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Expert Analysis

A Review Of Legal Challenges To California's Greenhouse Gas Cap-And-Trade Regulations

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As of Jan. 1, 2013, power plants and industrial facilities that emit greenhouse gases in California must comply with an emissions cap mandated by new regulations adopted by the California Air Resources Board. The regulations, which establish a California-based cap-and-trade program for greenhouse gas emissions, were adopted by CARB under authority granted to the agency by the Legislature under the 2006 Global Warming Solutions Act, Cal. Health & Safety Code § 38500.

California's cap-and-trade program is an extraordinarily ambitious effort to address the global problem of climate change, with far-reaching national and international implications. As such, ordinarily a slew of legal challenges would be expected. So far, though, the challenges have been few. Only two lawsuits have been filed challenging the cap-and-trade regulations, and both are narrowly focused on specific provisions of the regulations. However, a larger potential challenge to the regulations has yet to be raised; it is premised on the federal dormant Commerce Clause.

This article examines the two cases that have been filed and discusses a possible challenge based on the dormant Commerce Clause challenge. We conclude with a theory as to why there have not been more challenges, particularly from regulated entities.

CALIFORNIA CAP-AND-TRADE REGULATIONS

The Global Warming Solutions Act, Cal. Health & Safety Code § 38550, requires a reduction in greenhouse gas emissions in California to 1990 levels by the year 2020. Under the act, the Legislature provided CARB with considerable power and discretion to craft regulations to meet the objectives of the act. The act does not specifically mandate a cap-and-trade program for greenhouse gas emissions, but it requires CARB to consider market-based mechanisms when crafting its regulations. *Id.* at § 38570. After reviewing other options and analyzing public comments, CARB opted for a cap-and-trade approach and adopted regulations implementing the program that became effective in 2012. 17 Cal. Code Regs. § 95800.

The regulations cover major sources of greenhouse gas emissions, including power plants, refineries, large industrial facilities and fuels for transportation. Under the

cap-and-trade program, these sources will be allocated emission allowances, which at the end of specific compliance periods must be surrendered in amounts equal to emissions. Businesses can buy and trade allowances to meet compliance requirements.

The regulations also provide for the use of offsets. Offsets are voluntary reductions in greenhouse gas emissions made by entities that are not required to participate in the cap-and-trade program. These reductions can be used by regulated entities to meet their compliance requirements. Offsets are permitted under the act, but they must result in reductions in greenhouse gas emissions that are in addition to reductions in greenhouse gas emissions already required by law or that would otherwise occur. Cal. Health & Safety Code §§ 35862(d)(2) and 38571. This is referred to as the "additionality principle." CARB approved four different protocols, or types of offsets, which included two different protocols for planting trees, removal of methane from livestock operations and the destruction of ozone-depleting substances that are also greenhouse gases.

CARB also reserved for itself allowances that it will make available at auction. 17 Cal. Code Regs. §§ 95870, 95910-95914. CARB held its first auction Nov. 14, 2012. The first compliance period began Jan. 1.

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LAWSUITS CHALLENGING THE CAP-AND-TRADE REGULATIONS

Two lawsuits have been filed challenging the regulations. The first was filed by two environmental justice organizations, Citizens Climate Lobby and Our Children's Earth Foundation, challenging the offset protocols adopted by CARB as part of the cap-and-trade regulations. *Citizens Climate Lobby et al. v. Cal. Air Res. Bd.*, No. CGC-12-519544, *complaint filed* (Cal. Super. Ct., S.F. County Mar. 28, 2012). This lawsuit has been resolved in CARB's favor.

The second lawsuit, which is still pending, was brought by the California Chamber of Commerce and argued that the CARB-sponsored auctions of allowances are an unconstitutional tax. *Cal. Chamber of Commerce v. Cal. Air Res. Bd.*, No. 2012-80001313, *memorandum of points and authorities in support of verified petition for writ of mandate and complaint for declaratory Relief* at 12-13 (Cal. Super. Ct., Sacramento County Nov. 13, 2012).

The challenge to the use of offsets

Environmental justice organizations have been particularly critical of cap-and-trade. They support the mandate to cut greenhouse gases; however, they favor a carbon tax or so-called command-and-control type regulations over a cap-and-trade approach. To many within the environmental justice community, cap-and-trade simply continues to foster what they see as a disproportionate burden on poor communities and communities of color by industrial pollution. They also believe that cap-and-trade favors industry, is subject to gaming and cannot be adequately monitored. Even before the cap-and-trade regulations were adopted, an environmental justice organization known as the Association of Irritated Residents sued CARB over its endorsement of a cap-and-trade approach in its 2009 Climate Change Scoping Plan. *Ass'n of Irritated Residents v. Cal. Air Res. Bd.*, 206 Cal. App .4th 1487 (Cal. Ct. App., 1st Dist. 2012).

The scoping plan was mandated by the act, and its purpose was to outline strategies for achieving reductions in greenhouse gas emissions. Cal. Health & Safety Code § 38561. The Association of Irritated Residents raised a number of technical arguments to claim that CARB's choice of a cap-and-trade approach did not comply with the

act. The California 1st District Court of Appeal, however, found that the Legislature granted CARB broad discretion in implementing the act. *Ass'n of Irritated Residents*, 206 Cal. App. 4th at 1495. The court also found that CARB's scoping plan was based upon extensive technical expertise and review, as to which the court afforded great deference. *Id.* at 1502.

Given the challenge to the scoping plan, it was not surprising that the environmental justice organizations also sued CARB over its cap-and-trade regulations. The lawsuit brought by Citizens Climate Lobby and Our Children's Earth Foundation was narrowly focused on the four offset protocols. It challenged the protocols because CARB used a standards-based approach for determining additionality instead of determining additionality for each project. The petitioners claimed that a standards-based approach will allow for offsets credits that were in fact not additional. They also argued that offsets lack environmental integrity and will result in nothing but illusory reductions in greenhouse gas emissions.

Regulated entities expect offsets to play a critical role in reducing the costs of their compliance requirements. Indeed, several of California's largest investor-owned utilities intervened in the case in support of CARB. In addition, the Environmental Defense Fund and the Nature Conservancy, both of which have advocated for both cap-and-trade and the use of offsets for addressing global climate change, also intervened to support CARB.

The key issue for the court was the applicable standard of review: *de novo*, or arbitrary and capricious, or both. Was CARB acting in a quasi-legislative capacity, in which case the deferential arbitrary and capricious standard would apply? Or was the CARB interpreting the legislative intent behind the act, in which case the standard would be *de novo*? Noting that the crux of the petitioners' argument was that CARB had "expanded its power beyond what the act allows by using a standards-based approach," the court found that the *de novo* standard applies to the narrow question of whether the Legislature delegated to CARB the authority to adopt a standards-based approach for determining additionality. *Citizens Climate Lobby*, No. CGC-12-519544, statement of decision at 21-22 (Jan. 25, 2013).

The court, however, held that if use of a standards-based approach was authorized by the act, an arbitrary and capricious standard would apply to the remaining issues in the case. *Id.* at 22. Even applying the *de novo* standard, the court had no difficulty finding that the Legislature granted "vast discretion" to CARB, including the ability to decide what mechanism to use to determine additionality. *Id.* at 23. Once the court determined that the use of a standards-based approach was authorized by the act, it held that CARB had not acted arbitrarily and capriciously when it adopted the four offset protocols. *Id.* at 25-33. The court noted that it did not have the power to do what the petitioners were asking it to do, to "[r]ewrite the statute to forbid the use of offsets." *Id.* at 24.

Are auction proceeds an unconstitutional tax?

Under the cap-and-trade regulations, CARB is permitted to allocate to itself a portion of the allowances, which it can then sell to regulated entities at auction. 17 Cal. Code Regs. §§ 95870, 95910-95914. On Nov. 13, 2012, the California Chamber of Commerce filed a petition for a writ of mandate challenging this provision as inconsistent with the act and an impermissible revenue-raising device. *See Cal. Chamber of Commerce,* No. 2012-80001313, at 12-13. In its petition, the chamber claims that the auction of allowances will raise as much of $70 billion for the state. *Id.* at 13.

The chamber's argument has two parts. First, nothing in the act authorizes CARB to withhold allowances for itself and to auction those allowances to the highest bidder. *Id.* at 12-13. Second, the auctioning of CARB-allocated allowances is nothing more than a tax. *Id*. Under the California Constitution, tax increases must be approved by a two-thirds majority of the Legislature. Cal. Const., art. XIII A, § 3. Because the act did not pass by a two-thirds majority, the chamber argues that CARB's auctions are unconstitutional. In other words, the Legislature could not have delegated to CARB the authority to do something that is illegal. *Id.* at 3.

Of course, two courts have already found that the Legislature granted CARB considerable discretion to formulate regulations to reduce greenhouse gas emissions. Nevertheless, the question of whether CARB exceeded its discretion will be a central issue here. The outcome may well turn on whether the auctions are deemed a regulatory fee (which does not require a two-thirds vote of the Legislature) or a tax. To decide this issue, the court will need to apply the standard articulated by the California Supreme Court in *Sinclair Paint Co. v. Board of Equalization*, 15 Cal. 4th 866 (Cal. 1997). Under the court's test, to be a regulatory fee there must be a reasonable relationship between the amount of the fee and the burden placed on the payer, the fee cannot be an unrelated revenue-raising device and the remedial measures must have a causal connection with the fee payer's conduct. *Id.* at 876-81. The chamber argues that CARB's allowance auctions cannot meet this standard.

THE LOOMING COMMERCE CLAUSE CHALLENGE

The widely anticipated challenge to the cap-and-trade regulations which has yet to materialize is a federal action premised on a violation of the dormant Commerce Clause. The Commerce Clause grants to Congress the power to regulate interstate commerce. The U.S. Supreme Court has held that included within the Commerce Clause is a restriction on the ability of states to regulate interstate commerce. *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 550 U.S. 330, 338 (2007). This is the so-called dormant Commerce Clause: A state is prohibited from burdening, discriminating against or extraterritorially regulating interstate commerce. *See*, *id.*; *Healy v. Beer Inst.*, 491 U.S. 324, 336-37 (1989).

There is little question that the cap-and-trade regulations reach outside the state of California, particularly with respect to the generation of electricity. For example, does California impermissibly discriminate against some out-of-state suppliers of electricity in its application of a default emission standard for all unidentified out-of-state sources when it will be using actual emissions to regulate in-state generators that can be identified? 17 Cal. Code Regs. § 98512.

Or, does California's prohibition on the use of resource shuffling by importers of out-of-state electricity improperly regulate interstate commerce by barring the swapping of purchases from power plants with high greenhouse gas emissions with purchases from plants with low greenhouse gas emissions? 17 Cal. Code Regs. § 95852(b)(2). Both of these provisions are central to the effectiveness of the cap-and-trade regulations because they tackle the key issues of leakages and resource shuffling, which if not addressed could lead to significant illusory reductions in greenhouse gas emissions from out-of-state sources. These are but two examples. There are more. For example, CARB's issuance of allowances to in-state sources of greenhouse gases arguably discriminates against out-of-state sources. (For a discussion of how California's cap-and-trade regulations may violate the dormant Commerce Clause, *see* Thomas Alcorn, *The Constitutionality of California's Cap-and-Trade Program and Recommendations for Design of Future State Programs*, Mich. J. Envtl. & Admin. L., Vol. 3 (2013).

The key issue will be whether a court applies strict scrutiny or a balancing test to the cap-and-trade regulations. If California is deemed to be discriminating against out-of-state entities or regulating extraterritorially, strict scrutiny will apply, which can only be overcome by a showing that no less discriminatory means exist for achieving California's goal of reducing GHG emissions. *See United Haulers*, 550 U.S. at 338; *Healy*, 491 U.S. at 336-37, 340-41. On the other hand, if California is deemed to be regulating in-state and out-of-state activity evenhandedly, a balancing test will be applied that will weigh the state interests against the burden on interstate commerce. *Pike v. Bruce Church Inc.*, 397 U.S. 137, 142 (1970).

CARB has already been found to have run afoul of the dormant Commerce Clause with the adoption of its low carbon fuel standards, which were also enacted to reduce greenhouse gas emissions. In December 2011, a federal district court in California held that CARB's fuel standards impermissibly discriminated against, and extraterritorially regulated, out-of-state commerce. *Rocky Mountain Farmers Union v. Goldstene*, 843 F. Supp. 2d 1071, 1078-79 (E.D. Cal. 2011). The central issue was how the fuel standards were applied to corn ethanol fuels produced in the Midwest. This ruling, which is on appeal, certainly does not bode well for California's cap-and-trade regulations, yet, interestingly, no dormant Commerce Clause challenge has yet been raised.

WILL THERE BE MORE CHALLENGES?

Given the scope of CARB's cap-and-trade regulations, it is surprising that there have only been two legal challenges. The environmental justice community simply does not like cap-and-trade and would prefer a different regulatory approach for meeting the goals of the act. What is most curious is that the only challenge so far from the business community is the Chamber of Commerce case, which is narrowly focused. A challenge based on the dormant Commerce Clause challenge seems overdue, and may yet be brought. However, any successful assault on California's cap-and-trade regulations would not undermine the basic parameters of the act requiring California to cut its greenhouse gas emissions. Scrapping cap-and-trade may make the environmental justice community happy, but the regulated business community seems to prefer cap-and-trade over any of the alternatives.

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