APPENDIX B

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MEMORANDUM FOR GENERAL COUNSEL OF THE ARMY
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SUBJECT: The Role of State Laws and Regulations in Utility Privatization

Section 2688 of title 10, United States Code, provides permanent authority to the Military Departments to convey certain listed types of utility systems to a utility company or other entity. As consideration for the conveyance, the Secretary shall receive fair market value, in the form of a lump sum payment or a reduction in charges for utility services provided by the utility or entity. The department commonly refers to the process of conveying the utility system to a non-Federal entity and concurrently contracting for services from the new owner, as privatization of that utility system. As we explore the role of state laws and regulations in utility privatization, we must be acutely aware of these two distinct and yet interrelated components, because the extent to which state laws and regulations are applicable to privatization varies depending on which component of privatization is at issue. Consequently, this memorandum addresses two questions: (1) Do state laws and regulations apply to the conveyance of an on-base utility system under section 2688 of title 10, United States Code?; and (2) Do state laws and regulations apply to or otherwise affect the Federal government's acquisition of utility services related to an on base utility system conveyed under section 2688 of title 10, United States Code? As discussed more fully below, the answer to this second question is different for the commodity electricity than for electric utility services, and for other types of utilities.

I. DO STATE LAWS AND REGULATIONS APPLY TO THE CONVEYANCE OF AN ON-BASE UTILITY SYSTEM UNDER SECTION 2688 OF TITLE 10, UNITED STATES CODE?

It is a longstanding Constitutional principle that the states may not regulate the Federal government except to the extent that the Constitution so provides or the Congress consents to such regulation, McCulloch v. Maryland, 17 U.S. 316 (1819). For Congress to consent to such regulation, it must waive the sovereign immunity of the United States. A waiver of sovereign immunity must be unequivocal. See, e.g., United States Department of Energy v. Ohio, 503 U.S. 607 (1992) ("(t)his Court presumes congressional familiarity with the common rule that any waiver of the Government's sovereign immunity must be unequivocal. Such waivers must be construed strictly in favor of the sovereign and not enlarged beyond what the language requires." Citation

omitted). In Hancock v. Train, 426 U.S. 167 (1976), the Supreme Court discussed Federal supremacy at length particularly as it relates to Federal installations:

> It is a seminal principle of our law "that the constitution and the laws made in pursuance thereof are supreme; that they control the constitution and laws of the respective States, and cannot be controlled by them." From this principle is deduced the corollary that "[it] is of the very essence of supremacy to remove all obstacles to its action within its own sphere, and so to modify every power vested in subordinate governments, as to exempt its own operations from their own influence." Id., at 427.
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> The effect of this corollary, which derives from the Supremacy Clause and is exemplified in the Plenary Powers Clause giving Congress exclusive legislative authority over Federal enclaves purchased with the consent of a State, is "that the activities of the Federal Government are free from regulation by any state."
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> Taken with the "old and well-known rule that statutes which in general terms divest pre-existing rights or privileges will not be applied to the sovereign" "without a clear expression or implication to that effect," this immunity means that where "Congress does not affirmatively declare its instrumentalities or property subject to regulation," "the federal function must be left free" of regulation. Particular deference should be accorded that "old and well-known rule" where, as here, the rights and privileges of the Federal Government at stake not only find their origin in the Constitution, but are to be divested in favor of and subjected to regulation by a subordinate sovereign. Because of the fundamental importance of the principles shielding Federal installations and activities from regulation by the States, an authorization of state regulation is found only when and to the extent there is "a clear congressional mandate," "specific congressional action" that makes this authorization of state regulation "clear and unambiguous."

426 U.S. at 178 (citations omitted).

The authority to convey an on-base utility system, granted by Section 2688, is in furtherance of the Congress' authority under Article IV, Section 3, of the Constitution "to dispose of and make all needful Rules and Regulations respecting the Territory or other Property belonging to the United States; ...". Consequently, in this instance, the "rights and privileges of the Federal Government at stake ... find their origin in the Constitution", specifically, the property clause of Article IV, Section 3.

Through Section 2688 Congress granted to the military departments the authority to convey its utility systems. Regardless of the jurisdictional/enclave status of the installation, the disposal of Federal property is a Federal action which may not be restricted by the state, absent an explicit waiver of Federal sovereignty. Consequently, if Congress were to waive the sovereign immunity of the United States with respect to the

conveyance of an on-base utility system, it is likely it would do so, if at all, in Section 2688. Section 2688 refers to state regulation in its subsection (c)(2)—

> (c) Consideration.—(1) The Secretary concerned shall require as consideration for a conveyance under subsection (a) an amount equal to the fair market value (as determined by the Secretary) of the right, title, or interest of the United States conveyed. The consideration may take the form of—
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> (A) a lump sum payment; or
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> (B) a reduction in charges for utility services provided by the utility or entity concerned to the military installation at which the utility system is located.
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> (2) If the utility services proposed to be provided as consideration under paragraph (1) are subject to regulation by a Federal or State agency, any reduction in the rate charged for the utility services shall be subject to establishment or approval by that agency.

Paragraph (2), by its own language, only applies when the consideration for the purchase of the on-base utility system is a reduction in charges, as opposed to a lump sum payment, and then only to the rate charged for the utility services. Consequently, if the sale is for a lump sum payment, there is no waiver of sovereign immunity under 10 U.S.C. § 2688. Furthermore, if the consideration for the sale is a reduction in charges, there is a waiver of sovereign immunity, but the waiver is limited to regulation of the rate charged for the utility services. There is nothing in Section 2688 that can be interpreted as a waiver of the Government's sovereign immunity from state or local regulation with respect to the conveyance of the on-base utility system. To the contrary, Section 2688 specifically indicates the manner by which the government may convey the on-base utility system: "[i]f more than one utility or entity . . . notifies the Secretary concerned of an interest in a conveyance . . . the Secretary shall carry out the conveyance through the use of competitive procedures." 10 U.S.C. 2688(b).

In addition to section 2688, there is, for electricity, a special statutory provision contained in the Department of Defense Appropriations Act, 1988, Public Law 100-202, that bears on the question of whether Congress has waived the sovereign immunity of the United States—

> Sec. 8093. None of the funds appropriated or made available by this or any other Act with respect to any fiscal year may be used by any Department, agency, or instrumentality of the United States to purchase electricity in a manner inconsistent with State law governing the provision of electric utility service, including State utility commission rulings and electric utility franchises or service territories established pursuant to State statute, State regulation, or State-approved territorial agreements: Provided, That nothing in this section shall preclude the head of a Federal agency from entering into a contract pursuant to 42 U.S.C. 8287; nor shall it preclude the Secretary of a military department from entering into a contract pursuant to 10 U.S.C. 2394 or from purchasing electricity from

any provider when the utility or utilities having applicable State-approved franchise or other service authorizations are found by the Secretary to be unwilling or unable to meet unusual standards for service reliability that are necessary for purposes of national defense.

As will be discussed in more detail later, this provision waives the sovereign immunity of the United States with respect to the acquisition of the electricity commodity. However, nothing in this provision can be construed as waiving the sovereign immunity of the United States with respect to the disposal of an on-base utility system.

Because Congress has not waived the sovereign immunity of the United States with respect to the conveyance of an on-base utility system under section 2688 of title 10, United States Code, state law is not applicable to the conveyance of an on-base utility system under Section 2688; rather, Section 2688 governs that conveyance. Accordingly, "[i]f more than one utility or entity . . . notifies the Secretary concerned of an interest in a conveyance . . ., the Secretary shall carry out the conveyance through the use of competitive procedures", not on a sole source basis to a utility that state law indicates has an exclusive right to provide utility service in the relevant geographic area.

Section 2688 also provides that the Secretary concerned may not make a conveyance of a utility system until he submits an analysis demonstrating, *inter alia*, that "the conveyance will reduce the long-term costs of the United States for utility services provided by the utility system concerned . . .." Whether this economic standard is met – and whether conveyance of the utility is permissible under section 2688 – can be substantially affected by whether state laws and regulations apply to the Federal Government's acquisition of utility services from the prospective new owner of the utility system. We now turn to address that question.

II. Do State Laws And Regulations Apply To Or Otherwise Affect The Federal Government's Acquisition Of Utility Services Related To An On-Base Utility System Conveyed Under Section 2688 Of Title 10, United States Code?

A. Can the States Regulate the Federal Government's Acquisition of Utility Services?

For the reasons discussed in the previous section, the states may not regulate the Federal government in any respect absent an unequivocal waiver of sovereign immunity. With one exception discussed below with respect to acquisition of the electricity commodity, there has been no such waiver with respect to Federal acquisition of utility services, hence states may not regulate these transactions directly.

Some have argued that through Section 8093 of the Department of Defense Appropriations Act, 1988, Congress may have waived the sovereign immunity of the United States with respect to the acquisition of electric utility services. As indicated previously, Section 8093 provides that

> [n]one of the funds appropriated or made available by this or any other Act with respect to any fiscal year may be used by any Department, agency, or instrumentality of the United States to purchase electricity in a manner inconsistent with State law governing the provision of electric utility service, including State utility commission rulings and electric utility franchises or service territories established pursuant to State statute, State regulation, or State-approved territorial agreements.

A plain reading of Section 8093's operative statutory language ("...to purchase electricity in a manner inconsistent with state law governing the provision of electric utility service...") necessarily leads to the conclusion that the waiver of sovereign immunity in that section is limited to purchase of the electric commodity (electric power) excluding distribution or transmission services.[1] There is nothing in this section to indicate that "purchase electricity" should be read in any way other than its plain language. Consequently, electricity does not include the provision of utility services other than the commodity itself. This reading of section 8093 is also buttressed by the rule of statutory construction that waivers of sovereign immunity should be narrowly construed. See, e.g., United States Department of Energy v. Ohio, 503 U.S. 607 (1992) ("(t)his Court presumes congressional familiarity with the common rule that any waiver of the Government's sovereign immunity must be unequivocal. Such waivers must be construed strictly in favor of the sovereign and not enlarged beyond what the language requires.").

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[1] In West River Elec. Assn., Inc. v. Black Hills Power & Light Co., 918 F.2d 713 (8th Cir. 1990), the United States Court of Appeals for the Eighth Circuit considered the application of section 8093 to the purchase of electricity at Ellsworth AFB. The court concluded that—

> ...Congress, through section 8093, has not provided the necessary clear authorization to defer its exclusive jurisdiction over Ellsworth and to apply in its stead the South Dakota utility service territories as established under South Dakota law.
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> Nor are we able to find in section 8093, on its face or in relation to the Appropriations Act as a whole, or from the legislative history, any clear and unambiguous declaration by Congress to amend the extensive and carefully-crafted body of federal procurement law. In fact, nowhere in section 8093 or its legislative history is the Competition in Contracting Act mentioned. Furthermore, as previously noted, the legislative history clearly states that this legislation was intended to protect against utility abandonment by their federal customers. It is undisputed that no abandonment is occurring here.

918 F.2d at 719. If the Department were to apply the holding of this case to all its privatization actions on installations with exclusive Federal legislative jurisdiction, the applicability of section 8093 would be limited to an even greater degree than suggested by this memorandum.

Furthermore, the legislative history indicates that the "provision is intended to protect remaining customers of utility systems from the higher rates that inevitably would result if a Federal customer were allowed to leave local utility systems to obtain retail electric utility service from a nonlocal supplier." Senate Report 100-235, Report of the Committee on Appropriations accompanying S. 1923, the Department of Defense Appropriations Bill, 1988, page 70. There is nothing about the disposal of a government constructed and owned utility distribution system, and the subsequent acquisition of services from that system, that in any way undermines the stated purpose of section 8093.

However, because section 8093 waives the sovereign immunity of the United States with respect to the purchase of the electricity commodity, whether we could purchase or obtain electricity from a generating facility the Department has transferred through section 2688 is dependent upon state law.

B. CAN THE STATES REGULATE PROVIDERS OF UTILITY SERVICES TO THE FEDERAL GOVERNMENT?

While states generally recognize that they cannot regulate Federal contracting functions directly, some states have tried to regulate Federal contractors. Using this device, states sometimes attempt to accomplish indirectly what they could not achieve through direct oversight over activities of the Federal Government. The result is often a conflict between Federal regulations affecting Federal purchases and state regulation of providers of goods and services in its territory. Typically states will require a provider of a particular service or item of supply to be licensed while Federal contracting rules do not require the vendor to obtain a state license.

Conflicts between state and Federal laws are resolved through the Supremacy Clause of the Constitution: "This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; . . . shall be the supreme Law of the Land; and the Judges in every state shall be bound thereby, any Thing in the Constitution or Laws of any state to the Contrary notwithstanding." Article VI, clause 2. Where there are direct conflicts between state and Federal law, state law must give way. The answer is less clear-cut where state and Federal laws do not directly conflict but where state laws affect Federal policies and programs to a greater or lesser degree. The Supreme Court has explained the rules for resolving conflicts between state and Federal law as follows:

> In determining whether a state statute is pre-empted by federal law and therefore invalid under the Supremacy Clause of the Constitution, our sole task is to ascertain the intent of Congress. See Shaw v. Delta Air Lines, Inc., 463 U.S. 85, 95 (1983); Malone v. White Motor Corp., 435 U.S. 497, 504 (1978). Federal law may supersede state law in several different ways. First, when acting within constitutional limits, Congress is empowered to pre-empt state law by so stating in express terms. E. g., Jones v. Rath Packing Co., 430 U.S. 519, 525 (1977). Second, congressional intent to pre-empt state law in a particular area may be inferred where the scheme of federal regulation is sufficiently comprehensive to make reasonable the inference that Congress "left no room" for supplementary state regulation.

> Elevator Rice v. Santa Fe Corp., 331 U.S. 218, 230 (1947). . . . As a third alternative, in those areas where Congress has not completely displaced state regulation, federal law may nonetheless pre-empt state law to the extent it actually conflicts with federal law. Such a conflict occurs either because "compliance with both federal and state regulations is a physical impossibility," Florida Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132, 142-143 (1963), or because the state law stands "as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." Hines v. Davidowitz, 312 U.S. 52, 67 (1941). See Michigan Canners & Freezers Assn., Inc. v. Agricultural Marketing and Bargaining Bd., 467 U.S. 461, 478 (1984); Fidelity Federal Savings & Loan Assn v. De la Cuesta, 458 U.S. 141, 156 (1982). Nevertheless, pre-emption is not to be lightly presumed. See Maryland v. Louisiana, 451 U.S. 725, 746 (1981).

California Fed. Savings & Loan Association v. Guerra, 479 U.S. 272, 284 (1987).

In the Federal contracting arena it appears that the second prong of the Guerra Supremacy Clause analysis applies. That is, the Federal Government has "occupied the field" of rules and standards applying to federal procurement and left no space for state intervention. In Miller v. Arkansas 352 U.S 187 (1956) the state attempted to prosecute a Federal contractor for not obtaining a contractor's license. The Supreme Court held that the Federal regulations establish methods for ensuring the responsibility of Federal contractors and that the states' attempt to insert themselves in this process violated the Supremacy clause. Many other cases since Miller have reaffirmed that the states may not require licensing of Federal contractors. The justification that regulation is intended to exclude bad contractors duplicates the Federal Government's own contractor selection procedures and is deemed an unwarranted interference with this Federal function. United States v. Virginia, 139 F.3d 984 (1998). Based on these precedents, state attempts to require that Federal utility service contractors operating a utility system on the installation obtain a state license to "ensure the Government gets quality service", should certainly fail.

States may justify regulation of a utility contractor on other grounds e.g. safety and health considerations affecting the broader utility distribution framework. This requires a different Supremacy Clause analysis since it is not the case that Congress has "left no room" for state regulation to ensure safe and economical operation of intrastate utility distribution systems. On the contrary, such regulation occurs in every state. Given potentially inconsistent Federal and state regulations each addressing legitimate concerns, a balancing test is required. United States v. Town of Windsor 765 F.2d 16, 19 (2d Cir, 1985)("application of the Supremacy Clause requires a balancing of the state and local interest in enforcing their regulations against the Government's interest in opposing the regulation."); United States v. Philadelphia 798 F2d 81, 87 (3d Cir. 1986)("a mere conflict of words is not sufficient; the question remains whether the consequences [of state regulation]....sufficiently injure the objectives of the federal program to require non recognition." citing McCarty v. McCarty, 453 U.S. 210, 232 (1981).

Using the balancing test, courts have found that a state building code is inapplicable to a Federal project, concluding that "[e]nforcement of the substance of the permit requirement against the contractors would have the same effect as direct enforcement against the Government." 765 F.2d at 19; and invalidated a state statute that prohibited carriers from transporting government property at rates other than those approved by a state commission because it was a prohibition against the Federal government and clearly in conflict with Federal policy on negotiated rates. Public Utilities Commission of California v. United States, 355 U.S. 534 (1958). On the other hand, in North Dakota v. United States, 495 U.S. 423 (1990), the Court held that state liquor reporting and labeling requirements imposed on contractors who sell liquor to the Federal government were not invalid because they did not regulate the Federal government directly, were not discriminatory, and did not impose a significant burden on the Federal government or conflict with a Federal system of regulations. Similarly, where the application of the state regulation required the contractor to comply with certain work safety rules, the Court found the impact on the Federal government's interest incidental and concluded that the rules were valid as applied against the contractor. James Stewart & Company v. Sadrakula, 309 U.S. 94 (1940).

In applying a balancing test, the Courts would be required to balance Federal policies favoring maximum possible competition in government contracting against whatever safety or other regulatory concerns the states could articulate. It would seem clear from the case law that the state could not impose a license requirement because that could operate to overturn the Federal selection of a contractor using competitive procedures. Miller v. Arkansas 352 U.S 187 (1956); United States v. Virginia, 139 F.3d 984 (1998). However, the state may well regulate the operation of that contractor in a non-discriminatory way to protect the health and safety of all its citizens as long as that regulation does not impose a significant burden on the Federal government or conflict with a Federal system of regulation. North Dakota v. United States, 495 U.S. 423 (1990). Some degree of state regulation of the contractor operating a utility system on the installation may be permissible, to ensure, for example, that the operation of the on-base system does not threaten the safety and reliability of any utility system to which the on-base system connects.

III. CONCLUSIONS AND RECOMMENDATIONS.

When the Department disposes of an on-base utility system, and more than one entity expresses an interest in the conveyance, the Department must dispose of the utility systems "using competitive procedures" notwithstanding state laws and regulations regarding who can own a utility system. Congress has not waived the sovereign immunity of the United States with respect to disposal. Any effort to dispose of the system in a non-competitive manner, when more than one entity expresses an interest in the conveyance, even if undertaken to voluntarily comply with state law, would violate the express terms of section 2688.

Additionally, the state may not regulate the Federal Government's acquisition of utility services related to the on-base utility system. Federal procurement laws and

regulations are supreme in this area. The Department must comply with state laws and regulations only when it is acquiring the electricity commodity.

Finally, while the entity to whom the Department conveyed the on-base utility system is not required to submit to state licensing or similar requirements that undermine the Federal competitive selection of that entity, to the extent the state has regulations regarding the conduct of operation and ownership of utility systems, the entity may have to comply with those requirements if those state requirements do not impose a significant burden on the Federal Government, conflict with a Federal system of regulation, or undermine the Federal policy being implemented. This will require a careful analysis of particular state requirements in relation to the Federal action.

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