ROFR statute and utilize the comprehensive analysis as evidence of a valid factor that demonstrably justifies discriminatory treatment in light of having no alternative means to preserve its interests. Ultimately, such an analysis may prove critical in the preservation of a state ROFR statute, whether a court applies the strict-scrutiny standard or the *Pike* test.

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