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CLIMATE CHANGE

EMISSIONS TRADING

A California state court is preparing to resolve major issues in two cases addressing the state's auctions of carbon allowances. The court will have to determine whether the legislature authorized the California Air Resources Board to conduct the auctions, and whether the billions of dollars raised by the auctions constitute revenue or a regulatory fee. The authors of this article believe that, even if the auctions do not survive the legal challenge, cap-and-trade will remain because the auctions are not essential to the program, as the allowances can be distributed for free.

California's State-Run Carbon Auctions—A Taxing Matter

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Two cases pending in state court in Sacramento could derail a major component of California's new greenhouse gas cap-and-trade regulations—the state-run auctions of carbon allowances. Both cases were filed on behalf of business interests, and they represent the first serious challenges by the regulated community to California's cap-and-trade program. Both cases argue that the auctions, which have the potential to raise billions of dollars in revenue, are: (1) not supported by the Global Warming Solutions Act of 2006, which authorized the regulations; or (2) even if authorized, then the auctions are an unconstitutional tax because the Act did not pass by a two-thirds majority,

which is required under California's constitution for all revenue-raising acts.

These lawsuits raise complex issues courts will struggle to resolve. Did the legislature authorize the California Air Resources Board (CARB) to conduct the auctions? Are the billions raised by the auctions "revenues"? Are they a permissible regulatory fee? These are close calls.

But while the auctions are a key component of CARB's regulatory program, they are not essential to its implementation. So even if the auctions are deemed extra-legal, cap-and-trade will likely survive. Indeed, given the alternatives, regulated businesses seemingly prefer cap-and-trade over a carbon tax or command-and-control type measures. They just do not like the state-run auctions.

The State-Run Carbon Allowance Auctions

The Global Warming Solutions Act (also known as AB32) mandates that California reduce its greenhouse gas emissions to 1990 levels by 2020.¹ The statute authorizes CARB to develop and implement regulations to achieve that goal.² Indeed, the statute grants the agency considerable discretion in crafting the regulations. The Act also grants CARB authority to “use market-based compliance mechanisms to comply with the regulations;” however, their use is not mandatory.³ Consistent with this statutory authority, CARB adopted regulations implementing what is commonly referred to as a “cap-and-trade” regulatory approach.⁴ Under cap-and-trade, CARB sets a limit for greenhouse gas emissions from regulated entities—the cap. Regulated entities are allocated or buy emission allowances. At the end of specific compliance periods, the regulated entities must surrender allowances in amounts equal to their emissions. Over time, CARB will lower the cap; thus, achieving a reduction in the emission of greenhouse gases.

Businesses can buy and trade allowances to meet compliance requirements.⁵ This is the trading component of cap-and-trade. CARB, however, added a twist. It reserved for itself carbon allowances that it will later make available at auction.⁶ At first, CARB will reserve only 10 percent of the allowances, but over time this will increase to 50 percent of all allowances.⁷ Other than the reference to the use of market-based compliance mechanisms in section 38570, the Act is silent as to what means CARB may employ to allocate allowances.

CARB is in a position to collect billions of dollars from businesses participating in the auctions. The Legislative Analyst’s Office projects that the auctions could raise more than \$70 billion depending on, among other factors, the price of carbon allowances.⁸ CARB has held four allowance auctions since November 2012. The first three raised more than \$791 million.⁹ Monies collected by CARB through the auctions are to be deposited into the state’s Greenhouse Gas Reduction Fund.¹⁰ Monies in the fund are to be apportioned by the legislature, and the state may borrow from the fund for loans to the General Fund.¹¹

The Two Lawsuits

The first of the two lawsuits was filed in November 2012 by the California Chamber of Commerce, representing some 14,000 members.¹² It raises two argu-

ments: first, the Act does not authorize CARB to raise revenue through auctioning carbon allowances; second, if the auctions are permissible under the Act, the Act is unconstitutional because it was not passed by the two-thirds vote required to enact revenue raising laws.¹³ The second lawsuit, filed on April 16, 2013, was brought by Morning Star Packing Co. and several other businesses and individuals.¹⁴ The Pacific Legal Foundation, a nonprofit property-rights legal organization, represents the plaintiffs. The Morning Star plaintiffs make essentially the same arguments as the Chamber of Commerce.¹⁵

Central to both cases is California’s Proposition 13, passed by the voters in 1978.¹⁶ Under Proposition 13, taxes enacted to raise revenue must be passed by a two-thirds vote of the legislature.¹⁷ The Global Warming Solutions Act was not passed by a two-thirds majority. Therefore, if the auctions are deemed to be a tax that raises revenues, the auctions would be unconstitutional. However, if the monies raised by the auctions are deemed to be something other than revenue raised by a tax—e.g., a fee—they could pass constitutional muster. In 1997, the California Supreme Court addressed the difference between a fee and a tax in *Sinclair Paint* opinion.¹⁸ Under *Sinclair Paint*, certain special taxes—such as some special tax assessments, development fees and regulatory fees—may not be taxes for the purpose of Proposition 13.¹⁹ Yet, even before the courts address whether the auctions are a revenue-raising tax subject to Proposition 13, they must first decide if the statute authorizes CARB to auction carbon allowances.

Does the Act Authorize the Auctions?

There is no language in the Act pertaining to the auction of carbon allowances. Section 38597 authorizes CARB to adopt “a schedule of fees to be paid by the sources of greenhouse gas emissions regulated pursuant to this division.”²⁰ It is unlikely, however, that a court will find that this provision authorizes CARB to

plaint for declaratory relief (Cal. Super. Ct., Sacramento County, Nov. 13, 2012).

¹³ *Cal. Chamber of Commerce v. Cal. Air Res. Bd.*, No. 2012-8001313, memorandum of points and authorities in support of verified petition for writ of mandate and complaint for declaratory relief at 12–13, 24 (Cal. Super. Ct., Sacramento County, Nov. 13, 2012). See also 219 DEN A-15, 11/14/12

¹⁴ *Morning Star Packing Co. v. Cal. Air Res. Bd.*, No. 2013-8001464, verified petition for writ of mandate and complaint for declaratory relief (Cal. Super. Ct., Sacramento County, April 16, 2013). See also 75 DEN A-3, 4/18/13

¹⁵ *Id.* at 2.

¹⁶ California Constitution, article XIII A (1978). Proposition 13 was amended by Proposition 26 in 2010. Among other things, the amendments broadened the reach of Proposition 13 by defining a “tax” and seemingly limiting the types of revenue raising fees that might fall outside of the scope of Proposition 13. Because the Global Warming Solutions Act was passed in 2006 prior to Proposition 26, most observers believe courts will look to the original language of Proposition 13 in deciding whether the carbon allowance auctions are constitutional. The analysis in this article is based upon the original language in Proposition 13.

¹⁷ *Id.* at § 3.

¹⁸ *Sinclair Paint Co. v. State Bd. of Equalization*, 15 Cal.4th 866 (1997).

¹⁹ *Id.* at 873–75.

²⁰ Cal. Health & Safety Code § 38597.

¹ Cal. Health & Safety Code § 38550 *et seq.* See also 188 DEN A-12, 9/28/06

² *Id.* at §§ 38560 and 38562.

³ *Id.* at § 38570.

⁴ 17 Cal. Code Regs. § 95800 *et seq.*

⁵ *Id.* at §§ 95920–95921.

⁶ *Id.* at § 95870, 95910–95914.

⁷ *Id.*

⁸ Legislative Analyst Office, “Evaluating the Policy Trade-Offs in ARB’s Cap-and-Trade Program.” Feb. 9, 2012, at p. 13.

⁹ The \$791 million was derived from information by CARB regarding auction results found at: <http://www.arb.ca.gov/cc/capandtrade/auction/auction.htm>

¹⁰ Cal. Gov’t Code § 16428.8.

¹¹ *Id.*

¹² *Cal. Chamber of Commerce v. Cal. Air Res. Bd.*, No. 2012-8001313, verified petition for writ of mandate and com-

auction carbon allowances. Indeed, the Chamber of Commerce argues that the legislative history is clear that the intent of this provision was to enact a fee to cover direct administrative costs, and nothing more.²¹

The Act, however, does authorize CARB to adopt a “market-based compliance mechanism to comply with regulations,”²² which is defined as:

(k) “Market-based compliance mechanism” means either of the following: (1) A system of market-based declining annual aggregate emissions limitations for sources or categories of sources that emit greenhouse gases. (2) Greenhouse gas emissions exchanges, banking, credits, and other transactions, governed by rules and protocols established by the state board, that result in the same greenhouse gas emission reduction, over the same time period, as direct compliance with a greenhouse gas emission limit or emission reduction measure adopted by the state board pursuant to this division.²³

There is little question that CARB was given broad discretion to utilize a market-based compliance mechanism. Also, there is little doubt that when the legislature crafted this portion of the statute, it had in mind cap-and-trade. How allowances or credits under any cap-and-trade are to be allocated—given away or auctioned—is a key design issue. Thus, the Act seems to have left to CARB the discretion to decide how allowances would be allocated. The Act, however, is not clear on this point, and a court could easily decide that a revenue-raising scheme that raises billions of dollars needs express statutory authorization.

Are Monies Raised by the Auctions a Tax That Raises Revenues?

Assuming the Act authorizes the auction, the court will then need to address a novel and difficult question—is the auction a “tax” that raises revenues? To answer this question, the court will need to determine the purpose of the auctions. Proposition 13 only governs “changes in State taxes enacted for the purpose of increasing revenues.”²⁴ So are the auctions intended to raise revenues? If not, then Proposition 13 would not apply.

The case for the auctions not being designed to increase revenue is compelling. Auctioning allowances, rather than giving them away, can be more efficient. Auctions can help to establish a market price, eliminate windfall profits and foster transparency.²⁵ In addition, regulated entities need not buy allowances at the auctions; they can choose to comply with the regulations in other ways—e.g., cut emissions or buy offsets. Under *Sinclair Paint*, “if regulation is the primary purpose, the mere fact that revenue is also obtained does not make

the imposition a tax.”²⁶ Thus, the argument can be made that the auctions—a key component of cap-and-trade—serve a primarily regulatory purpose by providing an efficient means for allocating allowances. It is not possible to predict how a court will approach this argument. The fact is, however, the auctions will raise billions of dollars in revenue, and so it would take a bold court to hold that the auctions are a mere regulatory device.

Alternatively, the allowances could be viewed as a form of property sold by the state, not dissimilar to the sale of rights to use other public resources (such as timber, grazing lands or the broadcast spectrum). By buying an allowance, the buyer is getting something—the right to emit greenhouse gases. On the other hand, the regulations clearly provide that the allowances do “not constitute property or a property right.”²⁷ So it would appear that the state has eliminated this argument, perhaps by design.

Are Revenues Raised by the Auctions Permissible Regulatory Fees?

Most observers believe that the cases will turn on whether the revenues raised by the auctions are deemed to be a permissible fee under the Supreme Court’s *Sinclair Paint* ruling. *Sinclair Paint* holds that some forms of revenue raising may not be a tax subject to Proposition 13.²⁸ At issue in that case was a fee charged under the Childhood Lead Poisoning Prevention Act of 1991. The fee was charged to all current and former manufacturers of lead or products containing lead.²⁹ The purpose of the fee was to provide revenue to support programs aimed at helping children at risk for lead poisoning. The Supreme Court held that the revenue raised was a “regulatory fee” and not a tax because it required companies that had contributed to the problem of lead contamination to assume a reasonable cost of mitigating the problem.³⁰

Sinclair Paint identified certain types of revenue activity that would not necessarily constitute a tax: “(1) special assessments, based on the value of benefits conferred on property; (2) development fees, exacted in return for permits or other government privileges; and (3) regulatory fees, imposed under the police power.”³¹ With respect to regulatory fees, the Court further held that for a fee to be a regulatory fee and not a tax, there must be a reasonable relationship between the amount of the fee and burden placed on the payer; the remedial measures must have a causal connection with the fee payer’s conduct; and the fee cannot be an unrelated revenue-raising device.³² Regulatory fees are a proper exercise of the police powers, and not a tax, if the “fees do not exceed the reasonable cost of providing the services necessary to the activity for which the fee is charged and which are not levied for unrelated revenue purposes.”³³

²¹ *Cal. Chamber of Commerce v. Cal. Air Res. Bd.*, No. 2012-8001313, memorandum of points and authorities in support of verified petition for writ of mandate and complaint for declaratory relief at 16 (Cal. Super. Ct., Sacramento County, Nov. 13, 2012).

²² Cal. Health & Safety Code § 38570(a).

²³ *Id.* at § 38505(k).

²⁴ California Constitution, article XIII A, § 3 (1978).

²⁵ See D. Lambe and D. Farber, “California’s Cap-and-Trade Auction Proceeds: Tax, Fees, or Something Else?” Berkeley Law, University of California, Center for Law, Energy & the Environment (May 2012), p. 10.

²⁶ *Sinclair Paint*, 15 Cal.4th at 880.

²⁷ 17 Cal. Code Regs. § 95820(c).

²⁸ *Sinclair Paint*, 15 Cal.4th at 874–75.

²⁹ *Id.* at 871–72.

³⁰ *Id.* at 875.

³¹ *Id.* at 874.

³² *Id.* at 879–81.

³³ *Id.* at 877 (internal citations omitted).

It is unlikely that a court will view the revenues raised by the auctions as a special assessment or a development fee, so the analysis will likely focus on whether the auctions are a permissible regulatory fee. Yet the auctions do not really look much like a regulatory fee either. The purpose of the auctions is not to fund some type of specific regulatory program, such as the children's health activities supported by the fees at issue in *Sinclair Paint*. The purpose is to allocate carbon allowances. The auctions will also raise billions of dollars. While these revenues are to be placed in the state's Greenhouse Gas Reduction Fund with the supposed purpose of "mitigating" the effects of climate change, it is not at all clear how the revenues will be spent. In addition, the governor has the ability to "borrow" from the fund to support the state's General Fund. And Gov. Jerry Brown is already doing this—he plans to borrow \$500 million to help balance the state's budget.³⁴ None of this makes for an easy argument that the auctions are a regulatory fee rather than a tax designed to raise revenue.

³⁴ J. Howard, "Brown taps cap-and-trade money." *Capital Weekly*, May 14, 2013 at <http://www.capitolweekly.net/article.php?xid=11fjqnp52905zjj>.

What Will Happen?

Without a crystal ball, we cannot predict what the courts will do. There are different paths the courts can travel. Perhaps the easiest and quickest is to find that the auctions are not authorized under the Act. If the courts find otherwise, they will then need to deal with the thorny issue of what the auctions are—a tax, a fee, property, or a regulatory tool.

Yet one thing seems certain, if the auctions do not survive legal challenge, cap-and-trade will almost certainly remain. The auctions are not essential to the program. Allowances can be distributed for free rather than auctioned off by the state. Once allowances enter the market, trading among regulated entities will set a price (most likely a lower price than was set by the auctions). Indeed, this may be what the regulated community is seeking. For many businesses, cap-and-trade is preferable to traditional command and control type pollution measures and even a carbon tax. A cap-and-trade program where the state does not auction off carbon allowances will be cheaper for business than one where the state gets to raise billions of dollars from the regulated community.

