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Honorable Harry E. Hull, Jr.
Acting Presiding Justice
And Honorable Associate Justices
Third District Court of Appeal
914 Capitol Mall, 4th Floor
Sacramento, CA 95814

RE: Supplemental Letter Brief of Respondents California Air Resources Board, et al.
California Chamber of Commerce et al. v. California Air Resources Board et al.
Case No. C075930
Morning Star Packing Company et al. v. California Air Resources Board et al.
Case No. C075954

Dear Honorable Justices of the Court of Appeal:

Respondents California Air Resources Board, et al., respectfully submit the following supplemental brief in response to the court's order of April 8, 2016.

1. What is the rationale for and purpose of regulations stating the auction credits confer no property right? (See Cal. Code Regs., tit. 17, §§ 95802(a)(299); 95820(c).)[1]

Although private parties treat allowances and other compliance instruments[2] for the Air Resource Board's (ARB) cap and trade program as valuable intangible assets or tradable commodities, ARB's regulations specify that allowances do not constitute

[1] All section references are to the California Code of Regulations, title 17, unless otherwise indicated.

[2] The auction credits to which the court refers in question number 1 above are the same as "allowances," the term used in the regulations. Allowances are one form of a "compliance instrument." (§ 95802, subd. (a)(69).)

property or a property right. This statement is necessary to clarify that, vis-à-vis the state, regulatory and enforcement actions taken by ARB in implementing the cap and trade program do not give rise to a constitutional takings claim. (See Administrative Record (hereafter AR) C-000247 to C-000248 [stating that a decision by ARB—for enforcement or regulatory reasons—to terminate, revoke or limit compliance instruments should not "creat[e] a loss to the people of California"].)

Compliance instruments in similar emissions trading programs have been described as "de facto property rights between private parties…."[3] ARB's statement in its regulations that compliance instruments do not constitute property is consistent with this concept.

A. Consistent with Precedent From Other Cap and Trade Programs, ARB Defined Allowances in a Manner that Preserved its Regulatory and Enforcement Powers

Section 95820, subdivision (c) provides that a compliance instrument is "a limited authorization to emit up to one metric ton of CO_2e of any greenhouse gas."[4] This subdivision reserves to the Executive Officer of ARB the right to "terminate or limit such authorization to emit," and specifies that a compliance instrument "does not constitute property or a property right." (§ 95820, subd. (c).)[5] ARB set forth the rationale for these provisions in the Initial Statement of Reasons (ISOR), released with the proposed regulations in 2010. In relevant part, ARB stated that:

> It is necessary for the Executive Officer to retain authority to terminate or limit the "authorization to emit" so that in the case of fraud or market manipulation, ARB has a mechanism to protect the market. Additionally, property rights cannot attach to the compliance instruments because, in the event of federal preemption in the cap-and-trade market or other conditions, California must have the ability to revoke the

[3] See Gehing & Streck, *Emissions Trading: Lessons from SOx and NOx Emissions Allowance and Credit Systems Legal Nature, Title, Transfer, and Taxation of Emission Allowances and Credits* (2005) 35 Envtl. L. Inst. 10219, 10224.

[4] "CO_2e" means "carbon dioxide equivalent." (See § 95802, subd. (a)(56).)

[5] ARB defines the term "property right" to include any type of right, and gives examples of "personal or real, tangible or intangible" property." (§ 95802, subd. (a)(299).)

> compliance instruments without creating a loss to the people of California.

(AR C-000247 to C-000248.) As this explanation indicates, ARB's statement that a compliance instrument does not constitute property or a property right is intended to clarify the limitations of constitutional takings claims.

ARB clearly has the authority to regulate greenhouse gas emissions to protect the public health and welfare. (Health & Saf. Code, § 38510.) For enforcement or regulatory reasons (or reasons beyond ARB's control such as preemption), ARB has retained the authority to terminate or limit compliance instruments held by private parties. (§ 95820, subd. (c).) These factors support ARB's statement in its regulations that compliance instruments are not property for purposes of the takings clause. (See *Bronco Wine Co. v. Jolly* (2005) 129 Cal.App.4th 988, 1031, citations omitted [discussing factors and noting that licenses and permits (which are analogous to allowances) generally do not constitute property rights for purposes of the takings clause]; see also *Conti v. United States* (Fed. Cir. 2002) 291 F.3d 1334, 1340.) However, to effectuate the "trade" component in its cap and trade program, ARB allows private parties to assign, sell and transfer allowances. (§§ 95920, 95921.)

ARB's classification of allowances as "non property" for purposes of the takings clause is consistent with the approach taken by nine other states and Congress. For example, all nine states participating in the Regional Greenhouse Gas Initiative[6]—a multistate cap and trade program for carbon dioxide emissions from power plants—have adopted regulations that provide in relevant part that: "[a] CO_2 allowance under the CO_2 Budget Trading Program does not constitute a property right." (See, e.g., 6 NYCRR 242-1.5, subd. (c)(9); 310 CMR 7.70 subd. (1)(e)3.i.) Similarly, when Congress established the acid rain cap and trade program, it defined "allowances" as "a limited authorization to emit sulfur dioxide" and specifically stated that "[s]uch allowance does not constitute a property right." (42 U.S.C. § 7651b.) Congress has taken the same approach with respect to the Federal Communications Commissions' auctioning of billions of dollars worth of spectrum licenses for broadcast and telecommunications services. (See 47 U.S.C. § 309, subd. (j)(6)(D).)

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[6] The nine states that participate in the Regional Greenhouse Gas Initiative are Connecticut, Delaware, Maine, Maryland, Massachusetts, New Hampshire, New York, Rhode Island and Vermont. (See https://www.rggi.org/design/regulations.)

In sum, ARB, other states and the federal government share a common approach in defining emissions allowances and other valuable instruments for purposes of the takings clause.

B. Allowances Are Treated by Private Parties as an Intangible Asset or an Economic Commodity

The regulatory determination that allowances do not constitute property or convey property rights does not deprive them of value, nor does it appear to change the way in which private parties account for, and transact in, allowances.

When determining whether an instrument constitutes property, the legal context matters. (See, e.g. *Bronco Wine Co. v. Jolly*, *supra*, 129 Cal.App.4th at pp. 1031-1033 [a federal wine label "certificate" constituted property for due process purposes, but not under the takings clause].) While allowances are not property *for purposes of the takings clause*, that fact is not determinative of whether allowances are property or analogous to property for other purposes. Rather, as between private parties, the ability to assign, sell or otherwise transfer allowances gives them the indicia of property. (*Bronco Wine Co.*, at pp. 1030-1031; *Conti v. United States*, *supra*, 291 F.3d at p. 1340.)

ARB's regulations refer in several places to "ownership" of allowances and, as explained in ARB's response to comments submitted during the cap and trade rulemaking:

> [t]he references to 'ownership interests' refers to any participating entity's right relative to other private parties to direct the use of allowances or offset compliance instruments held in accounts in the California cap-and-trade program.

(AR H-001296.)

Here again, ARB's approach and private parties' conduct is consistent with precedent. As one court of appeals has found, "the [Clean Air] Act provides that [acid rain cap and trade] emissions allowances may be bought and sold as any other commodity." (See *Ormet Corp. v. Ohio Power Co.* (4th Cir. 1996) 98 F.3d 799, 802, citing 42 U.S.C. § 7651b(b); 101 Cong. Rec. S16980 (daily ed. Oct. 27, 1990).)[7]

[7] See also Sen.Rep. No. 228, 101st Cong., 2d Sess. 321 (1989), reprinted in 1990 U.S. Code Cong. & Admin. News, p. 3704 ("[T]he allowance system is designed so that

(continued…)

Commentators have similarly noted that, between private parties in a cap and trade program, "all the normal property rights (usus, fructus, and abusus) are available…. Utilities and all other allowance holders can exclude all others, besides the government, from interfering with their possession, use and disposition of allowances." (Gehing & Streck, *supra*, 35 Envtl. L. Inst. at p. 10223.)

The very design of cap and trade programs, including ARB's, relies on private parties treating allowances as a valuable commodity that can be sold or otherwise transferred, so that those who can reduce their emissions at the lowest cost have an incentive to do so. Major public corporations such at PG&E Corporation, Edison International and NRG Energy describe their holdings of allowances to investors as "inventory," "current assets," or "intangible assets."[8]

Indeed, that a purchaser receives this recognized, quantifiable, and transferable value is one of the reasons the ARB auction system is not a tax. (See ARB respondents' brief, pp. 54-55; see also Burtraw amicus brief, p. 11.)

(…continued)

allowances will be treated in part like economic commodities … [subject to] commercial, antitrust and other relevant laws").

[8] See PG & E Corporation and Pacific Gas and Electronic Company, *Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the Fiscal Year ended December 31, 2015* (Feb. 18, 2016) at p. 85 (available at http://investor.pgecorp.com/financials/sec-filings/sec-filings-details/default.aspx?FilingId=11193370); see also Edison International and Southern California Edison, *Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the Fiscal Year ended December 31, 2015* (Feb. 23, 2016) at p. 53 ("Energy Credits and Allowances") (available at http://www.edison.com/home/investors/sec-filings-financials/sec-filings.html?company=&formType=&pageNum=4); NRG Energy, Inc., *Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the Fiscal Year ended December 31, 2015* (Feb. 29, 2016) at p. 135 (available at http://investors.nrg.com/phoenix.zhtml?c=121544&p=irol-SECText&TEXT=aHR0cDovL2FwaS50ZW5rd2l6YXJkLmNvbS9maWxpbmcueG1sP2lwYWdlPTEwNzgwODEyJkRTRVE9MCZTRVE9MCZTUURFU0M9U0VDVElPTl9FTlRJUkUmc3Vic2lkPTU3.)

2. Describe the relationship, if any, between the probable environmental impacts caused by covered entities and the revenue generated from the auctions, and whether the record shows the Board established a reasonable relationship between the two.

As a threshold matter, it is important to note that the law does not require ARB to demonstrate that the probable environmental impacts caused by covered entities exceed the revenue generated from auctions, because the *Sinclair Paint* tax/fee analysis does not apply to this case. However, ARB can easily make such a showing. The environmental harm resulting from the covered entities' emissions, amounting to approximately 85 percent of all greenhouse gas emissions in California, greatly exceeds the total revenue generated by the auction system.

A. The Relationship Between Probable Impacts and Revenue Is Not Relevant

The relationship between auction revenues and environmental harms is not relevant, because Proposition 13 does not require the auction system to meet the legal requirements for a fee. (See ARB respondents' brief, pp. 43-49.)

When applied to a regulatory fee, Proposition 13 requires that fee revenue cannot exceed the reasonable cost of regulation. (*Sinclair Paint Co. v. State Bd. of Equalization* (1997) 15 Cal.4th 866, 870 (hereafter *Sinclair Paint*) [affirming the constitutionality of a fee imposed "to mitigate the actual or anticipated adverse effects of the fee payers' operations," where the amount of the fees bore a "reasonable relationship to those adverse effects"].) A regulatory fee must reasonably "shift the costs" of a governmental activity to those who caused the harm the fee seeks to remedy. (*Id.* at p. 879.) But not all laws that generate revenue are analyzed under this tax/fee dichotomy.

Unlike a regulatory fee, the cap and trade auction revenue is not collected to pay for a government program to mitigate the impacts of fee payers' activities. ARB did not create the auctions to shift the costs of governmental services, but rather to operate as one of the critical elements of the cap and trade program, which is designed to reduce greenhouse gas emissions. (ARB respondents' brief, pp. 10-16, 49-52; see Burtraw amicus brief, pp. 9-16.)

Any cap and trade program requires a system to govern the initial distribution of allowances, and ARB determined that including auctions as one component of that system would make the entire program more fair, efficient, stable, and predictable, consistent with the Legislature's stated objectives. (See ARB respondents' brief, pp. 10-16, 49-52; Health & Saf. Code, § 38562, subd. (b)(1); see Burtraw amicus brief, pp. 9-16.) Since the purpose of the auction system is not to generate revenue for any particular purpose (or to produce revenue at all), the amount of revenue that the auctions generate is not relevant for Proposition 13 purposes.

This court's second question appears to rest on a fundamentally incorrect premise advanced by plaintiffs. They ask the court to declare that, unless the cap and trade program's regulatory auction mechanism is enacted as a tax—i.e., by a two-thirds majority of the Legislature—covered entities have a constitutional right to receive allowances for free. But the language of Proposition 13 only concerns taxes; it does not govern the design of cap and trade programs, and it should not be applied to payments that are "not the type of exaction which [Proposition 13] was designed to reach." (*Alamo Rent-A-Car, Inc. v. Board of Supervisors* (1990) 221 Cal.App.3d 198, 206.) When the courts interpret Proposition 13, "'the voters should get what they enacted, not more and not less.'" (*People v. Park* (2013) 56 Cal.4th 782, 798, quoting *Hodges v. Superior Court* (1999) 21 Cal.4th 109, 114.)

Because the auction system is neither a tax nor a fee, it does not need the attributes of a regulatory fee to survive a Proposition 13 challenge. For this reason, the concept that a regulatory fee cannot exceed the reasonable cost of the governmental activity for which the fee is collected is not relevant here.

B. The Probable Environmental Impacts Caused by Covered Entities Are Much Larger than the Revenue Generated from Auction

Assuming *arguendo* that it was necessary to compare auction revenues with the environmental harm resulting from the covered entities' emissions, that inquiry would strongly support the validity of the auction system.

The record demonstrates ARB established a reasonable relationship between the damage caused by a ton of emissions and the proceeds generated via the auction. ARB's staff report for the cap and trade program states that "[t]he potential effects of climate change on California could cause severe economic damage." (AR C-000209.) There, ARB cites to a 2009 report to the Governor, which states that "if no … action is taken in California, damages across sectors would result in 'tens of billions per year in direct costs' and 'expose trillions of dollars of assets to collateral risk.'" (*Ibid*, citing 2009 California Climate Adaptation Strategy 2009: A Report to the Governor of the State of California in response to Executive Order S-13-2008, p. 9.) And the very first legislative finding in AB 32 itself is that "[g]lobal warming poses a serious threat to the economic well-being, public health, natural resources and the environment of California." (Health & Saf. Code, § 38501, subd. (a).)

Evidence quantifying the impact of greenhouse gas emissions also supports the conclusion that these impacts exceed the auction revenue. After exhaustive study, a task force of federal agencies produced estimates of the monetary damage per metric ton of

carbon dioxide emitted, which the task force referred to as the "social cost of carbon."[9] A comparison of the task force's estimates of the per-ton social cost of carbon to the per-ton clearing price at ARB's cap and trade auctions provides a measure of the relationship between the probable environmental impacts caused by the covered entities' emissions and the proceeds from the auctions.

The task force's first report, prepared in 2010, estimated the "central value" of the damages associated with a metric ton of carbon dioxide emitted in 2015 at $23.80.[10] Three years later the task force revised its estimate of the central value of the damage from emitting a ton of carbon dioxide in 2015 upwards to $38.[11] By comparison, the per-ton clearing price in all four ARB auctions in 2015 was between $12 and $13,[12] roughly *one-third* the federal government's latest estimate of the damage caused by a ton of carbon dioxide emissions emitted in 2015. Indeed, since the first auction in November 2012, the clearing price of an allowance has never exceeded the task force's central value estimate of the damage from one ton of carbon dioxide emissions.[13]

Moreover, this methodology understates the cost comparison, since ARB allocated nearly 90 percent of allowances during 2013-2014 and about half of the allowances in 2015-2016 to covered entities at no cost. (See ARB respondents' brief, pp. 12, 16; §§ 95890-95895.) Thus, ARB has collected no revenue for more than half the greenhouse gas pollution emitted by covered entities. In fact, ARB's total revenue from the auction of allowances is less than *one-sixth* the social cost of emissions from the covered entities (using the task force's central value for a ton of greenhouse gas emitted

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[9] See Technical Support Document—Social Cost of Carbon for Regulatory Impact Analysis—Under Executive Order 12866 (Feb. 2010). (California Air Resources Board, et al.'s Supplemental Request for Judicial Notice (hereinafter ARB's Supp. RJN), Exhibit A).

[10] See ARB's Supp. RJN, Exhibit A, p.1. The Task force produced several estimates of the damage from a metric ton of carbon dioxide in 2015, with a range from $5.70 to $80.70, depending on the methodology applied and the discount rate applied to the damage caused in future years (once emitted carbon dioxide remains in the atmosphere contributing to climate change for decades). (*Ibid.*)

[11] See 2013 Task Force Report (ARB's Supp. RJN, Exhibit B, pp. 12-13). The report notes that "the 3 percent discount rate is the central value. The range identified in this report for emission of a ton in 2015 was from $12 to $109. (*Id.* at p.13.)

[12] ARB Summary of Auction Settlement Prices and Results, ARB Supp. RJN, Exhibit C, p.1.

[13] Compare, ARB's Supp. RJN, Exhibit B, p. 18 (3 percent values) and Exhibit C, p.1.

in 2015).[14] In short, the monetary cost of the probable environmental impacts caused by covered entities' greenhouse gas emissions greatly exceeds the proceeds generated from ARB's auctions.

As discussed above and in respondents' merits briefs, a *Sinclair*-type fee analysis is inapt here. Nonetheless, there is a readily established reasonable relationship between the probable environmental impacts caused by covered entities emissions and the revenue generated from the auctions.

3. Can the auction system be defended against the Proposition 13 challenge on the ground it is akin to a development fee? Address what standards apply when assessing the legality of such fees and how the auction system does or does not meet them.

The auction system is akin to a development fee in at least two important respects that are among the factors distinguishing the auction from a tax.

First, both the payment of development fees and the purchase of allowances through the auction system provide a governmental privilege to the payor. By definition, development fees are "exacted in return for building permits or other governmental privileges." (*Sinclair Paint*, *supra*, 15 Cal.4th at p. 874.) "Development is a privilege not a right." (*Trent Meredith, Inc. v. City of Oxnard* (1981) 114 Cal.App.3d 317, 328.) Similarly, under the cap and trade program, covered entities purchase emissions allowances in return for the privilege of emitting air pollutants. No one has the right to pollute, so the state can restrict and condition that privilege. (*Communities for A Better Environment v. South Coast Air Quality Management Dist.* (2010) 48 Cal.4th 310, 324.) Taxpayers, in contrast, generally do not receive a valuable, tradable governmental privilege in exchange for their payment; they gain nothing other than compliance with a legal obligation. (*California Farm Bureau Federation v. State Water Resources Control Bd.* (2011) 51 Cal.4th 421, 437 (hereafter *California Farm Bureau*); see also ARB respondents' brief, pp. 54-55.)

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[14] The number of tons emitted by covered entities, who are responsible for approximately 85 percent of all greenhouse gas emissions in California (AR C-000025), is more than two times the number of allowances sold by ARB at auction (not accounting for any banking of allowances for use in future years). And, the social cost associated with these emissions (using the central value of $38) is approximately three times ARB's average auction price from November 2012 through February 2016 ($11.47). (See ARB Suppl. RJN, Exhibit C, p.1 [listing auction clearing prices].) By this measure, the total costs imposed by covered entities' emissions are about six times (2x volume x 3x allowance price) the revenue collected by ARB through the auction.

Second, both the payment of development fees and the purchase of allowances through the auction system are non-compulsory. Development fees are considered non-compulsory because they result from a voluntary decision to engage in development. "Even though the developer cannot legally develop without satisfying the condition precedent, he voluntarily decides whether to develop or not to develop." (*Trent Meredith, Inc. v. City of Oxnard*, *supra*, 113 Cal.App.3d at p. 328.) Participation in the auction system is non-compulsory in a similar way. The covered entities voluntarily decide to conduct the kind of business that emits greenhouse gases. Covered entities may comply with the cap and trade program by reducing their emissions to a level commensurate with the number of allowances distributed to them free of charge, by choosing to purchase allowances at auction, by acquiring emissions offsets, or by purchasing allowances from non-governmental sources through the secondary market. (See ARB respondents' brief, pp. 56-58.) Taxes, in contrast, are generally compulsory; one cannot avoid paying income taxes merely by reducing one's demand for government services or shifting one's income to a different line of work. (See response to question 6 below.)

Fundamentally, however, the development fee analysis does not apply squarely to the auction system because ARB did not create the auction system to pay for any governmental costs or benefits provided to covered entities, as explained above in response to question 2. Development fees also differ from the auction system in that development fees are typically imposed by local governments, rather than the state, and they are therefore subject to different constitutional provisions and statutory requirements. (See, e.g., *Walker v. City of San Clemente* (2015) 239 Cal.App.4th 1350 [applying Mitigation Fee Act]; *Shapell Industries, Inc. v. Governing Bd.* (1991) 1 Cal.App.4th 218 [applying School Facilities Act]; *Russ Bldg. Partnership v. City and County of San Francisco* (1987) 199 Cal.App.3d 1496, 1504-1506 [applying Cal. Const., art. XIII A, § 4].)

Thus, while the auction system need not fit the same mold as a development fee, the similarities between the two help explain why the auction system does not violate Proposition 13.

4. Can the auction system be defended against the Proposition 13 challenge on the ground that it essentially sells to covered entities the privilege to pollute?

One of the reasons the auction system does not violate Proposition 13 is that unlike a tax, it allows covered entities to acquire the valuable, tradable privilege of emitting defined amounts of greenhouse gases in exchange for their payment of the purchase price. Auction participants would not otherwise have that privilege, because there is no right to pollute. (See *Communities for A Better Environment v. South Coast Air Quality Management Dist.*, *supra*, 48 Cal.4th at p. 324.) As with any auction or

bidding for privileges granted by a public entity, auction prices are determined by the market; auction participants determine how much to bid based on the value of that privilege to their particular businesses. The auction system is also non-compulsory. (See responses to question 3 above and question 6 below.) The payment of taxes, in contrast, is generally compulsory and governed by a predetermined tax rate, and taxpayers do not receive any privilege that is a valuable, tradable benefit. (See ARB respondents' brief, pp. 54-55.)

In *Alamo Rent-A-Car, Inc. v. Board of Supervisors, supra*, 221 Cal.App.3d 198, the court applied some of these same considerations. The charge in *Alamo* was imposed on car rental companies that used shuttle buses to serve an airport from offsite. (*Id.* at p. 200.) The stated purpose of the charge was to help the airport be financially self-sufficient by requiring those companies to contribute to the cost of the airport "to an extent commensurate with the value of the privileges" they enjoyed from the access granted. (*Id.* at p. 202.) Noting that the charge was triggered by a voluntary decision to do business at the airport and that airports differed from ordinary county services, the court held that the charge was "not the type of exaction which [Proposition 13] was designed to reach." (*Id.* at pp. 205-206.) The sale of a governmental privilege through the auction system, like the charge for airport privileges in *Alamo*, is not the type of transaction Proposition 13 was designed to reach.

Under other circumstances, the enjoyment of a governmental privilege could be the subject of a tax. (*Weekes v. City of Oakland* (1978) 21 Cal.3d 386, 395 ["the power of a governmental entity to tax the privilege of engaging in any and all types of trade or business within its jurisdiction is not open to serious question"].) And if a charge is intended to pay the government's costs of providing a privilege, the charge must be approved by a two-thirds legislative majority unless it satisfies the requirements applicable to fees. (See, e.g., *Sinclair Paint*, *supra*, 15 Cal.4th at pp. 874-875 [development fees may constitute taxes if they are not reasonably related to the governmental costs for which they are imposed].) However, the auction system was not created to cover ARB's costs, so it need not fit the same mold as a fee, as explained in response to question 2, above. The auction system was created to improve the regulatory function of the cap and trade program through the non-compulsory sale of a valuable, tradable governmental privilege at a market price, and as such it does not offend the tax limitation purposes of Proposition 13.

5. Although the current petitions do not seek to invalidate any particular expenditures of the auction revenue, the record shows the revenue is used for a wide variety of programs. The plaintiffs suggest that the auction proceeds – at least in part – are being used to replace what would otherwise be general fund expenditures.

a. How directly must a particular expenditure of auction revenue be related to the goal of reducing greenhouse gases?

It is unnecessary to require a close relationship between expenditures of auction revenue and the goal of reducing greenhouse gases, and, as with most budget priorities, the Legislature has broad authority and discretion to make determinations regarding expenditures.

Most taxes are used for the general support of the government. (See *California Tow Truck Association v. City and County of San Francisco* (2014) 225 Cal.App.4th 846, 859 ["In broad strokes, taxes are imposed for revenue purposes, while fees are collected to cover the cost of services or regulatory activities"].) Since auction revenue is *not* used for the general support of the government, but is instead used exclusively to advance the regulatory purposes of AB 32, the auction system differs materially from a tax. (See ARB respondents' brief, pp. 58-61.)

Moreover, "[i]t goes without saying that 'the power to collect and appropriate the revenue of the State is one peculiarly within the discretion of the Legislature.'" (*Southern California Edison Company v. Public Utilities Commission* (2014) 227 Cal.App.4th 172, 202, internal citations omitted.) Even in the context of fees, which unlike the auction system are developed to provide funding for particular governmental activities, the courts review expenditures flexibly to avoid interfering with discretionary spending decisions. For example, in *Collier v. City and County of San Francisco* (2007) 151 Cal.App.4th 1326, the court found it reasonable for revenue from a local building permit fee to be shared among the local building department, fire department, and planning department, each of which participated in regulating the construction industry. (*Id.* at p. 1341.) The court cautioned against "depriving municipalities of a reasonable degree of flexibility" in determining how to use fee revenues "in furtherance of the purpose for which those fees were assessed. [Citations.]" (*Id.* at p. 1340.) Thus, in the context of fees, the Constitution requires only a reasonable relationship between expenditures and the relevant regulatory purpose. There is no reason to look for a closer relationship between expenditures and the goal of reducing greenhouse gases here.

In any event, the Legislature has explicitly made the link between auction revenues and the greenhouse gas emission reduction by requiring all auction revenue to be used to advance the regulatory purposes of AB 32. (Health & Saf. Code, § 39710 et

seq.; Gov. Code, §§ 12894 & 16428.8 et seq.) By statute, for example, all expenditures must facilitate the reduction of greenhouse gas emissions (Health & Saf. Code, § 39712, subd. (b)); the state must not approve an expenditure until it has determined that the expenditure will further the regulatory purposes of AB 32 (Health & Saf. Code, § 39712, subd. (a)(2)); and the relevant state agency must prepare a record describing how each expenditure will reduce emissions and advance the regulatory purposes of AB 32 (Gov. Code, § 16428.9).[15] The court should also consider that AB 32 was intended not only to reduce emissions, but to reduce emissions "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." (Health & Saf. Code, § 38562, subd. (b)(1).) There has been no showing that this legislative mandate has been violated by auction revenues being used for any purpose other than to advance the goal of reducing greenhouse gas emissions.[16]

b. What standards should the judiciary apply in reviewing expenditures that are alleged to be replacements for general revenue expenditures?

Whether a particular expenditure of auction revenue replaces current expenditures from the general fund is not relevant to the constitutionality of the auction system.

Even a fee can reduce demands on the general fund by shifting the cost of an existing program from the taxpayers to those who benefit from the program or make the program necessary. (See, e.g., *California Farm Bureau*, *supra*, 51 Cal.4th at pp. 430, 437-440 [upholding a statute that imposed a regulatory fee to pay for activities formerly supported by the general fund]; *Knox v. City of Orland* (1992) 4 Cal.4th 132, 150 [city's history of using tax revenues to build and maintain public parks "should not prevent it from deciding later that funding by special benefit assessment would be more appropriate"]; *San Diego Gas & Electric Co. v. San Diego County Air Pollution Control Dist.* (1988) 203 Cal.App.3d 1132, 1148 ["a reasonable way to achieve Proposition 13's goal of tax relief" is to shift regulatory costs from the taxpaying public to the regulated parties].) A fee may be used in any reasonable manner consistent with the purpose for

[15] Per statutory direction, ARB has issued guidance to state agencies on preparing a record of the expenditure and quantifying anticipated the greenhouse gas emissions: http://www.arb.ca.gov/cc/capandtrade/auctionproceeds/quantification.htm; http://www.arb.ca.gov/cc/capandtrade/auctionproceeds/arb-funding-guidelines-for-ca-climate-investments.pdf

[16] ARB has also issued an annual report detailing current expenditures of auction revenue and quantifying the anticipated greenhouse gas reductions: http://arb.ca.gov/cc/capandtrade/auctionproceeds/cci_annual_report_2016_final.pdf.

which the fee is imposed. (See, e.g., *Collier v. City and County of San Francisco*, *supra*, 151 Cal.App.4th at pp. 1339-1344 [rejecting claim that building permit fees were used improperly to support unrelated governmental activities].)

Auction revenue, too, may be used to support existing general fund programs without being treated as general revenue. The relevant consideration in determining the constitutionality of the auction system is not whether auction revenue is being used to support general fund programs, but whether auction revenue is being collectively used to advance the regulatory purposes of AB 32.

c. What, as a practical matter, would be the remedy, if, under the applicable standards a court finds a particular program is not sufficiently tethered to the goals of Assembly Bill No. 32?

Even if, hypothetically, a particular expenditure of auction revenue were found not to advance the goals of AB 32, that expenditure would not demonstrate that the auction system is unconstitutional. The issue under Proposition 13 is whether the auction system *as a whole* imposes a tax enacted for the purpose of increasing revenues. Expenditures should be considered collectively, not individually. Particular programs and expenditures are insufficient to render the entire auction system unconstitutional. (See generally, *Pajaro Valley Water Mgmt. Agency v. Amrhein* (2007) 150 Cal.App.4th 1364, 1380 [constitutional invalidity "must be based upon a clear, substantial, and irreconcilable conflict with the fundamental law"]; *Collier v. City and County of San Francisco*, *supra*, 151 Cal.App.4th at pp. 1339-1340 [expenditures of building permit fees should be reviewed under a flexible standard]; see also Health & Saf. Code, § 39712 subd. (a)(2) [providing that an expenditure determined to be inconsistent with the law shall not affect expenditures for other measures or projects.]) At most, those particular expenditures might be declared contrary to statute. (See Health & Saf. Code, § 39710 et seq.; Gov. Code, §§ 12894 & 16428.8 et seq.)

6. Address the proper test of voluntariness in the context of determining whether a payment is or is not voluntary for the purposes of deciding whether it is a compulsory exaction or freely-entered transaction. Apply the test to explain whether or not the auction payments are voluntary. As part of the discussion, assume for purposes of argument only that the trial court credited the Rabo declaration, and that Morning Star (purely as a hypothetical case) will be forced out of business due to the lack of feasible, affordable, technology to reduce its greenhouse gas emissions, if it must continue to obtain emissions credits in order to operate its tomato processing facilities.

There is no general test to distinguish between voluntary and compulsory payments. Instead, the courts offer the general observation that "[m]ost taxes are compulsory rather than imposed in response to a voluntary decision to develop or to seek other government benefits or privileges." (*California Farm Bureau*, *supra*, 51 Cal.4th at p. 437, quoting *Sinclair Paint*, *supra*, 15 Cal.4th at p. 874.) Fees, in contrast, often allow fee payers "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." (*California Bldg. Industry Assn. v. San Joaquin Valley Air Pollution Control Dist.* (2009) 178 Cal.App.4th 120, 132, italics added.) In the context of environmental fees, for example, fee payers often "can modify their conduct to pollute less or consume less water." (*Ibid.*) Fees can therefore serve to regulate future conduct by deterring harmful activities and by stimulating research and development efforts. (*Sinclair Paint*, *supra*, 15 Cal.4th at p. 877.) Even a compulsory charge may be considered a fee and not a tax. (*Id.* at p. 874.)

In disputing that payments made in the auctions are non-compulsory, the plaintiffs disregard that the auction system is just one component of the cap and trade program. The cap and trade program allows covered entities to choose a method of compliance best suited for their individual circumstances.

To begin with, covered entities know when they decide to engage in an activity that causes emissions that they are subject to regulation. They know that existing emissions limits may be lowered and also that previously unregulated pollutants may become regulated. In that respect, they are akin to developers who must pay development fees only after they "voluntarily decide[] whether to develop or not to develop." (*Trent Meredith, Inc. v. City of Oxnard*, *supra*, 113 Cal.App.3d at p. 328.) Once they are subject to ARB's regulations, covered entities may comply with the cap and trade program without ever purchasing allowances through the auction system; they may find ways to reduce their emissions, or they may purchase allowances from each other in the secondary markets, or they may purchase "offset credits" from private parties, or they may comply through some combination of the three. (See ARB

respondents' brief, p. 57.) And if they do choose to participate in the auction system, covered entities can decide for themselves how much to bid. (*Id.* at pp. 55-56.) Thus, covered entities have a variety of ways to exercise "some control" over if, when, to whom, and how much they will pay through the auction system. (See *California Bldg. Industry Assn. v. San Joaquin Valley Air Pollution Control Dist.*, *supra*, 178 Cal.App.4th at p. 132.) Taxes do not allow the same level of control. (See *California Farm Bureau*, *supra*, 51 Cal.4th at p. 437 ["Most taxes are compulsory rather than imposed in response to a voluntary decision to develop or to seek other government benefits or privileges"].)

Morning Star alleges that the nature of its existing business allows no economically viable option but to purchase allowances through the auction. Even if that allegation were true—which has not been adjudicated—the fact that a remedial measure is mandatory does not, by itself, invoke Proposition 13; the police power is broad enough to include mandatory remedial measures to mitigate the past, present, or future adverse impact of the fee payer's operations. (*Sinclair Paint*, *supra*, 15 Cal.4th at pp. 877-878.) Moreover, the face of the regulations and the record establish that the cap and trade program leaves the manner of compliance up to covered entities themselves, and covered entities will make their decisions based on *economic* considerations, rather than by government compulsion. (See Rabo declaration filed 8/6/2013 at pp. 2-3 [Morning Star assumes allowances will be least expensive through the auction system and therefore chooses not to purchase allowances in the secondary market].) Thus, the design of the auction system has a strongly voluntary quality that is not characteristic of a tax.

The court asks the parties to assume, hypothetically, that Morning Star will be forced out of business if it must continue to obtain emissions credits. Critically, Morning Star's need to obtain emissions credits would not go away even if ARB allocated all the allowances for free. Rather, Morning Star's need to obtain emissions credits is a product of the regulation's declining cap—which Morning Star does not challenge. (Morning Star opening brief, p. 34 ["AB 32 permits but does not require CARB to regulate greenhouse gases by a market-based cap and trade program."].) The declining cap means that—even with free allocation of all allowances—entities that do not reduce their emissions over time will face a shortfall and will need to obtain allowances from other entities. Assuming *arguendo* that Morning Star will not or cannot reduce its emissions, it faces a need to continue to obtain emissions credits under any cap and trade program. Whether Morning Star acquires those allowances through purchases from other private parties or through participation in the auction remains a voluntary choice.

Moreover, under AB 32, ARB could have adopted regulations that did not give Morning Star the option to purchase allowances to cover its failure to reduce emissions. In particular, AB 32 provided ARB with sufficient authority to require Morning Star and other emitters to achieve the necessary emissions reductions directly at their facilities, without offering any other compliance options. (See Health & Saf. Code, §§ 38505,

subd. (e) [defining "direct emission reduction measure"], 38561, subd. (b) [directing ARB to consider "direct emission reduction measures" in its Scoping Plan].) In that situation, Morning Star's options would be even fewer.

When the Legislature passed AB 32, it established an ambitious goal of reducing emissions, at a minimum, to 1990 levels by 2020. (Health & Saf. Code, § 38550; see also *Association of Irritated Residents v. California Air Resources Bd.* (2012) 206 Cal.App.4th 1487, 1505.) Given that goal and given Morning Star's significant level of greenhouse gas emissions, the company was bound to face regulation. Any concerns the company has with the regulatory goals of AB 32 should be presented to the Legislature, rather than the courts.

7. If this court finds the auction is deemed to be an invalid tax, what is the remedy regarding the regulation, other than a declaration invalidating the auction component?

The plaintiffs have challenged a central component of an environmental regulation that is essential to addressing a pollution problem that the Legislature found "poses a serious threat to the economic well-being, public health, natural resources and the environment of California." (Health & Saf. Code, § 38501, subd. (a).) The continued viability of the cap and trade program is of critical importance to the State of California in meeting the 2020 statewide greenhouse gas emissions limit mandated by the Legislature in AB 32. As discussed more fully below, if this court finds in favor of the plaintiffs, the court should follow established precedent and exercise its inherent power to preserve the status quo by ordering that all portions of the regulations implicated by its findings and declaration shall remain in effect until such time as ARB has had a reasonable opportunity to promulgate amendments to the cap and trade regulations to come into compliance with any such decision. (See *California Hotel and Motel Assn. v. Industrial Welfare Com.* (1979) 25 Cal.3d 200, 216; see also *Morning Star Co. v. Board of Equalization* (2006) 38 Cal.4th 324, 341-342.)

In addition, any declaration of invalidity should be carefully crafted, to avoid invalidating or calling into question those portions of the regulations that concern private parties' consignment of allowances for sale in ARB's auctions. (§§ 95893, 95910, subd. (d).) Those consignment sales do not produce any proceeds for the state, and the ability of private parties to use ARB's auction as a vehicle to sell allowances has not been challenged by the plaintiffs.

A. Courts Exercise Their Inherent Power to Preserve the Status Quo to Allow Regulators to Cure Deficiencies in Regulations Critical to Protection of the Environment

In California, courts have the "inherent power to make an order to preserve the status quo pending correction of deficiencies" in an agency's regulation or order. (See *California Hotel and Motel Assn. v. Industrial Welfare Com.*, *supra*, 25 Cal.3d at p. 216; see also *Morning Star Co. v. Board of Equalization*, *supra*, 38 Cal.4th at pp. 341-342.) In cases involving the collection of fees, the courts have exercised this inherent power where "the continued viability of the … program is of critical importance to the State of California, as determined by the Legislature…." (*Morning Star*, at p. 342.) For example, in *Morning Star* the court found, on statutory grounds, that the Department of Toxic Substances Control's implementation of a hazardous materials fee was invalid, but exercised its inherent power to preserve the status quo given that any disruption in collection of the fee would seriously undermine the hazardous materials program. (*Morning Star*, at pp. 341-342 [directing that on remand the superior court "shall issue an order … maintaining the fee system as presently interpreted and implemented by the agencies…."]; see also *California Farm Bureau*, *supra*, 51 Cal.4th at p. 435 [noting the court of appeal found Water Board fee unconstitutional as applied but stayed proceedings before the Water Board or Board of Equalization until Water Board could adopt a new fee schedule formula].)

In addition to state court precedent, California courts have relied on federal precedents where a "remand without vacatur" has the same effect as an order in state court preserving the status quo.[17] Here, several federal decisions concerning an air pollution program with a trading element provide apt examples. Those cases involve a series of challenges to U.S. EPA's Clean Air Interstate Rule (CAIR), which governs several states' emissions of two air pollutants—sulfur dioxide and nitrogen oxide—from stationary sources. (See *North Carolina v. EPA* (D.C.Cir. 2008) 531 F.3d 896, 903 [noting that CAIR revises regulations governing the Acid Rain cap and trade program

[17] See *California Hotel and Motel Assn. v. Industrial Welfare Com.*, *supra*, 25 Cal.3d at p. 216, n. 42, citing *Rodway v. United States Dept. of Agriculture* (1975) 514 F.2d 809, 817-818 [federal food stamp regulations, held invalid, remained operative pending remand for further rulemaking]; see also *Morning Star Co. v. Board of Equalization*, *supra*, 38 Cal.4th at p. 342, citing *Sugar Cane Growers Co-op of Florida v. Veneman* (D.C.Cir. 2002) 289 F.3d 89, 97-98 [remanding without vacating where agency failed to engage in required notice and comment]; *American Medical Assn. v. Reno* (D.C.Cir. 1995) 57 F.3d 1129, 1135-1136 [remanding without vacating].

and replaces another regulation with a trading program].) In 2008 and again in 2012, the District of Columbia Circuit Court of Appeals determined that EPA's original rule—which it found suffered from "more than several fatal flaws"—should remain in place while EPA worked on a first and then a second replacement rule. (See *North Carolina v. EPA* (D.C.Cir. 2008) 550 F.3d 1176, 1178 (hereafter *North Carolina II*) [on rehearing amending its opinion to remand the rule without vacating, to remain in effect until it is replaced by a rule consistent with the court's opinion]; see also *EME Homer City Generation, L.P. v. EPA* (D.C.Cir. 2012) 696 F.3d 7, 37-38 [finding EPA's replacement for CAIR invalid, and again ordering EPA "to administer CAIR pending its development of a valid replacement"]; see also *EME Homer City Generation, L.P. v. EPA* (D.C. Cir. 2015) 795 F.3d 118, 132 [remanding without vacatur for recalculation of 2014 emissions budgets].) In both 2008 and 2012, the federal court of appeals found that:

> [I]t is appropriate to remand without vacatur where vacatur would at least temporarily defeat the enhanced protection of the environmental values covered by the EPA rule at issue.

(*North Carolina II*, at p. 1178; *EME Homer City Generation*, at pp. 37-38.) The court further declined to "impose a particular schedule by which EPA must alter CAIR," choosing instead to remind EPA that the court did not intend to grant an indefinite stay of the effectiveness of its decision. (*North Carolina II*, at p. 1178)

B. <u>This Court Should Preserve the Status Quo to Allow ARB a Reasonable Opportunity to Take on the Complex Task of Amending the Cap and Trade Program</u>

ARB is under direction from the Legislature to reduce California's statewide greenhouse gas emissions to, at minimum, 1990 levels by 2020, and to do so in ways that achieve the maximum technologically feasible and cost-effective reductions. (Health & Saf. Code, §§ 38550, 38562, subd. (a).) "The challenges inherent in meeting these goals can hardly be overstated." (*Association of Irritated Residents v. California Air Resources Bd., supra*, 206 Cal.App.4th at p. 1505.) ARB, expert advisory committees, and stakeholders invested eighteen months in informal rulemaking and another year in formal rulemaking—including dozens of public meetings and thousands of pages of staff reports and responses to comments—to arrive at the design of the cap and trade regulations. (See ARB respondents' brief, pp. 7-16.) The result is cap and trade regulations that cover emissions from sources responsible for approximately 85 percent of statewide greenhouse gas emissions. (AR C-000025.) Moreover, the cap and trade program is working. The

first two-year compliance period is now complete and ARB has reported a greater than 99.9 percent compliance by covered emitters.[18]

The cap and trade program, however, contains various elements that work together. At present, ARB's regulations allocate approximately half of the allowances at no cost directly to covered entities. (§§ 95890-95895.) This no-cost allocation is done pursuant to carefully calculated benchmarks and formulas embedded in the regulations that are designed to, among other things, prevent leakage and protect electricity and water ratepayers, consistent with the balancing of multiple objectives set forth by the Legislature. (See, e.g., §§ 95891 [Allocation for Industry Assistance], 95892 [Allocation to Electrical Distribution Utilities for Protection of Electricity Ratepayers]; see also Health & Saf. Code, §§ 38562, subds. (b)(1), (b)(8).) ARB distributes the other half of the allowances that make up the cap on a quarterly basis via the auction. (§§ 95910-95914.)

Any change in the distribution of allowances would require that ARB amend the intricately detailed regulations and ensure that any changes take into consideration the many factors that AB 32 requires. Thus, ARB would need to consider—in an open and public rulemaking process—the impact of a change in distribution on the AB 32 factors mentioned above, as well as "the potential for direct, indirect and cumulative emissions impacts … including localized impacts in communities that are already adversely impacted by air pollution" and the ability of an amended cap and trade mechanism to "prevent[] any increase in the emissions of toxic air contaminants or criteria air pollutants." (See Health & Saf. Code, §§ 38570, subds. (b)(1) and (b)(2).)[19]

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[18] See 2013-2014 Compliance Obligation Detail for ARB's Cap-and-Trade Program (Apr. 1, 2016), available at http://www.arb.ca.gov/cc/capandtrade/2013-2014compliancereport.xlsx.

[19] The plaintiffs may argue that this court could or should issue an order directing ARB to allocate all allowances to covered entities at no cost. Such a request, however, would vastly oversimplify the issue and would invite the court to prejudge the outcome of complex issues and judgments that the Legislature delegated to ARB and that should be left to its quasi-legislative rulemaking process. (See generally, *Carrancho v. Cal. Air Resources Bd.* (2003) 111 Cal.App.4th 1255, 1265 ["The court does not 'weigh the evidence adduced before the administrative agency or substitute its judgment for that of the agency, for to do so would frustrate the legislative mandate'" (citation omitted)]; see also *Association of Irritated Residents v. California Air Resources Bd.*, *supra*, 206 Cal.App.4th at p. 1502 ["Determining the best means of identifying and implementing the most cost-effective and feasible measures to maximize greenhouse gas emissions

(continued…)

As in *Morning Star* and *North Carolina*, the regulations at issue here further an important legislative protection of the environment. (See *Morning Star Co. v. Board of Equalization*, *supra*, 38 Cal.4th at pp. 341-342; *North Carolina II*, *supra*, 550 F.3d at p. 1178.) The cap and trade program is undoubtedly of critical importance to the state of California, and any alteration to one of the components of the program should be carefully considered to ensure that ARB can continue to provide "the enhanced protection of the environmental values covered by" the regulations. (See *North Carolina II*, at p. 1178.)[20] For these reasons, any finding against ARB should be accompanied by an order that the auction of allowances remain in effect until such time as ARB has had a reasonable opportunity to promulgate amendments to the cap and trade regulations to come into compliance with this court's opinion.

* * *

Respondents appreciate the opportunity to address the court's questions and respectfully submit that the judgment should be affirmed.

Sincerely,

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(...continued)

reductions involves numerous highly technical and novel scientific, technical and economic issues"].)

[20] While a finding that the auction is an invalid tax would constitute a significant deficiency, the flaws found in several other cases where the status quo has been maintained were similarly significant. (See, e.g., *California Farm Bureau*, *supra*, 51 Cal.4th at p. 435 [noting in procedural history that the court of appeal stayed further proceedings before the Water Board or the Board of Equalization on a fee it found unconstitutional as applied]; see also *North Carolina II*, *supra*, 550 F.3d at p. 1178 [finding that EPA's trading regulation suffered from "more than several fatal flaws"].)

DECLARATION OF ELECTRONIC SERVICE AND SERVICE BY U.S. MAIL

Case Name: **Cal Chamber v. Cal Air Resources Board**
No.: **C075930 and C075954**

I declare:

I am employed in the Office of the Attorney General, which is the office of a member of the California State Bar, at which member's direction this service is made. I am 18 years of age or older and not a party to this matter. I am familiar with the business practice at the Office of the Attorney General for collecting and processing electronic and physical correspondence. In accordance with that practice, correspondence placed in the internal mail collection system at the Office of the Attorney General is deposited with the United States Postal Service with postage thereon fully prepaid that same day in the ordinary course of business. Correspondence that is submitted electronically is transmitted using the TrueFiling electronic filing system. Participants who are registered with TrueFiling will be served electronically. Participants in this case who are not registered with TrueFiling will receive hard copies of said correspondence through the mail via the United States Postal Service or a commercial carrier.

On May 23, 2016, I electronically served the attached **SUPPLEMENTAL LETTER BRIEF OF RESPONDENTS CALIFORNIA AIR RESOURCES BOARD, ET AL.** by transmitting a true copy via this Court's TrueFiling system. Because one or more of the participants in this case have not registered with the Court's TrueFiling system or are unable to receive electronic correspondence, on May 23, 2016, I placed a true copy thereof enclosed in a sealed envelope in the internal mail collection system at the Office of the Attorney General at 1300 I Street, Suite 125, P.O. Box 944255, Sacramento, CA 94244-2550, addressed as follows:

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I declare under penalty of perjury under the laws of the State of California the foregoing is true and correct and that this declaration was executed on May 23, 2016, at Sacramento, California.

Jennifer Goldsmith
Declarant

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