



CALIFORNIA CAP-AND-TRADE AUCTION LITIGATION Frequently Asked Questions | January 19, 2017

California Chamber of Commerce et al. v. California Air Resources Board, et al.
Morning Star Packing Co. v. California Air Resources Board

Basics

Who's involved in the lawsuit?

The lawsuit was brought by the California Chamber of Commerce and Morning Star Packing Co., a regulated food processor in the cap-and-trade program. The National Association of Manufacturers has intervened on their behalf. Amicus briefs supporting petitioners have been filed by the National Federation of Independent Business, California Taxpayers Association and California Manufacturers and Technology Association. The Natural Resources Defense Council and Environmental Defense Fund have intervened on behalf of the California Air Resources Board (ARB). Amicus briefs supporting ARB have been submitted from a group of prominent environmental economists, business interests (including several major California utilities), and The Nature Conservancy.

What's happened in the cases up until now?

The CalChamber filed suit on the eve of the first auction in November 2012. Morning Star followed suit shortly thereafter and the cases were consolidated. The Sacramento Superior Court ruled in favor of ARB on all counts on November 12, 2013. Petitioners appealed that decision to the Third District Court of Appeal, which will hear oral arguments next week on January 24. All parties submitted answers to a set of supplemental questions raised by the court in May 2016.

What is the basis for the lawsuit?

Industry groups ("Petitioners") challenge components of the Air Resources Board's regulations adopted under the Global Warming Solutions Act of 2006, known as AB 32. The regulations establish the market-based cap-and-trade program, a cornerstone of California's plan to achieve AB 32's requirement to reduce statewide greenhouse gas emissions to 1990 levels by 2020. Relative to traditional air pollution regulation, the program provides regulated entities with *choices* on how to comply: they can either reduce their emissions or obtain (either at the auctions or on the private market) allowances that authorize them to emit GHGs. This program design lowers costs and provides flexibility for regulated entities.

Petitioners assert two legal attacks, based solely on California state law: *First*, that ARB's distribution system for allowances, including some free distribution and some distribution via auction and reserve sales, is not authorized because AB 32 does not explicitly call for the sale of emission allowances as a means of operating a carbon control program. *Second*, Petitioners assert that the auction and price containment reserve sales constitute "taxes" for purposes of

Proposition 13 (Art. XIII A of the California Constitution), and thus are unlawful because the Legislature did not approve AB 32 by a two-thirds majority.

When can we expect a decision?

Ordinarily, California Courts of Appeal issue their decisions within 90 days from when the case is submitted. If the court does not request any further briefing, a decision will likely be issued before April 24, 2017, which is 90 days from the date of oral argument (January 24, 2017). But the court may issue a decision any time following oral argument.

What happens if the court sides with ARB? With the Chamber?

Whichever side loses in the Court of Appeal has the option of asking the California Supreme Court to exercise its discretion to review the case. If the court affirms the lower court decision, the cap-and-trade program and auctions will remain in effect. If the court sides with Petitioners, what happens next will depend on how the court rules and particularly on what remedy it imposes. Courts have significant flexibility in developing a remedy; in the unlikely event of a negative ruling, we would advocate strongly for a remedy that would result in the least disruption to the program. Any remedy would likely require further rulemaking by ARB.

In the unlikely event of an adverse ruling, the State, NRDC, and EDF would almost certainly file a petition for review in the California Supreme Court. No decision by the Court of Appeal would become effective unless and until the Supreme Court denied that petition for review. If the Supreme Court were to grant review, the auctions would continue while the Court considered the case.

Authority claim

Why didn't the Legislature specify how auction proceeds should be spent if it intended ARB to include an auction in the program?

AB 32 delegated broad authority to ARB to design rules and regulations to achieve the statute's 2020 emissions limit, including whether to include a market-based system, such as a cap-and-trade program, and how to design any such market-based system. It is thus not surprising that AB 32 doesn't speak about an auction or auction proceeds (or other specific elements of program design), as doing so would have prejudged the outcome of both ARB's development of a Climate Change Scoping Plan and its extensive rulemaking process. But, notably, the Legislature expressly delegated to ARB, in the event it decided to adopt a market-based system, the responsibility to "design the ... distribution of emissions allowances" to advance specified criteria, including equity and encouraging early action to reduce emissions. Because sales, via auction or otherwise, are undeniably a method for distribution, this broad instruction to design a system for distributing allowances clearly authorizes ARB's decision to design a distribution system that includes an auction and reserves sales along with free allocation. Distribution by auction is one of the most prominent, well-known means of distributing emissions allowances, one that has been employed by numerous other jurisdictions and has received extensive support in scholarly literature. The enactment of subsequent legislation in 2012 addressing the use of auction proceeds in conformity with AB 32's regulatory goals further confirms that the auction lies well within ARB's statutory authority.

Prop 13 claim

Is this about whether the auction is a fee or a tax?

Petitioners have caused considerable confusion on this issue because they have focused on arguing that the auction fails the *Sinclair Paint* test, which the California Supreme Court established to delineate regulatory fees from taxes. But the auction is not a traditional regulatory fee, as the proceeds do not fund the administrative costs of implementing a regulatory program (AB 32 has a separate cost of implementation fee). And California law is clear that courts do not evaluate whether a charge is a tax by simply concluding it does not fit neatly within an established fee category (you may hear legal experts use shorthand that “no reverse logic” is allowed). Many payments – such as purchases or leases of state assets – do not fall into a binary fee/tax category. The Petitioners have not met their burden to demonstrate that the sale of emissions allowances is a tax.

How is the auction different from a tax?

California’s carbon auctions are not a tax designed to raise revenue; they are part of an environmental regulation, designed to make the cap-and-trade program for reducing GHG pollution more effective. The auction differs markedly from the types of charges California courts have recognized as taxation. For instance:

- Winning bidders get a valuable asset in return: Unlike a tax payment, bidders in the auction receive a valuable private asset that can be used, banked, or sold. Once acquired, allowances are treated just like other assets on the books of businesses.
- Participation in the auction is not compulsory: Purchasing allowances at auction is merely one of several means of achieving compliance with the declining cap. As Morning Star concedes in its briefing, regulated entities only purchase allowances when they are cheaper than the cost of reducing their own emissions. Allowances may also be purchased from other market participants rather than via the auction or reserve sales. And *non-regulated* parties frequently participate in the auctions with the expectation of earning a profit on resale.
- The proceeds do not fund general government purposes: Taxes typically fund the general functions of government. Here, proceeds from the auction are restricted to funding projects that reduce greenhouse gas emissions and advance the regulatory purposes of AB 32, such as weatherizing low-income homes, expanding access to zero-emission vehicles and building affordable housing near transit.
- The government doesn’t set the price: Auction payments are determined by the market through a public bidding process that occurs at quarterly auctions.

Any of these factors by itself distinguishes the auction program from taxation; the presence of all of them shows that the question here is not close.

Auction overview

Why does ARB auction allowances?

The administrative record in this case demonstrates that ARB included an auction in combination with free allocation to enhance the regulatory functions of the cap-and-trade program consistent with the Legislature’s direction in AB 32. As was well established prior to AB 32, and reaffirmed by expert advisory panels during ARB’s rulemaking, auctions perform several vital functions in a cap-and-trade system, including fostering the smooth functioning and transparency

of emissions trading markets, treating new businesses fairly, and preventing the sort of windfall gains for polluters at consumers' expense that had occurred in other jurisdictions. If the auctions were merely a pretext for generating revenue, as Petitioners contend, ARB would not have taken several steps to *reduce* the amount of revenue they generate – such as permitting the use of offsets (which depresses demand for allowances), including a cost-containment reserve, and allocating allowances at no cost to serve other legislative policy objectives.

How much revenue have the auctions brought in? How much has been spent?

The auctions have generated \$4.4 billion since the program's inception. Of that amount, the legislature has thus far appropriated \$3.4 billion, which the administration estimates has allowed the state to leverage an additional \$3 in private capital for every dollar spent. In addition, over 10.8 million households have received Climate Credits funded by auction proceeds on their electricity bills biannually since 2014. An [analysis](#) by UCLA researchers found that representative low-income households will benefit financially from the cap-and-trade program by an estimated \$200 to \$250 cumulatively by 2020.

When is the next auction?

ARB holds auctions every quarter. The next auction is scheduled for February 22, 2017.

Misc.

How do the legislative proposals seeking to extend the cap-and-trade program beyond 2020 affect this case?

In his proposed budget, the Governor requested urgency legislation to confirm ARB's authority to administer the cap-and-trade program with auctions post-2020. Assemblymembers Autumn Burke (D-Inglewood) and Jim Cooper (D-Elk Grove) have also recently proposed legislation (Assembly Bill 151) intended to confirm ARB's authority to continue the cap-and-trade program beyond 2020. In their current form, these proposals have no bearing on this case, as they are limited to the separate question of ARB's authority beyond 2020, which is not at stake in this litigation.

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