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SUPERIOR COURT OF THE STATE OF CALIFORNIA

COUNTY OF SACRAMENTO

CALIFORNIA CHAMBER OF COMMERCE, et al.,

Petitioners/Plaintiffs,

v.

CALIFORNIA AIR RESOURCES BOARD, et al.,

Respondents/Defendants,

ENVIRONMENTAL DEFENSE FUND and NATURAL RESOURCES DEFENSE COUNCIL,

Respondent-Intervenors.

Case Nos.: 34-2012-80001313
34-2013-80001464
(related)

RESPONDENT-INTERVENORS' BRIEF IN OPPOSITION TO PETITIONS FOR WRITS OF MANDATE

Date: August 28, 2013
Time: 9:30 a.m.

Assigned for All Purposes to:
Hon. Timothy M. Frawley, Dept. 29

Actions Filed: November 13, 2012
April 16, 2013

MORNING STAR PACKING COMPANY, et al.,

Petitioners/Plaintiffs,

v.

CALIFORNIA AIR RESOURCES BOARD, et al.,

Respondents/Defendants,

ENVIRONMENTAL DEFENSE FUND and NATURAL RESOURCES DEFENSE COUNCIL,

Respondent-Intervenors.

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INTRODUCTION AND SUMMARY OF ARGUMENT

California is leading the nation in responding to the epochal challenge of climate change. In 2006, the Legislature adopted The Global Warming Solutions Act ("AB 32"), in which it mandated that statewide emissions of greenhouse gases ("GHGs") fall to their 1990 levels by 2020. The Legislature tasked the California Air Resources Board ("ARB") with developing a comprehensive regulatory program to reach that goal, and ARB, which has led California's path-breaking efforts to control automobile pollution since the 1960s, rose to that task.

ARB spent the next four years working with the public and outside experts to design complementary and cost-effective policies to reduce GHG emissions from numerous activities and industrial sectors. The backbone of those policies is the cap-and-trade program at issue here, which ARB designed to minimize the total cost of achieving emission reductions by creating an allowance trading market to identify the most cost-effective emission reductions within the covered sectors. The program establishes gradually more protective limits on overall emissions from many sources in the covered sectors. Cap-and-trade reduces the cost of compliance relative to traditional "command-and-control" regulation, a one-size-fits-all system in which regulators specify emission reductions that individual sources must achieve on-site.

ARB's program works by setting an annual cap on emissions from all regulated sources and creates a pool of tradable emission allowances equal to the total volume of emissions allowed under the cap. Every three years, sources subject to the cap must surrender to ARB enough allowances to cover their total emissions over the prior three-year period. The cap falls further each year, ensuring that emissions decline over time. By setting the cap and requiring each covered source to hold enough allowances to authorize their emissions, the program creates demand for, and scarcity in, the allowances. Those factors make the allowances valuable.

To create an emissions market, the regulator must somehow distribute those allowances. The design of a cap-and-trade program therefore presents an ineluctable choice

about who will receive these valuable emission allowances and how. There is no "natural" or inherent way to distribute allowances under a cap-and-trade regime; a choice must be made about how to do it. These facts bear repeating: allowances *inevitably* have value and someone must *inevitably* decide who receives that value and on what terms.

Petitioners' lawsuits attack ARB for making those inescapable choices. Based on scholarly research and experience with other cap-and-trade regulatory programs, ARB developed a system for distributing allowances with three components: (1) free allocation of many allowances, (2) sale of a portion of the allowances at auction, and (3) direct sale of a small quantity of allowances from a price containment reserve ("reserve"). ARB determined that a combination of distribution methods best satisfies policy criteria set out in the statute, which include ensuring equity and transparency, avoiding windfall profits, and encouraging early emission reductions, as well as facilitating the operation of a robust private market in emissions allowances.

Undoubtedly recognizing that the alternative of command-and-control regulation would be far more expensive for their constituents, Petitioners do not challenge the cap-and-trade program as a whole. Nor do they challenge ARB's decision to give away many of the allowances to emitters for free. Instead, they challenge "only" the auction and reserve—the parts of the program that allow regulated entities to purchase allowances from the state. (Petitioners appear untroubled by the fact that many entities will need to purchase allowances from other *private* parties.) In sum, Petitioners contend that the state's largest sources of GHG emissions are entitled to the windfall of free—but valuable—allowances. Petitioners' emphasis on the millions of dollars that regulated entities will pay for allowances at auction only underscores the scale of the windfall they seek. Because allowances have the same value however they are distributed, if ARB had given away the allowances that it instead decided to auction, it would have given away millions of dollars of value in the emission trading market to the largest contributors to the problem of climate change.

Petitioners' claims are plainly insubstantial. They contend that AB 32 and Proposition 13 demand that ARB give away all of the allowances for free—that the Legislature did not "authorize" ARB to distribute allowances by auction or through the reserve and that doing so "taxes" those who purchase the allowances.

Petitioners claim the Legislature did not authorize the auction or reserve, but they must show more than the absence of specific authorization. They concede that the Legislature authorized ARB to enact a cap-and-trade regulatory program. Because such a program necessarily requires *someone* to choose a method or methods to distribute allowances, Petitioners must show that the Legislature itself made that choice for ARB by prohibiting the use of an auction or reserve or affirmatively requiring that all allowances be given away. But Petitioners point to nothing in AB 32 that shows the Legislature decided how allowances must be distributed.

Quite the contrary. The Legislature plainly did not make that policy choice itself, but rather *expressly delegated* the choice to ARB by mandating that ARB "[d]esign the regulations, *including distribution of emissions allowances where appropriate*." (Health & Saf. Code § 38562(b)(1) (emphasis added).)[1] This unambiguous delegation is consistent with the Legislature's intention, reflected throughout the text and structure of the statute, to give ARB wide discretion to select the regulatory means to achieve the 2020 emissions limit that would best serve policy criteria enumerated in the statute. In fact, as Petitioners concede, the Legislature pointedly did not require ARB to adopt a cap-and-trade program at all; ARB could have adopted a traditional, and more expensive, command-and-control program. Because AB 32 left to ARB's discretion the choice and design of any cap-and-trade program, including the necessary distribution of allowances, Petitioners cannot show that the auction and reserve are unauthorized.

Nor have Petitioners even attempted to show that ARB's choice of distribution mechanisms was arbitrary and capricious, an implicit concession that it was not. In fact,

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[1] All further unattributed statutory references are to the Health and Safety Code.

ARB carefully designed the distribution of allowances to implement the policy criteria that AB 32 sets forth in addition to the 2020 emission limit. Petitioners are remarkably candid in dismissing as merely hortatory these criteria that the Legislature specified to guide ARB's selection of regulatory devices.

Petitioners' Proposition 13 argument—that the auction and reserve impose "taxes" subject to a supermajority voting requirement—fares no better. Though they have the burden of proving that the auction and reserve impose taxes, they do not even attempt to make that showing but instead hoist and attack a straw man: they argue that the auction and reserve do not impose valid "regulatory fees," one of the several categories of charges that courts have held do *not* constitute taxes. Petitioners cannot prove an affirmative conclusion (the auction and reserve impose taxes) based solely on a negative premise (the auction and reserve do not impose regulatory fees).

In fact, neither the auction nor the reserve shows any of the indicia of taxation. First, they were not developed for the purpose of increasing state revenue. By its terms, Proposition 13 applies its supermajority approval requirement only to charges adopted for that purpose. The auction and reserve were designed for purely regulatory purposes: to distribute allowances in a way that avoids problems associated with free allocation, serves the needs of a robust market in allowances, and advances additional policy goals articulated in AB 32. Petitioners have done nothing to show that ARB's purpose was to increase state revenue.

Second, unlike all taxes, neither the auction nor reserve is compulsory. Regulated entities have several options for complying with the cap-and-trade rule that do not involve the auction or reserve, including reducing emissions, purchasing allowances from third parties, using banked allowances from prior years, and purchasing emission offsets (instruments that evidence voluntary emission reductions from outside the capped industrial sectors). There is no penalty whatsoever for failure to participate in the auction or reserve. Moreover, several financial firms, which are not subject to the cap-and-trade rule, have *voluntarily* purchased allowances through the auction. No one volunteers to pay a tax.

Third, unlike taxes, which offer no direct benefit to the payors, the auction and reserve provide participants something of value in exchange for the purchase price: tradable emission allowances. They may be used for current emissions compliance, banked for future compliance, or sold, each of which offers value to the holder. In this respect, a purchaser of allowances from the auction or reserve is more like a purchaser of state property than it is like a taxpayer.

Finally, Petitioners have pointed to no case in which a court has invalidated any comparable payment as a tax or even suggested that they might be considered taxes. Lacking any precedent to support their tax claim, Petitioners' claim runs afoul of our Supreme Court's holding that Proposition 13 should not be lightly extended to invalidate duly adopted public policies. (See *City and County of San Francisco v. Farrell* (1982) 32 Cal.3d 47, 52.)

In sum, ARB's decision to include the auction and reserve—alongside free allocation—in its system for distributing emissions allowances under the cap-and-trade regulatory program reflects a conscientious response to the Legislature's direction that ARB "design" a program for the "distribution of emissions allowances." ARB, in its expert judgment, determined that this combination of distribution methods would best serve the policy goals identified in the statute and the smooth functioning of the market it was establishing. Nothing in the stack of briefs Petitioners have filed shows that the Legislature objected to that result or had other ideas about the appropriate way to distribute emission allowances.

Nor have Petitioners borne their burden of showing that the auction and reserve impose unconstitutional "taxes." They point to no comparable program that any court has ever invalidated as a violation of Proposition 13. Nor can they identify any case finding a sub rosa tax in a *voluntary* payment made as part of a transaction where the payor receives a direct benefit with monetary value.

While Petitioners understandably prefer that allowances be distributed to them or their members for free, they have offered no *legal* basis for this Court to invalidate a core

component of the quasi-legislative program that ARB developed to respond to one of the most pressing challenges of our time.

The Court should deny all of Petitioners' requested relief.

BACKGROUND

A. The Legislature Passed AB 32 to Address the Serious Threat Climate Change Poses to the Economic Well-Being, Public Health, Natural Resources, and Environment of California.

California is already experiencing the impacts of climate change. (See generally AR Add. A:31482-31681.)[2] "Sea levels have risen by as much as seven inches along the California coast over the last century, increasing erosion and pressure on the state's infrastructure, water supplies, and natural resources" and leaving almost half a million Californians at risk of displacement. (*Id.* at 31486.) Higher average temperatures have resulted in more heat waves and extreme weather events, while wildfires have become more frequent and more intense due to longer dry seasons. (*Ibid.*)

Absent mitigation policies such as AB 32, those impacts "threaten[] the health and well-being of all Californians." (*Id.* at 31513.) If current emissions trajectories hold, California could lose as much as 90 percent of the Sierra snowpack and experience a 55 inch rise in sea level by the end of the century. (*Id.* at 31548.) "The state's water supply, already stressed under current demands and expected population growth, will shrink under even the most conservative climate change scenario." (*Id.* at 31486.) Increased heat waves will exacerbate heat-related deaths and illnesses, in particular for the poor and elderly. (*Id.* at 31514.) Higher average temperatures will also increase the formation of ground-level pollutants and smog from chemicals in the atmosphere, aggravating public health risks for the millions of Californians who already experience "the worst air quality in the

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[2] The Administrative Record is divided into parts A through I. Citations to the record are in the format [part]:[Bates number.]. Citations to the Addendum to the record are indicated by the prefix "Add. A" or "Add. B" in place of the part.

nation, with annual health and economic impacts estimated at 9,000 deaths and $60 billion per year." (AR Add. A:6071.)

Unmitigated climate change will also translate into significant economic costs for California. More than half of the state's $4 trillion in real estate assets are at risk from extreme weather events, sea level rise, and wildfires. (AR Add. A:31486.) Increased droughts, floods, and heat waves threaten California's agricultural productivity, a pillar of the state economy. (*Id.* at 31575.) In the Central Valley alone, where limited riverbed capacity exacerbates flood risk, the costs of controlling and repairing flood damage could reach several billion dollars. (AR Add. A:23757.) Loss of snow cover in the Sierras could reduce annual revenue of the winter sport industry by $1.4 billion (2006 dollars) annually by 2050, translating into a loss of over 14,000 jobs. (*Id.*)

The Legislature adopted AB 32 to mitigate these threats to California's citizens, economy, and natural resources "by placing California at the forefront of national and international efforts to reduce emissions of greenhouse gases." (§ 38501(c).)

B. The Legislature Delegated Broad Authority to ARB to Design the Most Effective Regulatory Tools to Achieve AB 32's Statewide Emissions Limit While Balancing Multiple Statutory Criteria.

AB 32 commits California to reduce statewide GHG emissions to 1990 levels by 2020 while minimizing costs and maximizing benefits—economic, environmental, and public health—to Californians. The Legislature designated ARB to implement the statute and delegated to the agency broad authority to design and implement a package of regulations to meet the statewide emissions limit. (§§ 38550, 38510; *Association of Irritated Residents v. California Air Resources Bd.* (2012) 206 Cal.App.4th 1487, 1495 ("*AIR*") [AB 32 "leave[s] virtually all decisions to the discretion of the Board...."].) The Legislature directed ARB to consult with other jurisdictions, academic experts, the environmental justice community, and industry and business stakeholders to identify and develop the most effective strategies to reduce GHG emissions and to review and update these strategies every five years. (§§ 38501(f), 38564.)

In selecting among the available regulatory tools and strategies, ARB must balance a set of nine diverse policy criteria, including cost-effectiveness, recognizing and encouraging early emission reductions, avoiding disproportionate impacts on low-income communities, and maximizing overall societal benefits, "to the extent feasible and in furtherance of achieving the statewide greenhouse gas emissions limit." (§ 38562(b)(1)-(9).)

The Legislature also explicitly delegated to ARB the option to adopt a "market-based compliance mechanism."[3] (§ 38570.) AB 32 defines "market-based compliance mechanism" broadly to include "a system of market-based declining annual aggregate emissions limitations for sources or categories of sources that emit greenhouse gases." (§§ 38505(k)(1), 38561(b), 38562(c).) As Petitioners concede, in authorizing ARB to adopt a "market-based compliance mechanism," the Legislature authorized, but did not require, ARB to adopt a cap-and-trade program. (Morning Star Brief ("MS Br.") at 20:21-22; California Chamber of Commerce Brief ("Chamber Br.") at 2:1-5, 4:15-18, 30:14-15; National Association of Manufacturers Brief ("NAM Br.") at 7:10-12.)

The Legislature also specifically authorized ARB to develop regulations for the distribution of allowances in the event it adopted a cap-and-trade program:

> The state board shall ... [d]esign the regulations, including the distribution of emissions allowances where appropriate, in a manner that is equitable, seeks to minimize costs and maximize total benefits to California, and encourages early action to reduce greenhouse gas emissions.

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[3] Ever since Congress enacted a cap-and-trade program as part of the 1990 Clean Air Act amendments, which resulted in substantial and efficient reductions in acid rain caused by SO_2 emissions, such programs have become a well recognized means of achieving cost-effective pollution reductions for greenhouse gases. (AR Add. A:2050-002051 [describing programs adopted or proposed in the European Union, three regional consortia of U.S. states and Canadian provinces, and proposed federal climate change legislation].) Since ARB adopted the cap-and-trade rule, additional jurisdictions around the world have developed new cap-and-trade programs to cost-effectively cut climate pollution. (See generally World Bank, *Mapping Carbon Pricing Initiatives* (May 2013) (available at http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2013/05/23/000350881_20130523172114/Rendered/PDF/779550WP0Mappi0til050290130morning0.pdf) [describing cap-and-trade programs in place or in development in China, South Korea, Australia, Quebec, Tokyo, and Kazakhstan].)

(§ 38562(b)(1).) The Legislature thus approached the "distribution of emissions allowances" in the same manner it approached the other regulatory decisions delegated to ARB in AB 32: it established the regulatory outcome and set broad policy criteria, but gave ARB the responsibility to select and design the most appropriate regulatory tools based on consideration of policy criteria set out in the statute.

C. ARB Developed the Cap-and-Trade Program and Auction Mechanism Through an Extensive Public and Expert Consultative Process That Carefully Considered AB 32's Multiple Policy Criteria.

The element of the cap-and-trade program that Petitioners challenge is the product of many years of public proceedings. (See generally AR C:486.) ARB convened four expert economic panels and an environmental justice advisory committee to advise it on policy design and implementation. ARB's policy development process included (1) developing a comprehensive Scoping Plan consisting of more than twenty discrete emission reduction measures (including the cap-and-trade program) and establishing the overall AB 32 regulatory framework, (2) engaging with member states and provinces of the Western Climate Initiative[4] to develop joint principles and recommendations on cap-and-trade design and best practices, and (3) conferring with other jurisdictions using cap-and-trade programs such as the Northeastern states involved in the Regional Greenhouse Gas Initiative ("RGGI")[5] and the European Union.[6] (AR Add. A:23756; 23771.) ARB held approximately 40 publicly noticed meetings and hearings to develop the cap-and-trade regulation alone. (AR Add. B:1070.)

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[4] The Western Climate Initiative included seven U.S. states and four Canadian provinces working together to create a regional approach to greenhouse gas reductions, which included developing recommendations and best practices for cap-and-trade design. (AR Add. A:23762.)

[5] RGGI is a collaboration between nine Northeastern states to limit GHG emissions from large electric power plants using a cap-and-trade program which began in 2009. (AR Add. A:24566.) ARB staff designed the California auction to closely resemble the auction used by RGGI. (AR C:80.)

[6] The European Union developed the world's first emissions trading program for carbon dioxide, which began in 2005. (AR Add. A:2376.)

1. A Cap-and-Trade Program Creates Emissions Allowances That Have Economic Value Regardless of How They Are Initially Distributed.

Any cap-and-trade program, by its nature, creates valuable allowances that must somehow be distributed—and the methods of distribution have important real-world effects. A cap-and-trade program establishes an enforceable and declining aggregate limit ("cap") on emissions from regulated sources. (See, e.g., AR C:1854.) Each source must, at periodic intervals, turn in an emissions allowance (or offset[7]) for every ton of pollution it emits. Because allowances can be traded and the cap predictably declines over time, the market ensures that the most cost-effective emission reduction opportunities are captured and provides a reliable economic incentive for innovation in emission reductions. (AR C:26.)

A cap-and-trade program thus creates value associated with the emissions allowances. (AR C:1719.) The supply of allowances is set by the cap. Demand is set by the quantity of emissions generated by capped emitters, because emitters must turn in an allowance for every ton they emit. The interaction between allowance supply and demand in the market sets the allowance price. Because allowances are a finite resource, as long as capped entities are generating emissions, allowances have an inherent value determined by the emissions market. (See AR Add. A:6120.)

2. ARB Consulted with a Range of Expert Bodies Which Recommended that ARB Rely on Auctioning as a Means of Distributing Allowances in the Cap-and-Trade Program.

Throughout ARB's consideration of the cap-and-trade program, the question of how to distribute emissions allowances was a prominent and controversial topic of expert analysis, public comment, and agency consideration. (See generally AR H:733-857, 1737-1826, 2476-2543; AR C:1714.) The two primary methods for distributing allowances are to give them away for free (to regulated sources or other entities or individuals) or to sell them via

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[7] Offsets are "credits" that can be used like allowances and that are generated from emission-reduction projects from sources outside the capped industrial sectors. (AR C:26.)

an emissions auction. (AR C:1858.) The diverse groups of experts consulted were unanimous in recommending that ARB include an auction component as an important element of a well-designed cap-and-trade program, citing reasons that correspond to the policy criteria mandated by the Legislature in AB 32. The Market Advisory Committee[8] report found that objectives of cost-effectiveness, fairness, and simplicity "favor a system in which California ultimately auctions all of its emissions allowances." (AR C:1576.) The Economic and Technology Advancement Advisory Committee ("ETAAC")[9] found "general agreement that some level of auctioning will be necessary" to foster early action, innovation, and clear price signals. (AR Add. A:7772.) And the Western Climate Initiative's design recommendations noted that both the EU and RGGI relied on some level of auctioning (most RGGI states utilize 100 percent auctioning; (See AR C:1656-57)) and advised that jurisdictions participating in the Western Climate Initiative should also "auction allowances as one component of allowance distribution." (AR C:1656.)

Finally, the Economic and Allocation Advisory Committee ("EAAC"), an expert panel of economists convened by ARB to evaluate and recommend on allowance distribution options that would best comport with the AB 32 policy criteria, recommended that ARB "rely principally, and perhaps exclusively, on auctioning" as the means of distributing allowances. (AR C:1850.)

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[8] The Market Advisory Committee was convened by the Secretary of the California Environmental Protection Agency in 2007, in advance of ARB's developing the Scoping Plan, to provide expert advice to ARB on developing a cap-and-trade program. (AR C:726.) It included a range of market experts with ties to government, non-profits, businesses, and academia. (AR C:1521.)

[9] Formation of the ETAAC was required by AB 32 and the committee issued a final report in 2008. (§ 38591(d); AR Add. A:7583-7889.)

3. ARB Designed the Distribution of Emissions Allowances to Implement AB 32's Express Policy Criteria.

After considering the input from stakeholders and experts and lessons learned from the experience of existing cap-and-trade programs,[10] ARB concluded that a mix of three emissions distribution methods would best serve AB 32's statutory objectives. ARB will (1) distribute a substantial portion (initially more than half) of the allowances at no cost to regulated entities, (2) sell a small portion of allowances from a strategic price containment reserve, and (3) sell the remainder of allowances through an auction. (AR C:68.) ARB designed each distribution method to meet the policy criteria that the Legislature established in AB 32.

a. ARB Distributed a Portion of Emissions Allowances Directly to Covered Sources to Provide Transition Assistance and Mitigate Leakage Risk.

ARB provided regulated entities with a significant free allocation at the beginning of the program to ease their transition into the program and free up capital for investments in pollution abatement technologies that will generate long-term reductions. (AR C:68; see also § 38562(b)(8).) The industrial sector, for example, will receive approximately 90 percent of the allowances needed to comply absent additional steps to reduce emissions during the first two years of the program. (AR C:68.)

Regulated sources face "leakage risk" if market dynamics prevent them from incorporating the price of carbon in their goods because competitors in other jurisdictions are not subject to comparable emission reduction requirements. Absent protection, this can precipitate a shift in demand away from goods produced in the regulating jurisdiction to-

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[10] The Clean Air Act requires the SO_2 trading program to freely allocate most allowances, and that rigid commitment to free allocation made it difficult for program administrators to respond to unexpected events. (AR C:1863; see also *supra* note 3.) After the first phase of the EU's cap-and-trade program (2005-2007), windfall profits led experts to call for increased auctioning in future years. (AR Add. A:2376.) AB 32 requires ARB to consult with other jurisdictions "to identify the most effective strategies and methods to reduce greenhouse gases." (§ 38564.)

ward goods produced elsewhere – resulting in a shift in production and emissions out-of-state called "emissions leakage." (AR C:1801, 1910.) ARB completed a detailed analysis of each regulated sector's leakage risk and provided sufficient free allowances to entities in each sector to minimize that risk. (§ 38562; AR C:1786-1844; Cal. Code. Regs. tit. 17, § 38570, Table 8-1.)

In addition, in the electricity sector, ARB allocated allowances to electrical distribution utilities on behalf of their customers. (Cal. Code. Regs. tit. 17, § 95892.) Unlike the industrial sector, the utilities' ability to raise rates to reflect the carbon price is controlled by regulators. Investor-owned utilities are allocated allowances at no cost, but they must auction all of those allowances and use the proceeds for the exclusive benefit of their customers, subject to guidance from the California Public Utilities Commission. (*Ibid.*) Publicly-owned utilities may elect to use freely allocated allowances directly for compliance or consign them to auction, under the oversight of their local governing boards. (*Ibid.*)

b. ARB Directed a Portion of Allowances into a Strategic Price Containment Reserve to Minimize Compliance Costs for Regulated Entities.

ARB distributed four percent of the emission allowances created under the cap into a price containment reserve. The reserve provides a form of insurance for the allowance market—and with it regulated entities and the economy at large—against "unexpectedly short supply or high prices." (AR C:1726.) Three weeks after each quarterly auction, allowances will be available at fixed prices during a reserve sale. (AR C:68-69.) A small percentage of allowances are set aside from each compliance period to populate the reserve. (*Ibid.*) Unlike the general auction, only regulated entities may purchase allowances through the reserve sale, ensuring that reserve allowances are available only to sources facing compliance costs. (Cal. Code. Regs. tit. 17, § 95913(c)(1).)

c. ARB Designated the Remaining Emissions Allowances for Auction to Advance the Purposes of AB 32.

Emissions allowances that are not distributed for free to regulated entities or placed in the price containment reserve are sold in quarterly auctions. (AR C:73.) ARB estab-

lished auctioning as the default mechanism for distributing allowances because auctions advance the AB 32 policy criteria by promoting *inter alia* equity among stakeholders and participants, fostering transparency, and encouraging early action to reduce emissions. (See AR C:73 [noting that "Staff recommends that these [auction] revenues be used primarily for the protection of California's consumers and to further the goals of AB 32."]; AR C:68.)

Avoiding windfall profits is an important equity consideration in the design of a cap-and-trade program. (See AR C:1863.) Absent other restrains, capped entities will pass the cost of compliance on to their customers. Where capped entities receive allowances for free and use them for compliance, they can often still pass along to customers the opportunity cost of foregoing the sale of the allowances at market. If allowances are allocated freely and their "cost" is still passed along to customers, then the capped entity earns windfall profits. (See, e.g., AR C:1720-21.) Windfall profits occurred in the electricity sector under the European Union's Emissions Trading System and can occur in any sector where the opportunity costs of not selling allowances received for free can be passed on to consumers. (AR C:1577.)

Auctioning also encourages early action, see § 38562(b)(1), by rewarding firms that voluntarily reduced emissions before the cap was put in place. (See, e.g., AR C:1582 ["If allowances are auctioned, early action may provide its own rewards by reducing the number of allowances a firm must purchase once the cap and trade program is in place."]; see also AR C:1862).

Auctions also provide critical market information to ARB, regulated entities, and other stakeholders and thereby promote market efficacy. As the economic experts who advised ARB on this question concluded, "auctioning is an especially transparent mechanism for allowance distribution." (AR C:1850.) Auctions facilitate "price discovery," a clear signal to the market of the prevailing cost of reducing a ton of carbon. (*Ibid.*) Additionally, "auctioning treats new entrants and existing emitters on a level playing field" in terms of access to needed allowances. (AR C:1579; see also AR C:1862.)

The auction mechanism also allows ARB to set a minimum price for allowance sales,[11] which promotes several AB 32 policy objectives. A stable minimum allowance price gives technology developers and innovators a guaranteed minimum price for products that reduce emissions. (AR C:81.) Similarly, entities developing offset projects—emission reduction projects in uncapped sectors that generate emission reduction credits that can be sold to capped entities and used for compliance with the emission cap—know that if they can reduce emissions at a cost below the floor price, they will also have a market for their offsets. (*Ibid.*) And by selling allowances for future compliance years, auctioning helps set a long-term price signal for the market and allows businesses to plan ahead with more certainty. (AR C:1727.)

Proceeds from the auctions can be used directly to further statutory emission reduction requirements in ways that fulfill policy objectives such as benefiting low-income communities, improving air quality, increasing energy diversification, transforming California into a low-carbon economy, and increasing technological innovation. (§§ 38501(h), 38562(b); AR C:73-74.) As explained below, in 2012, after ARB adopted the final cap-and-trade program with an auction component, the Legislature passed three bills restricting the use of auction proceeds to activities that further the regulatory purposes of AB 32. (Stats. 2012, ch. 39 (Senate Bill No. 1018, codified at Gov. Code §§ 16428.8-16428.95); Stats. 2012, ch. 807 (Assem. Bill No. 1532, codified at Health & Saf. Code § 39712); Stats. 2012, ch. 830 (Senate Bill No. 535, codified at § 39711).)

[11] The floor price started at $10 per ton in 2012 and increases by five percent plus inflation each year thereafter. (§ 95911(c).)

ARGUMENT

I. The Legislature Did Not Decide How Emissions Allowances Are to Be Distributed, but Rather Left That Decision to ARB's Discretion.

Petitioners concede that AB 32 authorized ARB to adopt a cap-and-trade program to regulate GHG emissions. (See Chamber Br. at 2:1-5; MS Br. at 20:21-22.)[12] Petitioners also do not contest that a cap-and-trade program inevitably requires that emission allowances be distributed in some manner; a market in allowances cannot exist if market participants have no allowances to trade. (See Chamber Br. at 28:23-29:2 [arguing that auctioning is not necessary because free allocation is available].)

The remaining question, then, is whether the Legislature has specified the manner in which that distribution must occur. Petitioners *assume*, but never demonstrate, that the Legislature made that decision in AB 32 and required that all of the valuable allowances created by the cap-and-trade program be freely given away—and to regulated entities. But Petitioners' assumption is not merely unsupported, it contradicts the statute: AB 32 *expressly* delegates that very decision to ARB.

But even without that express delegation, ARB would have faced an inevitable choice of how to distribute allowances because the Legislature did not make that choice itself. Petitioners can displace the judgment that ARB reached—a combination of free allocation, auctioning, and reserve sales—only by showing that it was arbitrary and capricious. They cannot, and have not even attempted to, do so.

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[12] While Petitioners seek to portray their challenge as limited to only peripheral aspects of the cap-and-trade program, in fact the auction is a central part of the program: As demonstrated below, ARB found that an appropriately designed use of the auction device would further a variety of key statutory objectives, and would make the emission trading system itself function more effectively, transparently, and fairly. Petitioners' attack on the program is thus no interstitial or technical challenge, but another effort to derail AB 32's implementation, brought only after repeated efforts to achieve such derailment in the legislature and through the ballot initiative process have failed.

A. Any Cap-and-Trade Program Creates Allowances with Monetary Value and Inevitably Presents a Choice About How to Distribute Those Valuable Allowances.

Petitioners represent interests that favor the distribution of emissions allowances to them for free. They cast that preferred distribution policy as a natural, default approach and contrast ARB's chosen policy as a deviation from that supposed default. (See, e.g., Chamber Br. at 7:16-17, 8:1 [introducing free allocation to covered entities as "run-of-the-mill" then describing the auction and reserve as ARB distributing allowances "to itself"].) But neither AB 32 nor the theory or practice of cap-and-trade program design offers a "natural" or "default" method of distributing allowances. The choice of such a method, or methods, is just that—a *choice*—that inevitably involves competing public policy considerations. Petitioners are simply dissatisfied with the policy choices that ARB made.

Petitioners do not claim that ARB lacked authority to adopt a cap-and-trade program with an annually declining emissions cap that requires emitters to hold allowances which, in total, authorize emissions equal to the cap. (See MS Br. at 20:21-22; Chamber Br. at 2:1-5; NAM Br. at 15:20-23.) Such an emissions trading program necessarily involves creation of emission allowances that can be used or traded. (See *supra* Background C.1.) And those allowances necessarily have value in the market. (*Ibid.*) Regulated entities can submit allowances in lieu of reducing their emissions, saving them the cost of making the reductions. (*Ibid.*) Entities that can cheaply reduce their emissions can sell allowances to others for whom emission reductions are more expensive. (See MS Br. at 10 [describing the value of allowances as a function of the opportunity cost of emission reduction].) The allowances' value is generated by the policy decision to cap emissions, which creates demand for allowances and scarcity of available allowances. (See *supra* Background C.1.) In sum, a cap-and-trade program necessarily creates allowances that have monetary value.

In designing any emissions trading program, policymakers must decide how to initially distribute the emissions allowances. That distribution thus determines who receives the allowances' value and accordingly raises questions of program efficacy, economic effi-

ciency, and equity. (See *supra* Background C.1.) Accordingly, allowance distribution has widely been recognized as one of the central policy design challenges in any cap-and-trade system, and it received exhaustive attention in ARB's rulemaking.[13] (See *supra* Background C.2.)

ARB designed a hybrid system of allowance distribution: free allocation, auctioning, and sale from the reserve. (See *supra* Background C.3.) Petitioners challenge some, but not all, of the policy choices ARB made in designing that system. They do not challenge ARB's decision to freely grant many of the allowances to regulated entities. But they never attempt to explain why *that* particular method is legally justified under AB 32 but all methods in which regulated entities must pay for the initial distribution of allowances are not.

Rather, Petitioners' arguments are based on an unstated, undefended, and incorrect assumption that the sale of allowances means forcing regulated entities to pay for something to which they are already entitled. But emissions allowances confer rights to use a *public resource*—the atmosphere's limited capacity to assimilate GHGs. No one has a right to pollute the air and thereby harm others, and thus no one is entitled to receive allowances authorizing emissions. (See *Communities for a Better Environment v. South Coast Air Quality Management Dist.* (2010) 48 Cal.4th 310, 324 [air emissions permit gave facility "no vested right to *pollute the air* at any particular level" (emphasis in original)]; *Sherwin-Williams Co. v. South Coast Air Quality Management Dist.* (2001) 86 Cal.App.4th 1258, 1273 [paint companies "cannot assert a property right to emit" pollutants]; *Mobil Oil Corp. v. Superior Court* (1976) 59 Cal.App.3d 293, 305 ["it is manifest the Oil Companies' right

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[13] Moreover, although auctions of carbon allowances are a relatively recent development, familiar regulatory programs at the federal, state, and local levels rely on auctions to distribute scarce resources, such as oil and gas leases, taxi medallions, grazing rights, timber rights, pollution permits, and fishing rights. (See AR C:1580; see also Afualo and McMillian, "Auctions of Rights to Public Property," *The New Palgrave Dictionary of Economics and the Law*, Vol. 1 (1998) pp. 125-129; 47 U.S.C. §§ 309(j), 337(a) [authorizing FCC to auction electromagnetic spectrum].)

to continue releasing gasoline vapors into the atmosphere is neither fundamental nor vested"].) Indeed, Petitioners never explain why regulated entities must receive 100 percent of the allowances—and their cash value—rather than, for example, low-income communities, organizations conducting research into carbon abatement strategies and technologies, or entities generating carbon-free energy. Petitioners' exclusive focus on the auction mechanism ignores the fact that allowances could be freely distributed to non-regulated entities, who can then sell them into the allowance market. (AR C:1858 [explaining that "free allocation can also be employed to provide allowance value to other parties [besides regulated entities]; these parties can subsequently convert this allowance value into cash by selling the allowances to the compliance entities."].)

Indeed, for all their strongly worded attacks on ARB's decision to employ auctions as part of its allowance-distribution approach, Petitioners conspicuously avoid any reference to the text or policies of AB 32 to justify *their* preferred distribution methodology. In fact, nothing in AB 32 even arguably commands ARB to give away emission allowances to regulated entities.

Moreover, AB 32 did not compel ARB to adopt a cap-and-trade program at all. (See MS Br. at 20:21-22.) The statute gives ARB the discretion to adopt a command-and-control regulatory program under which ARB would compel all or a subset of GHG sources to individually reduce their emissions. Had ARB done so, regulated entities would face higher compliance costs than under the cap-and-trade program, in which allowances can be purchased when they are cheaper than reducing emissions on-site. And they would have no claim that ARB had overreached in imposing those costs on them. Just as regulated entities have no right to be free from the cost of directly reducing their GHG emissions at the source, they have no right to receive for free the valuable emission allowances that enable them to avoid that cost.

B. The Text and Structure of AB 32 Demonstrate That the Legislature Delegated to ARB the Inevitable Choice of How to Distribute Emission Allowances.

Any cap-and-trade program presents a choice about how to distribute emission allowances. Just as the Legislature in enacting AB 32 did not choose a cap-and-trade program over other potential regulatory means to achieve its ends, it did not choose how allowances would be distributed under a cap-and-trade program. Rather, as the text and structure of AB 32 make clear, the Legislature left both choices to ARB's expert discretion.

1. ARB's Determination That AB 32 Allowed It to Distribute Some Allowances Through the Auction and Reserve Is Entitled to Deference.

As described below, AB 32 unambiguously leaves to ARB the choice of how emission allowances are to be distributed. But even if there were some uncertainty about whether the Legislature intended to dictate how allowances would be distributed, ARB's interpretation of the statute would be entitled to great deference.

In a recent case involving another air pollution control rule, the California Supreme Court held that a court must "accord[] great weight and respect to the administrative construction." (*American Coatings Assn., Inc. v. South Coast Air Quality Dist.* (2012) 54 Cal.4th 446, 461.) The degree of deference is "situational," but "greater weight may be appropriate when an agency has a 'comparative interpretive advantage over the courts,' as when 'the legal text to be interpreted is technical, obscure, complex, open-ended, or entwined with issues of fact, policy, and discretion.'" (*Ibid.* (internal quotation marks omitted).) Accordingly, if there is doubt about such a statute's meaning, a court must "defer to the [agency's] reasonable construction." (*Id.* at 469.)

Moreover, the *American Coatings* Court held that, in some circumstances, the Legislature "has *delegated* the task of interpreting or elaborating on a statute to an administrative agency." (54 Cal.4th 446, 461 (emphasis in original).) Such delegation need not be explicit, but may be found "when the Legislature employs open-ended statutory language that an agency is authorized to apply or when an issue of interpretation is heavily

freighted with policy choices which the agency is empowered to make." (*Ibid.* (internal quotation marks omitted); see also *R. L. Management Co. v. Nagel* (1997) 58 Cal.App.4th 1285, 1290 ["The degree of deference is highest in the case where the administrative agency has embodied its construction of the statute in a regulation."].)

The present case lies at this far end of the spectrum of deference. Although AB 32 is not especially "obscure," its subject is very much "technical" and "complex," and its delegation to ARB is unquestionably "open-ended" and "entwined with issues of fact, policy, and discretion." As described below, the Legislature granted ARB wide latitude to choose regulatory means to achieve the statute's 2020 emissions limit, including balancing an array of broadly worded statutory objectives. (See *infra* Argument I.B.3.) Moreover, the decisions about how to design a regulatory regime to reduce GHG emissions from an economy of California's size and diversity are necessarily "complex" and "technical." (See *AIR*, *supra,* 206 Cal.App.4th 1487, 1502 [holding that "it is not for the court to reweigh the conflicting views and opinions that were expressed on the[] complex issues" that ARB considered during an exhaustive public process].)

Although AB 32 is clear in delegating virtually all of the specifics of a GHG regulatory program to ARB—including, most importantly, the "design" of methods to distribute emission allowances *if* ARB decided to adopt a cap-and-trade program—the Court should resolve any remaining uncertainty in favor of ARB's interpretation, informed as it is by ARB's "expertise and technical knowledge." (*American Coatings*, *supra*, 54 Cal.4th 446, 469.)

2. AB 32 Explicitly Delegated to ARB the Responsibility to "Design" Methods for "Distribution of Allowances" if It Adopted a Cap-and-Trade Program.

AB 32 authorized ARB to adopt "market-based compliance mechanisms," including a cap-and-trade program, though it did not mandate such a program. (See *supra* Background B.) Contrary to Petitioners' assumption, the Legislature did not decide how allowances would be distributed under such a program. Rather, the statute expressly empowers

ARB to decide how best to distribute allowances and provides criteria to guide that choice. It directs ARB to "design the regulations, *including distribution of emissions allowances where appropriate*, in a manner that is equitable, seeks to minimize costs and maximize the total benefits to California, and encourages early action to reduce greenhouse gas emissions." (§ 38562(b)(1) (emphasis added).) ARB's choices must be designed to avoid disproportionate impacts on low-income communities; reward early action; consider "cost-effectiveness" and "overall societal benefits," and minimize administrative burdens and emissions leakage. (§ 38562(b)(2)-(8); see also § 38570(b).)

Petitioners fail to show that the Legislature's direction to ARB to "design" the "distribution of allowances" refers solely to free allocation to regulated entities. Nor could they: whether given an ordinary or technical meaning, "distribution of allowances" could refer to a variety of mechanisms including free allocation (to regulated entities or others), direct sale, or auctioning. (See *City of Alhambra v. County of Los Angeles* (2012) 55 Cal.4th 707, 718-19 [statutory terms should be given "ordinary and usual meaning"]; *Yassin v. Solis* (2010) 184 Cal.App.4th 524, 531-32 ["In the absence of legislative intent to the contrary, or other overriding evidence of a different meaning, technical terms or terms of art used in a statute are presumed to have their technical meaning." (fn. omitted.)]

In its ordinary sense, "distribution" includes auctioning and other means of sale. Numerous California cases in a variety of commercial contexts use forms of the word "distribute" to refer to the sale of products or property, such as the distributor of a product who sells that product to retailers or end users. (See, e.g., *Johnson v. Ford Motor Co.* (1980) 35 Cal.4th 1191, 1202 [discussing "automobile distributors"]; *Guild Wineries & Distilleries v. J. Sosnick & Son* (1980) 102 Cal.App.3d 627, 645, fn. 4 [noting a "dual distribution system markets a product through two separate and competitive channels"]; *Carretti v. Italpast* (2002) 101 Cal.App.4th 1236, 1250 [discussing a "product distribution system" including sales to third parties]; *Ruger v. Superior Court* (1981) 118 Cal.App.3d 427, 431 [discussing a corporation that "markets its products nationwide through distributors"]; see also *People v. Covarrubias* (2011) 202 Cal.App.4th 1, 14 [referring to "a complex heroin

distribution scheme"].) In fact, "distribution" has been used specifically to describe the operation of an auction. (See, e.g., *Mahan v. Wood* (1872) 44 Cal. 462, 468 [discussing articles of incorporation providing that "parcels and subdivisions to be distributed shall be offered by auction to the members."].) For example, the FCC's auctioning of electromagnetic spectrum licenses is commonly referred to as "distribution" of such licenses. (See, e.g., *Sioux Valley Rural Television, Inc. v. F.C.C.* (D.C. Cir. 2003) 349 F.3d 667, 669; *DIRECTV, Inc. v. F.C.C.* (D.C. Cir. 1997) 110 F.3d 816, 825.)

Moreover, the phrase "distribution of emissions allowances" has a technical meaning that encompasses at least the most widely recognized means of initially allocating tradable emissions allowances in cap-and-trade systems. Auctioning is a widely recognized methodology for distributing allowances and was recognized as such when AB 32 was enacted. Indeed, Petitioners concede that the Legislature was aware that auctions were used in other cap-and-trade programs. (Chamber Br. at 20-21.) The Climate Action Team[14] produced a high-profile public report submitted to the Governor and the Legislature five months before AB 32 was enacted. (AR Add. A:6025-6281.) In discussing "[a]llowance distribution" under "market-based program design options," the report states, "[e]mission allowances can be auctioned or given to regulated sources." (AR Add. A:6113.) Under the heading "Allowance Distribution," the report further explains:

> A market-based program requires that each facility under the cap hold sufficient emission allowances to cover its emissions. Emission allowances can be auctioned (i.e., sold) or given away. . . . A hybrid approach can also be used, in which some allowances are given away and some are auctioned.

(AR Add. A:6120; see also AR C:1855 [main mechanisms of allowance distribution as "free allocation and auctioning of allowances"].) In the terminology of GHG control policy as it existed on the eve of AB 32's enactment, an instruction to design regulations including the

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[14] The Climate Action Team was created by Executive Order S-3-05 in 2005 and is chaired by the Secretary of the California Environmental Protection Agency. The CAT is tasked with coordinating statewide efforts to reduce greenhouse gas emissions. AR Add. A:23768.

"distribution of allowances" to satisfy various objectives would be understood to require consideration of auctioning as well as free allocation.

Finally, even if the meaning of "distribution of allowances" were unclear, the Court would need to defer to ARB's interpretation of the phrase embodied in the cap-and-trade rule. Because "[t]his is an area where 'the agency has expertise and technical knowledge,'" and has applied that expertise in implementing the statutory language, the Court must "defer to the [agency's] reasonable construction." (*American Coatings*, *supra*, 54 Cal.4th 446, 469 (internal quotation marks omitted).) In fact, AB 32's use of "open-ended statutory language that an agency is authorized to apply" and the fact that the choice of distribution methods "is heavily freighted with policy choices" both suggest that the Legislature delegated to ARB the authority to give content to the undefined phrase "distribution of emission allowances." (See *id.* at 461.)

3. The Legislature's Delegation of Authority to Design Methods of Allowance Distribution Is Consistent with AB 32's Broad Grant of Authority to ARB to Develop Regulatory Means to Achieve the Statute's Ends.

Petitioners' assertion that the Legislature did not give ARB the authority to include an auction and reserve in the cap-and-trade program also collides with the structure of AB 32. Although the statute is specific in identifying procedural tasks and deadlines for ARB in developing regulations to achieve the statute's emission reduction goals, it leaves wide discretion to ARB about the *choice* of regulatory tools to achieve those goals and how best to apply an array of specified policy criteria in doing so. ARB's decision to incorporate the auction and reserve into its cap-and-trade program was an exercise of the latter broad discretion.

As summarized above, the statute leaves it to ARB to identify, design, and implement measures to reduce GHG emissions to meet the statewide limit. (See *AIR, supra,* 206 Cal.App.4th 1487, 1495 [observing that planning provisions "leave virtually all decisions to the discretion of the Board...."]; see also *supra* Background B.) Throughout the statute, the Legislature defined ultimate objectives and set forth guiding values, but assigned ARB

the task of selecting the regulatory means to satisfy those objectives and values. (See, e.g., § 38530(a), (b) [GHG emission reporting rules]; § 38560 [instruction to adopt regulations to "achieve the maximum technologically feasible and cost-effective greenhouse gas emissions reductions"]; § 38560.5 [early action measures]; § 38561(a), (b) [scoping plan to identify measures ARB deems "necessary or desirable" to achieve reductions]; § 38562(a), (b), (c), (d) [emission limits and emission reductions measures]; § 38570 [market-based compliance mechanisms].)

AB 32 thus does not dictate that ARB use a cap-and-trade mechanism or a command-and-control mechanism or any other mechanism; that choice is entirely ARB's to make. Under the statute, the decisions about the design of such a mechanism are also ARB's to make. Instead of dictating the selection or design of tools to achieve the statute's emission reduction goals, the statute provides objectives to inform ARB's decision. ARB's chosen mechanisms must operate "in a manner that is equitable, seeks to minimize costs and maximize the total benefits to California, and encourages early action to reduce greenhouse gas emissions," (§ 38562(b)(1)), and that "improves and modernizes California's energy infrastructure and maintains electric system reliability, maximizes additional environmental and economic co-benefits for California, and complements the state's efforts to improve air quality," (§ 38501(h)). The statute does not specify the weight that ARB is to give these various criteria.

By contrast, AB 32 does provide specific direction to ARB in other areas. The statute specifies the process for ARB's development of regulatory tools and specifies dates by which the required steps in that process must be complete. (See, e.g., § 38550 [requiring ARB to determine by January 1, 2008 what statewide emissions were in 1990 and establish a statewide limit for 2020 equal to that 1990 level]; § 38560.5 [providing specific deadlines for identifying and adopting "early action [GHG] emission reduction measures" and for the enforceability of those measures]; §§ 38561-62 [identifying deadlines for adoption and effectiveness of the scoping plan and implementing regulations]; § 38591 [requiring ARB to convene an Environmental Justice Advisory Committee and ETAAC].) That the

Legislature was careful to cabin ARB's discretion on these procedural issues demonstrates that its decision to avoid prescribing the choice and design of regulatory tools for ARB was an intentional delegation of discretion. (Cf. *Friends of Juana Briones House v. City of Palo Alto* (2010) 190 Cal.App.4th 286, 308 ["As a comparison of the two provisions demonstrates, the City knows how to legislate with greater specificity when it intends to, a circumstance that undercuts respondent's argument for implying language into [the law.]"].)

Moreover, the varied policy criteria that must guide ARB's design choices—cost-effectivness, equity, maximizing benefits to California, maximizing emission reductions, etc.—demonstrate that the Legislature wanted ARB to consider a wide array of alternatives to find an optimal fit with AB 32's objectives. ARB determined that many of the objectives are best furthered by the use of auctions. Petitioners strain to *read the objectives out of the statute*, repeatedly suggesting that the relevant question is whether it would be possible to achieve 1990 emissions levels by 2020 without the use of allowance auctions or reserve sales. (See NAM Br. at 14:9-10 ["the sale of allowances is not remotely necessary to satisfy the legislative purpose of AB 32, *i.e.*, to reduce GHG emissions"]; Chamber Br. at 14:20 [stating that "GHG reduction was the Legislature's sole aim."].) By mischaracterizing the statute as concerned exclusively with reaching the 2020 emissions target, Petitioners attempt to portray the auction as an illegitimate departure from the proper scope of this "environmental protection statute." (Chamber Br. at 22:22-23) The Chamber goes so far as to *dismiss broad swaths of the statute's plain language* as merely "aspirational." (*Id.* at 6, fn. 3.) It should go without saying that a statutory argument predicated on denying effect to large portions of the statute is fundamentally flawed. (See *Delaney v. Superior Court* (1990) 50 Cal.3d 785, 798-99 ["Significance should be given, if possible, to every word of an act. Conversely, a construction that renders a word surplusage should be avoided."] (citations omitted).)

4. AB 32 Did Not Need to Specifically Authorize an Auction.

Petitioners invoke barkless dogs and elephant-filled mouse holes to argue that AB 32 does not allow auctions because it does not *explicitly* allow them. (See Chamber Br. at 17:14-17; NAM Br. at 13:1-2; MS Br. at 22:7-9.) Their menagerie of metaphors is a canard.

First and most important, AB 32 *does* specifically address the "distribution of allowances": it expressly delegates to ARB the "design" of a system of distribution if ARB decides to use a cap-and-trade system. (See *supra* Argument I.B.2.) None of Petitioners' cases involve an agency's exercise of authority under such an explicit delegation.

In fact, that express delegation demonstrates that Petitioners' theory is backwards. As explained above, in 2006, auctioning and free distribution were both widely recognized methods of distributing allowances. (See, e.g., AR Add. A:6120). Having delegated to ARB the choice of distribution methods, if the Legislature had meant to exclude from ARB's consideration one or another of the recognized methods, it surely would have said so. But instead the Legislature left to ARB the task of evaluating the potential ways of distributing emissions to achieve the statutory objectives.

Second, even without this specific delegation of authority to ARB, Petitioners' position would be inconsistent with the statute's structure and approach: AB 32 works not by specifying particular regulatory mechanisms, but by directing ARB to apply its expertise and conduct a thorough fact-finding process to decide what mechanisms best serve the statutory objectives. (See *supra* Argument I.B.3.) Nor does the open-endedness of such a delegation mean that the Legislature failed to authorize the specific action the agency decided to take. As the Third District has held, "The absence of any specific [statutory] provisions regarding the regulation of [an issue] does not mean that such a regulation exceeds statutory authority . . . . The [agency] is authorized to 'fill up the details' of the statutory scheme.'" (*California School Boards Assn. v. State Bd. of Equalization* (2010) 191 Cal.App.4th 530, 544 (alterations in original).)

AB 32's open-ended delegation to ARB distinguishes this case sharply from *Dyna-Med, Inc. v. Fair Employment and Housing Commission* (1987) 43 Cal.3d 1379, and *Peral-*

ta Community College District v. Fair Employment and Housing Commission (1990) 52 Cal.3d 40, on which NAM heavily relies. (NAM Br. at 11-15, 17-18.) Those cases construed statutory language that authorized the Fair Employment and Housing Commission to apply remedies "including, but not limited to" five enumerated remedies (Gov. Code § 12970(a)), none involving damages. Concluding that the enumeration of remedies limited the Commission's ability to impose a very different remedy based solely on the general "including, but not limited to" language, the Court held that the Commission lacked the authority to impose punitive damages. (See *Dyna-Med,* 43 Cal.3d at 1391; *Peralta*, 52 Cal.3d at 50-51.) Unlike *Dyna-Med* and *Peralta,* AB 32 does not enumerate particular regulatory mechanisms, but rather gives the agency discretion to choose its own mechanisms guided only by general policy criteria.

Third, it is hardly surprising that the Legislature delegated the choice of distribution methods to ARB rather than explicitly requiring or prohibiting any, when ARB might moot the issue entirely by deciding not to use a cap-and-trade program at all.[15] (See § 38570(a); see also MS Br. at 20:21-22 ["A.B. 32 permits but does not require CARB to regulate greenhouse gases by a cap and trade program . . . ."].) When AB 32 was enacted in 2006, the Legislature wanted ARB to make program design decisions based upon an extensive administrative record yet to be assembled and public hearings yet to be conducted. (See §§ 38561, 38662(e)-(f), 38564, 38591, 38562(a).) It would have been bizarre for the Legislature to preempt that elaborate planning process for the eventual regulatory program by specifying the means of distributing emissions allowances that might never exist.[16]

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[15] The same can be said for the argument that AB 32 withheld auction authority because it did not specify how auction proceeds would be expended. (See NAM Br. at 13:14-15.)

[16] In 2010, two years after ARB included in the Scoping Plan a proposed cap-and-trade program with an auction, Governor Schwarzenegger vetoed a bill that would have created a community benefits fund with a portion of the auction proceeds. Even in 2010 the Governor found that the legislation "propose[d] to spend money that does not currently exist and might not ever exist." (RJN, Ex. 1 (Assembly Bill No. 1405, Veto Message (Sept. 30, 2010).) This example illustrates the unreality of Petitioners' suggestion that the Legisla-

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Finally, the controversial nature of allowance distribution and the sums involved do not show that the Legislature would have specified an auction if it had intended ARB to use it. Because allowances are inherently valuable (see *supra* Background C.1), distributing those valuable allowances was sure to be a topic of "vigorous debate" however it was resolved. (See NAM Br. at 15:13.) Giving away all of the allowances—and their millions, if not billions, of dollars in value—to the state's largest polluters would have been at least as controversial as auctioning. In fact, ARB's decision to freely allocate a substantial portion of the allowances *did* provoke widespread opposition during the rulemaking. (See, e.g., AR H:773-780; see also AR C:1784.)

5. AB 32's Administrative Fee Provision Does Not Aid Petitioners.

Petitioners argue that AB 32's administrative fee provision, section 38597, shows that the Legislature did not intend ARB to have auction authority. (Chamber Br. at 20:2-7; MS Br. at 19:12-15; NAM Br. at 13:1-2.) That section authorizes ARB to adopt "a schedule of fees to be paid by the sources of greenhouse gas emissions regulated pursuant to" AB 32, to pay for the administrative costs of carrying out the statute. (§ 38597.) As an initial matter, Petitioners' "statutory argument would require this court to assume that our Legislature chose a surprisingly indirect route to convey an important and easily expressed message." (*Debbie Reynolds Prof. Rehearsal Studios v. Superior Court* (1994) 25 Cal.App.4th 222, 232.) The contention is particularly "surprising" given that AB 32 included a "[]direct route" in which it could have delivered the message: the Legislature could have limited the statute's express delegation to ARB of the design of provisions for "distribution of allowances."

Moreover, Petitioners incorrectly assume that administrative fees and an allowance auction are similar devices, so that the Legislature's endorsement of one implies rejection

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ture, in 2006, well before ARB had decided whether to adopt and how to design a market-based compliance obligation, surely would have focused debate upon the possible future use of auction proceeds. (Chamber Br. at 15.)

of the other, and that the fee provision would be mere "surplusage" if ARB could also auction allowances. (Chamber Br. at 20:8-11.) In fact the two serve fundamentally different functions. The sole purpose of the section 38597 fee is to offset administrative costs (see § 57001 [requiring each department to establish a "fee accountability program" so that fees are not more than reasonably necessary to fund cost-effective and efficient programs]) while the purpose of an auction is to distribute allowances in a manner that will serve the varied statutory policies spelled out in AB 32 such as equity, administrative efficiency, maximizing benefits to California, and encouraging early reductions. (See *supra* Background C.3.c.) Given these explicitly different statutory purposes and functions, section 38597 cannot be read to impliedly preclude authority to employ allowance auctions. (See *Silverbrand v. County of Los Angeles* (2009) 46 Cal.4th 106, 126 [the canon that expression of one thing implies exclusion of others "applies only when the Legislature has intentionally changed or excluded a term by design. Furthermore, the principle always is subordinate to legislative intent."] (quotation marks and citations omitted).)

C. Additional Considerations Demonstrate That the Auction and Price Containment Reserve Are Within the Legislature's Broad Delegation to ARB.

1. The 2012 Statutes Confirm ARB's Authority Under AB 32 to Auction or Sell Allowances.

Beyond distorting the text and structure of AB 32, Petitioners' arguments would also vitiate *three* recently enacted state statutes, the sole purpose of which is to guide the investment of funds generated by the State's sale of allowances (See Sen. Bill No. 1018, Stats. 2012, ch. 39, § 25 (2011-2012 Reg. Sess.) (adding Gov. Code §§ 16428.8-16428.95); Assem. Bill No. 1532, Stats. 2012, ch. 807, § 1 (2011-2012 Reg. Sess.) (adding § 39712); Sen. Bill No. 535, Stats. 2012, ch. 830 (2011-2012 Reg. Sess.) (adding § 39711).) The 2012 legislation directing the use of auction proceeds reflects the Legislature's awareness of, approval of, and response to ARB's exercise of its delegated authority to adopt and design a cap-and-trade program with an auction.

SB 1018 creates the Greenhouse Gas Reduction Fund, where auction proceeds are deposited and requires agencies to develop a record documenting how expenditures further the regulatory goals of AB 32. (See Gov. Code § 16428.8(b) [applying to "all moneys collected by the State Air Resources Board from the auction or sale of allowances, pursuant to a market-based compliance mechanism established pursuant to [AB 32]."]) AB 1532 directs ARB and the Department of Finance to develop triennial investment plans for the expenditure of auction proceeds in measures and projects that reduce GHG emissions in specific categories that further the regulatory purposes of AB 32. (§ 39712(f), added by Stats. 2012, ch. 807, § 1.) Finally, SB 535 requires that at least 25 percent of auction proceeds be invested in measures and projects that reduce GHG emissions and provide benefits to California's most disadvantaged communities, and that ten percent of those measures and projects be located in those communities. (§ 39713(a), added by Stats. 2012, ch. 830, § 2.)

"A subsequent expression of the Legislature as to the intent of the prior statute, although not binding on the court, may properly be used in determining the effect of a prior act." (*Western Security Bank v. Superior Court* (1997) 15 Cal.4th 232, 244.) The 2012 statutes are compelling evidence of the meaning of AB 32, because their very reason for existence is dependent on the Legislature's having previously authorized ARB to auction or sell allowances when it enacted AB 32. If it did not, each of those three statutes would be a nullity. Plainly, the Court should avoid an interpretation of AB 32 that *entirely vitiates* three separate statutes. (See *Coso Energy Developers v. County of Inyo* (2004) 122 Cal.App.4th 1512, 1530 [adopting an interpretation of an earlier statute that "gives effect" to a later statute and rejecting contrary interpretation because it would render the later statute "virtually meaningless"]; see also *Shoemaker v. Myers* (1990) 52 Cal.3d 1, 22 ["We do not presume that the Legislature performs idle acts, nor do we construe statutory provisions so as to render them superfluous."].)

The 2012 legislation also demonstrates that "the Legislature [knew] full well that" ARB had interpreted AB 32 to authorize allowance distribution through auctions and re-

serve sales "and the Legislature is fine with that interpretation." (See *Morning Star Co. v. Bd. of Equalization* (2011) 201 Cal.App.4th 737, 748.) "This is strong evidence that" ARB's allowance-distribution policies are consistent with AB 32. (See *ibid.*)

2. Article 16, § 6 of the State Constitution Further Supports ARB's Construction of AB 32.

Petitioners' position that AB 32 requires free allocation to emitters *in all circumstances* is all the more untenable because it would contravene the California Constitution's prohibition upon gifts of "things of value" absent a public determination that the gift serves some public purpose. (See Cal. Const., Art. 16, § 6 [providing that the Legislature shall have no "power to make any gift or authorize the making of any gift, of any public money or thing of value to any individual, municipal or other corporation whatever"]; see also *City of Marina v. Bd. of Trustees of the Cal. State Univ.*(2006) 39 Cal.4th 341, 363 fn.13 [constitutional prohibition "also applies to public agencies"]; *People v. Honig* (1996) 48 Cal.App.4th 289, 352 ["public officials have no authority to spend public funds" without a "legislative determination" that it is in the public interest].)[17]

"[W]hen some or all allowances are allocated gratis ... government is transferring wealth to the private sector." (AR Add. A:9970.) Free allocation of some allowances serves public purposes in some circumstances. (See AR C:68.) However, a rigid rule mandating a full giveaway of all allowances to emitters would be an unjustified wealth transfer from the public to private interests.

Petitioners do not identify any finding in AB 32 or any basis in the rulemaking record to conclude that a giveaway of *all* allowances would serve the public interest. Their reading therefore runs straight against the state constitutional prohibition against gifts of

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[17] California also recognizes a private right of action against public officials to enjoin the waste of public funds. (See Code Civ. Proc. § 526a; *County of Ventura v. State Bar* (1995) 35 Cal.App.4th 1055, 1059 ["A public expenditure is a waste of public funds . . . if it is 'totally unnecessary' or 'useless' or 'provides no public benefit.'" (quoting *Sundance v. Munic. Ct.* (1986) 42 Cal.3d 1101, 1138-39)].)

public resources, and that is another reason, beyond its disconnection from the statutory text, to reject it.

3. The "Constitutional Avoidance" Canon Does Not Aid Petitioners.

Petitioners are correct that courts should read statutes, if possible, to avoid constitutional problems (Chamber Br. at 24:7-9), but that principle "does not come into play unless there is an ambiguity that raises serious constitutional questions." (*Gilbert v. City of Sunnyvale* (2005) 130 Cal.App.4th 1264, 1285 (citing *People v. Anderson* (1987) 43 Cal.3d 1104, 1146). In particular, "the interpretation to be rejected must raise *grave and doubtful* constitutional questions." (*Anderson*, 43 Cal.3d 1104, 1146.) Because, as we show below, their "unconstitutional tax" argument is meritless, the constitutional doubt principle does not aid Petitioners.[18]

D. Petitioners Cannot Show That ARB's Choice of Methods to Distribute Allowances Is Arbitrary and Capricious.

Because the Legislature contemplated that ARB would decide how to distribute the valuable allowances that are necessarily a part of any cap-and-trade program, Petitioners can only undo ARB's choice if they can prove that ARB's choice was arbitrary and capricious. They have not come close to doing so.

The cap-and-trade rule is a quasi-legislative act, which brings to court a "strong presumption of validity." (*Western States Petroleum Ass'n v. State Dep't of Health Servs.* (2002) 99 Cal.App.4th 999, 1007.) The court's review is "confined to the question of whether the [action] is 'arbitrary, capricious, or [without] reasonable or rational basis.'" (*American Coatings, supra,* 54 Cal.4th 446, 460 (second alteration in original).) "A court passing on the means employed by an agency to effectuate a statutory purpose will not substitute its judgment for that of the agency in the absence of arbitrary and capricious action." (*Carrancho v. Cal. Air Resources Bd.* (2003) 111 Cal.App.4th 1255, 1272.) Review is par-

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[18] And, as just noted, Petitioners' own reading of the statute would contravene the state constitutional ban on donations of public resources that lack a public purpose.

ticularly limited where, as here, the agency's action involves "technical matters requiring the assistance of experts and the study of marshaled scientific data," and thus "courts will permit administrative agencies to work out their problems with as little judicial interference as possible." (*Stauffer Chemical Co. v. Air Resources Bd.* (1982) 128 Cal.App.3d 789, 795.) Courts exercise this limited review of quasi-legislative acts "out of deference to the separation of powers between the Legislature and the judiciary, to the legislative delegation of administrative authority to the agency, and to the presumed expertise of the agency within its scope of authority." (*San Francisco Fire Fighters Local 798 v. City and County of San Francisco* (2006) 38 Cal.4th 653, 667.)

Petitioners have not begun to carry this heavy burden. In fact, ARB's judgment was sound and fully consistent with the criteria that AB 32 directed it to apply. ARB distributed some allowances for free to help covered entities transition into the program and avoid leakage risk. (See *supra* Background C.3.a.) ARB placed a small number of allowances in a strategic price containment reserve to keep costs in-check. (See *supra* Background C.3.b.) And ARB chose to distribute the remaining allowances via auction because auctions provide many benefits—promoting equity, creating transparency, supporting market efficacy, avoiding windfall profits, and recognizing early reductions—that further the fulfillment of AB 32's policy criteria. (See *supra* Background C.3.c.) Auctions support market efficacy because they:

> facilitate price discovery and support the smooth functioning of the allowance market. Auctioning is especially important for price discovery when the majority of the allowances are distributed through administrative allocation. Without a centralized market, transaction costs are likely to impair the efficient flow of allowances.

(AR C:1775; see also AR C:1749 [citing experience with European Emissions Trading System].) Further, ARB found that auctions avoid firms' earning unjustified windfall profits by receiving free allowances and passing through to customers the "cost" of using those allowances for compliance rather than selling them on the market, as occurred under the EU-ETS. (AR C:1721.) ARB also concluded that auctions can promote economic efficiency, competition, and fairness by "treat[ing] new entrants fairly and reward[ing] efficient

firms." (AR C:1776; see also *ibid.* ["Auctioning allowances would treat these potential new businesses equitably relative to previously established firms"].) And it found that auctions serve the statutory interest in supporting early emissions reductions. (AR C:1743, 1776; see also §§ 38562(b)(1), 38562(b)(3).)

ARB's decision to sell a limited number of allowances from the reserve also furthers the statutory objectives giving effect to AB 32's focus on achieving emission reductions cost-effectively, as market price spikes can create large and avoidable costs for participants and the program as a whole. (§ 38562(b)(1), (5).)

But in other contexts, ARB concluded, free distribution of allowances would best serve the legislative objectives. For example, ARB distributed emissions allowances at no cost to "trade-exposed industries," which would not be able to pass on compliance costs, to guard against emissions leakage. (AR C:1779.) Similarly, ARB set up a system tailored to the unique characteristics of the electricity sector in which allowances are distributed for free but utilities are required to sell all allowances at auction and use the proceeds to benefit rate payers and further AB 32's purposes. (AR C:1724.)

Petitioners have not come close to demonstrating that ARB acted irrationally in applying the statutory policy criteria to design a system of allowance distribution. Accordingly, the Court must uphold ARB's carefully designed system.

II. Neither the Distribution of Allowances by Auction nor the Sale of Allowances from the Price Containment Reserve Imposes a Tax Under Proposition 13.

Petitioners also argue that distributing emissions allowances by auction or from the reserve violates Article XIII A, Section 3 of the California Constitution, the restrictions on new state taxes adopted in 1978 as part of Proposition 13. On the contrary, both the auction and the reserve are markedly different from taxes, and the Court should reject Petitioners' efforts to shoe-horn them into that category.

When AB 32 was enacted in 2006, Article XIII A, Section 3 provided,

> any changes in State taxes enacted for the purpose of increasing revenues collected pursuant thereto whether by increased rates or changes in methods

> of computation must be imposed by an Act passed by not less than two-thirds of all members elected to each of the two houses of the Legislature . . .

Because neither the auction nor the reserve constitutes a "tax[] enacted for the purpose of increasing revenues," neither was subject to Proposition 13's procedural requirements.[19]

A. Petitioners Must Prove that the Sale of an Allowance from the Auction and the Price Containment Reserve Imposes a Tax.

1. Petitioners Have the Burden of Proof.

To prevail, any party challenging a program under Proposition 13 bears the burden of demonstrating that the program imposes a tax. (*California Farm Bureau Federation v. State Water Resources Control Board* (2011) 51 Cal.4th 421, 436.) Petitioners thus bear the burden of proving that the auction and sale of allowances impose "taxes enacted for the purpose of increasing revenues" under Proposition 13. (See *ibid.*)

Petitioners also must contend with canons of construction that preclude courts from invalidating state statutes and regulations unless that invalidity is indubitable. First, "because article XIII A's two-thirds vote requirement is inherently undemocratic," its terms "must be strictly construed and ambiguities therein resolved so as to limit the measures to which the two-thirds requirement applies." (See *Collier v. City and County of San Francisco* (2007) 151 Cal.App.4th 1326, 1338 (quoting *City and County of San Francisco v. Farrell* (1982) 32 Cal.3d 47, 52).) Second, "*any* constitutional limitations on legislative power are to be narrowly construed." (*California Housing Finance Agency v. Patitucci* (1978) 22 Cal.3d 171, 175 (emphasis added).) "If there is any doubt as to the Legislature's power to act in any given case, the doubt should be resolved in favor of the Legislature's action." (*Collins v. Riley* (1944) 24 Cal.2d 912, 916.)

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[19] Section 3 of Article XIII A was amended by Proposition 26 in 2010, after enactment of AB 32 but prior to ARB's adoption of the cap-and-trade rule. Petitioners do not argue that it applies here, and for good reason: it applies only to "any change in state *statute* which results in any taxpayer paying a higher tax" (Cal. Const. Art. XIII A, § 3 (2013) (emphasis added)), and thus it does not apply to ARB's cap-and-trade *regulation*.

2. Petitioners Cannot Carry Their Burden Merely by Showing That the Auction Does Not Impose a *Sinclair Paint* Regulatory Fee.

Petitioners maintain that they need only prove that ARB's system of distributing allowances does not meet the standards for a "regulatory fee" set out in *Sinclair Paint Co. v. State Board of Equalization* (1997) 15 Cal.4th 866. (See MS Br. at 9:20-22; NAM Br. at 19:9-13 [arguing that "[b]ecause" AB 32 does not satisfy the *Sinclair* test, it "imposes an unconstitutional tax"]; see also Chamber Br. at 24:26.) This is a straw man. The auction and reserve do not, and are not intended to, impose regulatory fees of the kind discussed in *Sinclair Paint*. But contrary to Petitioners' mistaken view, that does not mean that they impose "taxes" subject to Proposition 13.

As California courts have repeatedly insisted, a plaintiff invoking Proposition 13 must affirmatively demonstrate that the challenged measure is a tax. In affirming this Court's holding that a penalty for understating corporate taxes was not a tax, the Third Appellate District held that Proposition 13 does not set up a regime "in which a 'tax' is the general rule and a 'fee' the limited exception." (*California Taxpayers Assn. v. Franchise Tax Bd.* (2010) 190 Cal.App.4th 1139, 1146.) A plaintiff cannot proceed by such "reverse logic"; it cannot establish that a given payment or charge is a tax simply because it is not among the categories of "fees" that previously have been held not to be taxes. (See *Alamo Rent-a-Car, Inc. v. Bd. of Supervisors of Orange County* (1990) 221 Cal.App.3d 198, 205-06.) If the challenged measure is "not the type of exaction which article XIII A was designed to reach," then further scrutiny is "unnecessary." (*Id.* at 206; accord, *Brydon v. East Bay Municipal Utility District* (1994) 24 Cal.App.4th 178, 194 [following *Alamo*].) Indeed, California courts have upheld a variety of charges though they did not fit into the general categories of charges that had been previously upheld. (See, e.g., *Alamo Rent-a-Car,* 221 Cal.App.3d at 205 [upholding off-airport rental car fee]; *Evans v. City of San Jose* (1992) 3 Cal.App.4th 728, 739 [upholding charge despite its differences from traditional special as-

sessments]; *California Taxpayers*, 190 Cal.App.4th 1139, 1150 [upholding penalty for underpayment of taxes].)

Accordingly, Petitioners must demonstrate *affirmatively* that sale of emissions allowances at auction or from the reserve "bears . . . the indicia of taxation which California Constitution, article XIII A purported to address." (*Brydon, supra*, 24 Cal.App.4th 178, 194.) It is not enough to show they are unlike one or more of the categories of fees that courts have previously held not to be taxes. Petitioners' efforts to pound the square peg of the auction and reserve into the round hole of *Sinclair Paint* are therefore misdirected.

Sinclair Paint considered an exaction imposed on manufacturers of lead products and intended to fund a public program to mitigate the harms of lead poisoning. The fee was adopted for the purpose of funding mitigation programs including services like screening and program management for children with lead poisoning, identifying lead contaminants, and providing education for health professionals. (*Sinclair Paint, supra,* 15 Cal.4th 866, 871.)

The auction and reserve are completely different. As described further below, they were not adopted for the purpose of raising revenue.[20] Rather, they are integral parts of ARB's system of distributing the valuable rights that are inevitably created in the operation of a cap-and-trade regulatory program. (See *supra* Background C.1, C.3.c.) The number of allowances that are distributed by auction or from the reserve, rather than by free allocation, is based not on raising revenue but rather on ARB's determination of how best to apply the policy criteria set out in AB 32.

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[20] In fact, AB 32 separately imposes a *Sinclair Paint* regulatory fee. (§ 38597.) That fee, which Petitioners do not challenge, is specifically designed to cover the full administrative costs of implementing AB 32.

B. The Sale of Allowances at the Auction and from the Price Containment Reserve "Bear[] None of the Indicia of Taxation."

Petitioners cannot meet their burden of showing the auction and reserve impose taxes, because these measures "bear[] none of the indicia of taxation which [Proposition 13] purported to address." (*Brydon*, *supra,* 24 Cal.App.4th 178, 194.)

1. ARB Did Not Adopt the Auction or Price Containment Reserve for the Purpose of Raising Revenue.

The constitutional supermajority requirement applies to "changes in State taxes enacted for the purpose of increasing revenues collected pursuant thereto." (Cal. Const., Art. XIII A, § 3, as adopted June 6, 1978.) Measures enacted for a non-revenue purpose thus fall outside the scope of Article XIII A, Section 3. (See, e.g., *Sinclair Paint, supra*, 15 Cal.4th 866, 879 ["If regulation is the primary purpose of the fee measure, the mere fact that the measure also generates revenue does not make the imposition a tax"] (citing *United Business Com. v. City of San Diego* (1979) 91 Cal.App.3d 156, 165); *River Garden Retirement Home v. Franchise Tax Bd.* (2010) 186 Cal.App.4th 922, 950 [rejecting a Proposition 13 challenge to a policy directive that "was not developed or implemented 'for the purpose of increasing revenues collected'"]; see also *Mills v. County of Trinity* (1980) 108 Cal.App.3d 656, 660 [rejecting broad definition of "tax" as including all fees and charges that exact money for public purposes].) Courts have repeatedly recognized that Sections 3 and 4 of Article XIII A were designed to encompass charges that are "intended to replace revenues lost as a result of" Proposition 13's restrictions on property taxes. (*Russ Bldg. Partnership v. City and County of San Francisco* (1987) 199 Cal.App.3d 1496, 1505; see also *San Diego Gas & Electric Co. v. San Diego County Air Pollution Control Dist.* (1988) 203 Cal.App.3d 1132, 1148.)

The California Supreme Court has likewise recognized that, "[i]n general, taxes are imposed for revenue purposes." (*Sinclair Paint, supra,* 15 Cal.4th 866, 874 (citing *County of Fresno v. Malmstrom* (1979) 94 Cal.App.3d 974, 983 ["Taxes are raised for the general revenue of the governmental entity to pay for a variety of public services."]); *Morning Star*,

supra, 201 Cal.App.4th 737, 756 [finding that a charge is a tax because it "seeks to raise revenue to pay for a wide range of governmental services and programs related to hazardous waste control that are unrelated to the [taxed] activity"]; *Northwest Energetic Services, LLC v. California Franchise Tax Bd.* (2008) 159 Cal.App.4th 841, 854 ["The essence of a tax is that it raises revenue for general governmental purposes. . . ."].) In contrast, policies that are not principally designed to raise revenue are not "taxes" under Article XIII A, Section 3. (See *California Taxpayers, supra,* 190 Cal.App.4th 1139, 1148 [explaining that a monetary penalty was not a tax "because a tax has as its primary purpose the raising of revenue"]; *River Garden Retirement Home*, *supra*, 186 Cal.App.4th 922, 950.)

Neither the auction nor the reserve was "enacted for the purpose of increasing revenue." ARB's reasons for including the auction and reserve as part of the system of emissions allowance distribution included promoting equity through avoiding windfall profits for regulated entities and enhancing the efficacy of the emissions trading program by promoting price discovery and information equity. (See *supra* Background C.3.c.) The purpose of the reserve is not revenue generation, but increasing certainty for regulated entities and ensuring market stability by offering a limited number of allowances at a specified price. (See *supra* Background C.3.b.) If the market price for allowances does not reach threshold levels, the reserve allowances will never be sold. (See *ibid.*) Since the reserve serves its purpose even if it generates *no* revenue at all, it clearly was not "enacted for the purpose of increasing revenues."

In fact, many of the choices ARB made in designing the cap-and-trade program operate to *reduce* the proceeds from the auction. For example, ARB chose to allow regulated entities to use "offsets" to meet up to eight percent of their compliance obligation. (Cal. Code Regs. tit. 17, § 95854.) If regulated entities could not purchase offsets, demand for allowances would be greater and prices at auction higher. (AR C:28.) Further, the primary purpose of the reserve itself is to prevent the price of allowances from rising too high by guaranteeing allowances will be available to regulated entities at lower-than-market prices if open-market prices exceed certain levels. ARB could instead have chosen to auction

those allowances and take advantage of high market prices if they occurred. And finally, of course, ARB chose to distribute many of the allowances for free.

2. Participation in the Auction Is Not Compulsory.

"[T]axes are compulsory in nature." (*California Bldg. Industry Assn. v. Governing Bd.* (1988) 206 Cal.App.3d 212, 236.) This fundament of taxation has been repeatedly recognized by the courts,[21] by lexicographers,[22] and by courts citing lexicographers.[23]

Citizens voluntarily pay money to the state in a wide variety of circumstances—including purchases or leases of state property and licensing use of state resources—but these payments have never been held to be taxes—and few if any would even argue them to be such. (See *Naglee*, *supra*, 1 Cal. 232, 253 [holding that charge imposed on foreign miners in California was not a tax because "[t]he foreigner may pay, or need not pay, the specified amount, depending upon his own option whether he will, or will not, engage in mining operations"].)

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[21] See, e.g., *People ex rel. Atty. Gen. v. Naglee* (1850) 1 Cal. 232, 253 ["The word tax, in its common acceptation, denotes some compulsory exaction, which a government makes upon persons or property within its jurisdiction, for the supply of the public necessities."]; *Northwest Energetic Services, supra,* 159 Cal.App.4th 841, 854 ["The essence of a tax is that it raises revenue for general governmental purposes and is 'compulsory rather than imposed in response to a voluntary decision to seek benefits.'" (quoting *Sinclair Paint*, *supra*, 15 Cal.4th 866, 874-75) (ellipses omitted)].

[22] See, e.g., *Black's Law Dictionary* 1457 (6th ed. 1990) ["Essential characteristics of a tax are that it is not a voluntary payment or donation, but an enforced contribution, exacted pursuant to legislative authority."]; *Webster's Third New International Dictionary* 2345 (2002) [defining tax as "a usu. pecuniary charge imposed . . . upon persons or property for public purposes: a forced contribution of wealth to meet the public needs of a government"]; *The Penguin Dictionary of Economics* 378 (7th ed. 2003) ["A compulsory transfer of money . . . from private individuals, institutions or groups to the government."]; Jay M. Shafritz, *The Harper Collins Dictionary of American Government and Politics* 557 (1992) ["A compulsory contribution exacted by a government for public purposes."].

[23] *Florists' Mut. Ins. Co. v. Ludy Greenhouse Manufacturing Corp.* (S.D. Ohio 2007) 521 F.Supp.2d 661, 688-89 ["[t]he definition of 'tax,' as provided in the Oxford English Dictionary, is '"a compulsory contribution to the support of government . . . ."'].

In numerous Proposition 13 cases, courts have found that payments are not compulsory, and therefore not taxes, where the payor's obligation is triggered by his own voluntary actions. (*Terminal Plaza Corp. v. City and County of San Francisco* (1986) 177 Cal.App.3d 892, 907 [holding that "fees [] exacted only if the property owner elects to convert his property to another use" are not a tax]; *Trent Meredith, Inc. v. City of Oxnard* (1981) 114 Cal.App.3d 317, 328 [holding that "the payment of fees as a condition precedent to development is voluntary in nature" and therefore not a tax]; *Russ Bldg. Partnership*, *supra*, 199 Cal.App.3d 1496, 1505 [a transit fee "triggered by the voluntary decision of the developer to construct office buildings" is not a tax].) In *California Bldg. Industry Assn.,v. San Joaquin Valley Air Pollution Control District* the court held that a regulatory requirement that developers either reduce local air emissions on-site or pay a fee to reduce the emissions off-site was not compulsory because

> fee payers have some control both over when, and if, they pay any fee, i.e., when or if they elect to engage in a regulated activity, and/or the amount of the fee they are compelled to pay. For example, fee payers can modify their conduct to pollute less or consume less water.

((2009)178 Cal.App.4th 120, 132; accord, *Brydon*, *supra,* 24 Cal.App.4th 178, 194 [holding that challenged water rate "was not compulsory to the extent that any consumer had the option of reducing his or her consumption"].)

The emissions allowance auction and reserve mechanisms involve even less compulsion than the charges upheld in the cases just mentioned. Under the cap-and-trade rule, regulated entities have complete control over whether and when they buy emission allowances at auction and from the reserve. As in *California Bldg. Industry Assn.,* regulated entities can reduce their GHG emissions and thereby reduce their compliance obligation and need for allowances. But regulated entities have even more leeway here: they need not purchase allowances from ARB whether or not they reduce their own emissions. They may

(and do) purchase allowances from private sellers or from other regulated entities.[24] (See *supra* Background C.1.) They may "bank" their allowances by reducing emissions early and saving allowances from the early program years, when allowances are relatively more plentiful and more are provided for free, and thereby reduce the need to purchase allowances in later years. (Cal. Code Regs. tit. 17, §§ 95802, 95922(a).) They also have the option to use offset credits from a sector not regulated by the cap-and-trade program to meet up to eight percent of their compliance obligation. (*id.* § 95854.) Finally, they need only surrender sufficient allowances or offsets to cover their emissions every three years, allowing them great flexibility in choosing from among these many compliance options. (*id.* § 95856; AR C:26; see generally AR C:1439-1483 [41-page "Compliance Pathways Analysis"].)

In other words, the auction is unlike a tax in that there is no legal requirement to participate in the auction and thus no penalty for declining to do so. The obligation imposed by the cap-and-trade program is not participation in the auction; it is the triennial surrender of compliance instruments in an amount equal to the entity's GHG emissions. (Cal. Code Regs. tit. 17, § 95856.) This requirement is unrelated to the auction because regulated entities can reduce their need for allowances in the numerous ways indicated above. By contrast, in the case of a tax there is a severe penalty imposed for failure to pay. (See *Naglee*, *supra,* 1 Cal. 232, 253 ["[A tax's] payment is enforced, sometimes, by imprisonment of the person; at others, by the sale of property."]; see also, e.g., Rev. & Tax. Code § 19138 [imposing a penalty for understating taxes by more than $1 million in any given tax year].)

Finally, the fact that unregulated entities, such as financial firms, have *elected* to purchase allowances at auction underscores that participation in the auction is voluntary.

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[24] They may also purchase allowances at the consignment auction, through which utilities may auction allowances that they were allocated for free. (Cal. Code Regs. tit. 17, § 95910(d); see also *supra* Background C.3.a.) Petitioners do not appear to challenge the consignment auction, but rather claim only that ARB cannot adopt any distribution method that results in *government* revenue.

The auction is an exchange where private entities (both regulated and unregulated) act as both buyers and sellers. (See Cal. Code Regs. tit. 17, §§ 95910(d), 95912(d).) Unregulated entities opt into the auction when they believe they will be able to sell the allowances later for more than they pay for them at auction. In the first three auctions, unregulated purchasers have bought between three and 12 percent of allowances. (Respondent-Intervenors' Request for Judicial Notice in Support of Opposition to Petitions for Writs of Mandate ("RJN"), Ex. 2, at 1-3. [California Air Resources Board Quarterly Auctions 1, 2, and 3: November 2012, February 2013, and May 2013 Summary Results Reports (June 5, 2013)]) True taxes are not known to attract volunteers.

3. Auction Participants Receive an Exclusive Private Benefit in Exchange for a Winning Bid.

The auction and reserve are also unlike tax mechanisms because the purchaser of allowances obtains a particularized and exclusive benefit as consideration for the purchase price: emissions allowances that can be used, banked, or sold. Taxes, by contrast, typically offer no direct return to the payor. "[A] tax can be levied 'without reference to peculiar benefits to particular individuals or property.' Indeed, '[n]othing is more familiar in taxation than the imposition of a tax upon a class or upon individuals who enjoy no direct benefit from its expenditure . . . .'" (*Knox v. City of Orland* (1992) 4 Cal.4th 132, 142 (quoting *Fenton v. City of Delano* (1984) 162 Cal.App.3d 400, 405 and *Carmichael v. Southern Coal Co.* (1937) 301 U.S. 495, 521-22) (citations omitted); see also 9 Witkin, Summary 10th (2005) *Tax*, § 1, p. 25 ["[I]n taxation . . . no compensation is given to the taxpayer except by way of governmental protection and other general benefits."].)

In contrast, charges that secure to the payor a specific benefit are exempt from Proposition 13:

> The public as a whole may be incidentally benefitted [from the expenditure of the charge], but the discrete group is specially benefitted by the expenditure of these funds. The public should not be required to finance an expenditure through taxation which benefits only a small segment of the population. If it is asked to do so, it must agree by a two-thirds vote. On the other hand, where the burden for these expenditures is borne by the group specifically benefitted by them, Proposition 13 is not implicated.

(*Evans*, *supra,* 3 Cal.App.4th 728, 738 (citations omitted).)

The auction and reserve represent a basic mercantile quid pro quo, in which successful bidders receive tangible benefits. These benefits constitute exclusive, highly valuable rights that are distinguishable from the generalized benefit of the cap-and-trade program enjoyed by the public at large.[25] (See *supra* Background C.1.) Allowances have value, which purchasers can realize by banking the allowances, selling them, or using them to meet their compliance obligation instead of investing in process or equipment modifications to reduce their emissions. (Cal. Code Regs. tit. 17, § 95922(a) [allowing banking]; *id.* § 95921 [governing trade of allowances]; *id.* § 95856 [governing surrender of allowances]. That value is not created by the auction, but rather by the emissions cap—which Petitioners have not challenged—which creates demand for and scarcity of emission allowances. (See *supra* Argument I.A.)

Participants bid in the auction precisely because allowances have value, and their bids will not exceed the value that they expect to receive from those allowances. Members of regulated industries may choose to participate if purchasing allowances at auction is cheaper than an equivalent reduction in emissions. In that case, the value to the bidder is the avoided cost of investments in emission reductions. (AR C:83 ["An entity would buy an allowance if the market value of the allowance is less than the entity's cost of reducing emissions"].) As previously noted, firms in the financial industry participate in the auction

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[25] Taxes frequently fund "public goods," such as transportation infrastructure or public safety. These goods are to a large extent "nonexcludable," in that individuals cannot readily be excluded from enjoying their benefits, and "nonrival," in that one's enjoyment of the benefits does not reduce another's ability to enjoy them. (See *The Penguin Dictionary of Economics, supra,* at 316-317.) By contrast, the allowances that bidders purchase at auction are private goods: they are enjoyed solely by the purchaser; it may exclude others from using them and the purchaser's use prevents another from using them. (See *ibid.*)

because the value of the allowances is not only manifest now, but expected to increase in the future.[26] (See *supra* Argument II.B.2.)

4. The Price of an Allowance Is Set by the Market, Not by ARB.

Another standard indicium of taxation is that the government fixes the amounts that taxpayers owe, using generally applicable rules. (9 Witkin, *Tax*, *supra,* § 1 ["in taxation, the taking applies uniformly among all persons in a particular class"].) The text of Article XIII A, Section 3 reflects this assumption that taxes are set by the State: it applies only to "changes in State taxes" that raise new revenue "by increased *rates* or changes in *methods of computation*." (Cal. Const. Art. XIII A, § 3 (emphases added); see *California Taxpayers Assn., supra,* 190 Cal.App.4th 1139, 1149 [it "carries a certain irony" that Petitioners claim that a policy that "does not impose an increase in the tax rate or a change in the method of tax computation" violates this provision].)

In contrast, the allowance purchase price is set by competitive bidding and the reserve is only accessed if the *market* drives prices above a certain level.[27] (See MS Br. at 15:19-22 [auction proceeds are not determined by ARB, "but rather [by] economic forces operating within the auction, which are a function of the internal calculus of each Covered Entity's cost-benefit analysis regarding whether to control emissions at the source or to purchase allowances"].) The allowance purchase price reflects principles of supply and demand including private decisions about how many privately-held allowances to sell at auction; the cost-effectiveness of on-site emission reductions, the price and availability of offset credits, and the price and availability of allowances on the private market. (See *ibid.*; see also AR C:26.) This marketplace does not bear any resemblance to a tax. The auction does not generate revenue by setting tax "rates" or any other "method[] of compu-

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[26] Ironically, the only tax that anyone will pay as a result of the auction is the tax on the gains from selling allowances at a profit. (See generally Joint Committee on Taxation, *Climate Change Legislation: Tax Considerations* (June 12, 2009).)

[27] As a result, as Petitioners recognize, there is broad uncertainty about the amount of revenue that the auction will generate; estimates ranged from $660 million to $3 billion annually. (NAM Br. at 9:11; MS Br. at 15:19-22.)

tation." Petitioners cite no case in which a court characterized as a tax a program that did not dictate the payment to be made or how to calculate it.

In concluding that the auction of carbon allowances to the aviation industry under the European Union's Emissions Trading Scheme does not constitute a tax, European authorities have relied heavily upon the stark difference in how tax rates and auction prices are set. In her advisory opinion to the European Court of Justice, Advocate General Kokott recommended that the auction of carbon allowances to the aviation industry not be deemed a tax because:

> [T]axes . . . are fixed unilaterally by a public body and laid down according to certain predetermined criteria, such as the tax rate and basis of assessment. . . . It would be unusual, to put it mildly, to describe as a charge or tax the purchase price paid for an emission allowance, which is based on supply and demand according to free market forces . . .

(RJN, Ex. 3, at I-59 [Air Transportation Assn. of America v. Sect. of State for Energy and Climate Change, Case C-366/10, European Court of Justice, Opinion of Advocate General Kokott (Oct. 6, 2011)].) Following that reasoning, the court ruled that the auction of carbon allowances is not a tax, holding that

> unlike a duty, tax, fee or charge on fuel consumption, the [program] apart from the fact that it is not intended to generate revenue for the public authorities, does not in any way enable the establishment, applying a basis of assessment and a rate defined in advance, of an amount that must be payable per tonne of fuel consumed.

(RJN, Ex. 4, at I-38 [Air Transportation Assn. of America v. Sect. of State for Energy and Climate Change, Case C-366/10, European Court of Justice, Judgment of the Court (Dec. 21, 2011)].)

5. The 2012 Statutes Constrain the Use of Auction Proceeds to Purposes That Advance the Goals of AB 32.

Finally, the auction and reserve do not resemble taxes because any revenue generated is deposited in discrete accounts and usable only for projects that advance the regulatory purposes of AB 32. By contrast, taxes are typically deposited into a general fund and available for expenditure for any public purpose. (See, e.g., Rev. & Tax Code § 4651.2 [providing for deposit of property taxes in general fund]; *id.* § 19603 [providing for balance

of personal income tax revenue to be transferred to the General Fund]; see *supra* Argument II.B.3.)

SB 1018 created the Greenhouse Gas Reduction Fund to hold "all moneys collected by the State Air Resources Board from the auction or sale of allowances, pursuant to a market-based compliance mechanism established pursuant to [AB 32]." (Gov. Code § 16428.8.) AB 1532 further added that "The state shall not approve allocations for a measure or program using moneys appropriated from the fund except after determining, based on the available evidence, that the use of those moneys furthers the regulatory purposes of [AB 32] and is consistent with law." (§ 39712(a)(2).) The statute states that "[m]oneys shall be used to facilitate the achievement of reductions of greenhouse gas emissions in this state" (§ 39712(b)) and tracks AB 32 in elaborating a set of policy objectives for the expenditures, including to "maximize economic, environmental, and public health benefits," "foster job creation," "compliment efforts to improve air quality," "direct investments toward the most disadvantaged communities," and "lessen the impacts and effects of climate change" on the state. (*Ibid.*)

NAM argues that the Court should ignore the program adopted by the Legislature in 2012 and instead focus on AB 32, which did not limit the use of auction proceeds. (See NAM Br. at 21, fn.8.) NAM does not explain why the distinction between the Legislature's action in AB 32 and its action in enacting the 2012 program is constitutionally significant, nor does it cite any authority that would allow a court to pretend that relevant statutes did not exist. In any event, it would have been premature for the Legislature to dictate the use of auction proceeds in AB 32 because AB 32 did not dictate that ARB adopt a cap-and-trade program, let alone an auction. (See *supra* Argument I.B.4, fn. 16.)

C. The Auction and Price Containment Reserve Are Unlike Anything That a Court Has Ever Held to Be a Tax.

ARB's allowance distribution system is completely unlike anything that has ever been adjudged a "tax." Throughout their three briefs, Petitioners conspicuously fail to cite *any* case involving a policy remotely analogous to the auction or reserve, let alone a case

invalidating such a policy as imposing a tax. Given that applicable interpretative principles require the Court to uphold the policies in cases of doubt (see *supra* Argument II.A.1), this failure is fatal to their claim. The Chamber and Morning Star focus exclusively on *Sinclair Paint* (see Chamber Br. at 24:24-26; MS Br. at 9:20-22), which *upheld* the challenged fee and in any event is inapplicable here. (See *supra* Argument II.A.2.) NAM relies on two cases, but neither suggests that anything remotely resembling ARB's allowance distribution policies is a tax. (NAM Br. at 21:10-14.)

Northwest Energetic Services, supra, involved a provision of the California Revenue and Taxation code that imposed a levy on companies organized as LLCs. (159 Cal.App.4th 841, 849.) The court held that the levy was a tax for purposes of Dormant Commerce Clause analysis because it is "a compulsory payment imposed for the purpose of raising revenues for general governmental purposes," reasoning that (1) the legislative history demonstrated that it was designed to recoup the *tax* revenue lost when a company forms as an LLC instead of a corporation and thus does not pay corporate income tax, (2) the levy was deposited in the general fund, and (3) the Franchise Tax Board administered the levy according to its income tax provisions. (*Id.* at 857.) As described previously, the auction and reserve bear none of these attributes.

NAM also relies on *Morning Star*, *supra,* for the proposition that purely non-regulatory programs designed to raise revenue, like the corporate charge that funds the State's Toxic Substances Control Account, are taxes. (NAM Br. at 24:19-22 (citing 201 Cal.App.4th 737, 755).) But the Legislature passed the law at issue in *Morning Star* as a tax with the specific intent to raise revenue to fund hazardous waste management. (*Morning Star*, 201 Cal.App.4th at 750, fn. 5.) The court upheld the charge as a valid tax against certain federal constitutional challenges because it sought to raise revenue and contained *no* regulatory component. (*Id.* at 755.) It distinguished that tax from programs that "regulate [a] Company's . . . generation of hazardous material," which, it held, are not taxes. (*Ibid.*)

Petitioners' failure to produce any authority finding a "tax" in any policy that bears even a loose resemblance to the auction or reserve, emphasizes that their challenges are fundamentally misguided. And even if Petitioners' legal arguments were stronger, this absence of precedent would be reason enough to reject their challenges. (See *supra* Argument II.A.1 [discussing rules that Proposition 13, and other constitutional limits on legislative authority, be strictly construed in all but the clearest cases].)

CONCLUSION

The Court should deny the petitions.

DATED: July 15, 2013

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PROOF OF SERVICE

Morning Star Packing Company, et al. v. California Air Resources Board, et al.
Case No. 34-2013-80001464
and Related Case

At the time of service, I was over 18 years of age and **not a party to this action**. I am employed in the City and County of San Francisco, State of California. My business address is 396 Hayes Street, San Francisco, CA 94102.

On July 15, 2013, I served true copies of the following document(s) described as:

BRIEF IN OPPOSITION TO PETITIONS FOR WRITS OF MANDATE;

REQUEST FOR JUDICIAL NOTICE IN SUPPORT OF OPPOSITION TO PETITIONS FOR WRITS OF MANDATE

on the parties in this action as follows:

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BY FEDEX: I enclosed said document(s) in an envelope or package provided by FedEx and addressed to the persons at the addresses listed in the Service List. I placed the envelope or package for collection and overnight delivery at an office or a regularly utilized drop box of FedEx or delivered such document(s) to a courier or driver authorized by FedEx to receive documents.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Executed on July 15, 2013, at San Francisco, California.

_____
Sara L. Breckenridge

SERVICE LIST
Morning Star Packing Company, et al. v. California Air Resources Board, et al.
34-2013-80001464
and Related Case
California Chamber of Commerce, et al. v. California Air Resources Board, et al.
34-2012-80001313
Superior Court of Sacramento County

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