IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

THIRD APPELLATE DISTRICT

CALIFORNIA CHAMBER OF COMMERCE, ET AL., Plaintiffs and Appellants, **v.** **CALIFORNIA AIR RESOURCES BOARD, ET AL.,** Defendants and Respondents, **NATIONAL ASSOCIATION OF MANUFACTURERS,** Intervener and Appellant, **ENVIRONMENTAL DEFENSE FUND, ET AL.,** Interveners and Respondents.	Case No. C075930 Sacramento County No. 34-2012-80001313 CU-WM-GDS Hon. Timothy H. Frawley
MORNING STAR PACKING COMPANY, ET AL., Plaintiffs and Appellants, **v.** **CALIFORNIA AIR RESOURCES BOARD, ET AL.,** Defendants and Respondents, **ENVIRONMENTAL DEFENSE FUND, ET AL.,** Interveners and Respondents.	Case No. C075954 Sacramento County No. 34-2013-80001464 CU-WM-GDS Hon. Timothy H. Frawley

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Case Name:	*California Chamber of Commerce, et al. v. California Air Resources Board, et al.*	Court of Appeal No.	C075930
	Morning Star Packing Company, et al. v. California Air Resources Board, et al.	Court of Appeal No.:	C075954

CERTIFICATE OF INTERESTED PARTIES OR ENTITIES OR PERSONS
(Cal. Rules of Court, Rule 8.208)

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[X] There are no interested entities or persons to list in this Certificate per California Rules of Court, rule 8.208(d).

[ ] Interested entities or persons are listed below:

Full Name of Interested Entity or Party	Party *Check One*	Non-Party *Check One*	Nature of Interest *(Explain)*
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The undersigned certifies that the above listed persons or entities (corporations, partnerships, firms or any other association, but not including government entities or their agencies), have either (i) an ownership interest of 10 percent or more in the party if an entity; or (ii) a financial or other interest in the outcome of the proceeding that the justices should consider in determining whether to disqualify themselves, as defined in rule 8.208(e)(2).

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February 25, 2015
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CONSTITUTIONAL PROVISIONS

INTRODUCTION

By enacting the Global Warming Solutions Act of 2006 ("AB 32"), the Legislature firmly placed California in a leadership role in combatting climate change. The Legislature clearly identified the statutory objective—reducing greenhouse gas emissions in a fair and efficient manner—and it set an initial emissions limit for 2020, putting the state on a path toward climate stabilization. But the Legislature did not prescribe the specific measures and approaches to achieve these statutory ends. Rather, it delegated to an expert state agency, the California Air Resources Board ("ARB"), the authority to study, select, and design measures to reduce greenhouse gas emissions in a manner that would achieve the Legislature's objectives.

Exercising this authority, and after several years of study, planning and public rulemaking, ARB adopted its cap and trade regulation. The regulation sets a statewide limit on the sources (i.e., emitters) responsible for 85 percent of California's greenhouse gas emissions. Every year ARB creates a declining and finite number of allowances, each of which allows the holder to emit one metric ton of greenhouse gases. Among the many complex decisions ARB had to make was how to distribute those allowances. This is the decision at issue in these cases.

Based on the policy criteria identified by the Legislature—including lessons learned from other cap and trade programs—ARB designed a three-pronged approach to distributing allowances that:

- gives most of the allowances to sources for free;
- creates a price containment reserve from which sources can purchase allowances at pre-established prices; and
- auctions the remaining allowances on a quarterly basis.

ARB designed the auction to advance multiple regulatory functions, including market transparency, efficiency and equity, as well as to foster incentives for innovation and early emission reductions, while avoiding any unintended windfalls for greenhouse gas emitters. Similarly, ARB designed the reserve to create a supply of allowances that sources could access in the event of a temporary shortfall in the market supply.

Plaintiffs Morning Star Packing Company ("Morning Star") and California Chamber of Commerce ("CalChamber"), along with intervener National Association of Manufacturers ("NAM") (collectively "plaintiffs"), do not dispute that ARB has the authority to adopt a cap and trade regulation, but they argue that ARB's sole design option is to give all the allowances away to greenhouse gas emitters for free. The plaintiffs claim that ARB lacks statutory authority to sell allowances and that Proposition 13 renders the sale of allowances unconstitutional. Neither argument has merit. The plaintiffs' statutory arguments contradict the Legislature's unambiguous delegation of authority to ARB, and their constitutional arguments ignore that the auction and reserve are not "taxes" and were not "enacted for the purpose of increasing revenues." Therefore, the plaintiffs' claims should be denied.

STATEMENT OF THE CASE

I. STATUTORY AND REGULATORY BACKGROUND

A. The Legislature Enacts the Global Warming Solutions Act of 2006 and Gives ARB Authority to Enact "Market-Based Mechanisms," Including Cap and Trade

In September 2006, California became the first state in the nation to adopt a comprehensive framework for reducing greenhouse gas emissions.

(Health & Saf. Code, § 38500 et seq.)[1] In AB 32, the Legislature declared that "[g]lobal warming poses a serious threat to the economic well-being, public health, natural resources, and the environment of California." (§ 38501, subd. (a).) To address this threat the Legislature established an initial target, to reduce the state's greenhouse gas emissions to 1990 levels by 2020, and called for the state to maintain and continue reductions in emissions beyond 2020. (§§ 38550, 38551, subd. (b); see also Exec. Order S-3-05 at 5 Joint Appendix ("JA") 1168-1169.)

AB 32 charges ARB "with monitoring and regulating sources of emissions of greenhouse gases that cause global warming in order to reduce the emissions of greenhouse gases." (§ 38510.) To guide ARB in its new role, the Legislature established a series of milestones for ARB to meet in developing a regulatory program, requiring ARB to: establish mandatory reporting and verification of greenhouse gas emissions (§ 38530); prepare and approve a scoping plan (§ 38561); and adopt greenhouse gas emission reduction measures into regulation (§ 38562).

Regarding this last responsibility—the adoption of regulations—the Legislature did not require the adoption of specific emission reduction measures, nor did it attempt to design such measures. (See, e.g., §§ 38560, 38562, 38570.) Rather, the Legislature directed ARB to select and design emission reduction measures "in an open and public process" (§ 38560), through consultation with other states, the federal government and other nations (§ 38564), taking into account a diverse set of policy "criteria" (§ 38562, subds. (b)(1) to (b)(9); see also § 38570). The Legislature also made clear that the regulations adopted by ARB should be based "upon the best available economic and scientific information" (§ 38562, subd. (e)),

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[1] All further statutory references are to the Health and Safety Code, unless otherwise noted.

should reflect "all relevant information pertaining to greenhouse gas emissions reduction programs in other states, localities, and nations" (§ 38561, subd. (c)), and should "continue [California's] tradition of environmental leadership" (§ 38501, subd. (c)).

While the Legislature did not mandate specific emission reduction measures, it expressly allowed ARB to adopt "market-based compliance mechanisms" such as cap and trade. (§§ 38562, subd. (c), 38570, subd. (a).) The Legislature defined "market-based compliance mechanisms" in a general way to include "a system of market-based declining annual aggregate emissions limitations for sources or categories of sources that emit greenhouse gases," as well as other market-based tools, such as "exchanges, banking and other transactions," to be "governed by rules and protocols established by [ARB]...." (§ 38505, subds. (k)(1), (k)(2); see also §§ 38561, subd. (b), 38562, subd. (c).) Particularly relevant to this case, the Legislature gave ARB the authority to "design ... the distribution of emissions allowances" if included as part of a market-based mechanism:

> [T]he 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 the total benefits to California, and encourages early action to reduce greenhouse gas emissions.

(§ 38562, subd. (b)(1), italics added.) Although AB 32 includes a definitions section (§ 38505), the Legislature did not define the word "distribution" or the phrase "distribution of emissions allowances," thus leaving it to ARB to fill that gap. As discussed below, providing a regulatory mechanism for distributing allowances is one of several decisions that must be made in designing a cap and trade program and that AB 32 left to ARB's expertise.

B. ARB Faces Numerous Design Decisions in Creating the Cap and Trade Program

While cap and trade programs vary, they all share certain attributes. Generally speaking, cap and trade is a "market-based tool for environmental protection" that provides certainty in emissions reductions while harnessing market forces to provide polluters with a monetary incentive to decrease emissions. (U.S. Environmental Protection Agency ("U.S. EPA"), Tools of the Trade (2003), Administrative Record ("AR") Add-A-8485.)[2] By using markets to incentivize the lowest cost reductions across sources—as opposed to prescribing a technology or quantity of reductions for each source—cap and trade achieves the same level of emission reductions at a lower cost. (*Id.* at Add-A-8485 to Add-A-8486.) The decision to employ a cap and trade approach to reduce emissions requires the drafter to make numerous important design choices.

Determining coverage. One initial design choice is which industries to include within the cap. Factors to consider in identifying those industries include the level of a particular industry's contribution to the emissions problem, the number and size of the emission sources within that industry, and the availability of methods to measure those emissions. (Tools of the Trade, AR Add-A-8504 to Add-A-8507.)

Establishing a cap and its rate of decline. The "cap" in cap and trade is a limit on the aggregate emissions from the identified set of sources

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[2] Citations to the Administrative Record contain the volume (A through I) and Bates page numbers. The addenda included in the Administrative Record—designated "Add-A" and "Add-B"—contain references included in ARB's cap and trade rulemaking file. The author, title and date of addenda references are provided herein, with pin cites to the Bates page. The electronic copy of the Administrative Record provided to the court contains an index in Excel, with hyperlinks by Bates page range.

included within the program. What level to set the cap at is another key design decision. Once the cap is set, the regulating authority then creates a finite number of permits, called "allowances," to emit a specific quantity (e.g., 1 ton) of the target pollutants. The total number of allowances created in a given year is equal to the cap for that year. The regulating authority decides how much to reduce the cap each year and reduces the number of allowances accordingly. (Tools of the Trade, AR Add-A-8485.)

Designing distribution and trading. The allowances created for the program must be "distributed" by the regulating authority. Methods of distribution include giving the allowances to polluters at no cost (i.e., free allocation) and selling allowances through direct sales or auctions. (Tools of the Trade, AR Add-A-8513.) Free allocation and sales also can be combined into a multi-pronged system of allowance distribution. (See U.S. Climate Action Partnership, A Blueprint for Legislative Action (2009), AR Add-A-18430 to Add-A-18431; see also National Council on Energy Policy ("NCEP"), Allocating Allowances in a Greenhouse Gas Trading System (2007), AR Add-A-8253, Add-A-8260 to Add-A-8264, Add-A-8267.) Once the regulating entity has distributed them, allowances may be traded between sources and other market participants, such as financial institutions. A source that can reduce a ton of its emissions for less than the price of an allowance has an incentive to do so, because that source can either (a) avoid having to purchase an allowance it would otherwise require for that ton of emissions, or (b) sell an allowance it already holds. (Tools of the Trade, AR Add-A-8485 to Add-A-8486.)

Other design considerations. Designing a cap and trade program requires many other decisions, including determination of: (1) the duration of compliance periods; (2) the amount of time before allowances will expire if not used; (3) procedures for the tracking and trading of allowances; (4) whether parties other than regulated sources may acquire and trade

allowances; (5) the availability of cost-containment mechanisms such as "offsets"[3]; and (6) the procedures for enforcement. (Tools of the Trade, AR Add-A-8500 to Add-A-8525.)

C. ARB Promulgates the Cap and Trade Regulation After an Extensive Public Process

After more than eighteen months of informal rulemaking activities involving over two dozen public meetings on various aspects of cap and trade (see AR B-1 to B-7055), and early consideration of the design options outlined above, ARB commenced its formal rulemaking on October 28, 2010, publishing a draft of the proposed regulation, along with a 472 page staff report (the Initial Statement of Reasons). (AR C-15 to C-486.) Extensive appendices to the staff report analyzed, among other things, a price containment reserve (Appendix G) and options for the distribution of allowances (Appendix J). (AR C-1454 to C-1510, AR C-1714 to C-1785.) During three separate comment periods, ARB received nearly 1,000 written comments, which it addressed in a 2,440 page Final Statement of Reasons. (AR H-534 to H-2973.) Staff proposed modifications to the regulation in response to public comments and board input (AR D-1 to D-18), and the board adopted the cap and trade regulation at its October 20, 2011 meeting. (AR G-1010 to G-1024; see also Cal. Code Regs., tit. 17, § 95870 et seq.)

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[3] An "offset" is a reduction in emissions or sequestration of a pollutant in an industry/sector that is not covered by the cap. For example, because the forestry sector is not covered by ARB's cap, projects that establish, manage or conserve forests to sequester greenhouse gases can generate offset credits if they meet ARB's standards. In ARB's program, each such credit is equal to one allowance. (See Cal. Code Regs., tit. 17, § 95970 et seq.)

The regulation became effective on January 1, 2012. (AR H-2994 to H-3690.)[4]

Cap and compliance periods. ARB's regulation sets a declining cap on the emissions of the multiple greenhouse gases specified in AB 32.[5] (See § 38505, subd. (g); see also Cal. Code Regs., tit. 17, § 95810.) ARB decided that during an initial compliance period of 2013-2014, the cap should cover the aggregate emissions from significant emitters in the electricity and industrial sectors. (Cal. Code Regs., tit. 17, §§ 95811, 95840.) Starting with the compliance period beginning in 2015, ARB adjusted the cap to incorporate the aggregate emissions from the consumption of natural gas and transportation fuels and expanded the compliance periods to three-year intervals. (*Id.*, § 95841.) Thus, as of January 2015, the cap covers approximately 85 percent of statewide emissions. (AR C-25, C-37.) ARB decided to reduce the number of allowances it creates each year at a rate of about 3 percent (excluding the adjustment in 2015 to expand the program), so that by 2020, ARB forecasts that the cap and trade program will reduce aggregate emissions by tens of

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[4] ARB amended portions of the cap-and-trade regulation in 2012, 2013, and 2014, which has changed the numbering of the regulation over time. (See ARB Cap and Trade, Current Regulation and Proposed Regulatory Amendments, available at www.arb.ca.gov/cc/capandtrade/capandtrade.htm.) The citations herein are to the current regulation.

[5] Each greenhouse gas has a different global warming potential, and therefore, each allowance is good for the emission of one metric ton of "carbon dioxide equivalent" or "CO_2e." (Cal. Code Regs., tit. 17, § 95802, subd. (a)(52).) Formulas in a sister regulation regarding emissions reporting provide for conversion of measurements of different greenhouse gases into CO_2e. (*Id.*, § 95102, subd. (a).)

millions of metric tons. (See Cal. Code Regs., tit. 17, § 95841; see also AR C-60 to C-62.)[6]

Allowance distribution. ARB's regulation distributes allowances through a combination of free allocation, direct sales from a price containment reserve, and auctions. (Cal. Code Regs., tit. 17, §§ 95870, 95890, 95910.) Electric utilities and industrial sources (e.g., oil refiners, cement and glass manufacturers) receive, for free, allowances equal to about 90 percent of their collective anticipated emissions in the first years of the program. This percentage declines over time, based on a detailed formula that takes into consideration each source's product output, "leakage risk,"[7] and need for "transition assistance."[8] (See *id.*, §§ 95870 (Table 8-1), 95870, subds. (d) and (e), 95891, 95892 (Table 9-3); see also AR C-1724, C-1748.) In addition, ARB has placed 4 percent of the allowances for the years 2012 through 2020 into a "price containment reserve," as explained in more detail below. (See Cal. Code Regs., tit. 17, §§ 95870, subd. (a), 95913, subd. (h)(3).) The remaining allowances are distributed by auction. (*Id.*, § 95870, subd. (i)(2).)[9]

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[6] ARB also allows sources to use "offset credits" instead of allowances for up to eight percent of their emissions in a given year. (Cal. Code Regs., tit. 17, § 95856, subd. (h)(1)(A).)

[7] Leakage can occur if, as a result of the program, consumption shifts from products made in California to products made in jurisdictions that do not regulate greenhouse gas emissions. (See § 38505, subd. (j).)

[8] Transition assistance is provided for sources that are locked into "legacy contracts" executed prior to September 1, 2006, and therefore cannot adjust their pricing to account for the costs of compliance with cap and trade. (Cal. Code Regs., tit. 17, § 95984, subd. (a).)

[9] The regulation also requires that investor-owned utilities consign to auction the allowances they have been given for free. The proceeds from the sale of consigned allowances are returned to the utilities to be used exclusively for the benefit of ratepayers. (Cal. Code Regs., tit. 17, § 95910, subds. (c) and (d).)

Auction procedures. ARB holds auctions on a quarterly basis. (Cal. Code Regs., tit. 17, § 95910, subd. (a).) At each auction ARB offers for sale roughly one-fourth of the current-year allowances remaining after free allocation to sources and set aside for the reserve, plus 2.5 percent of a future year's allowances. (*Id.*, §§ 95910, subd. (c); 95870, subds. (b) and (i).) Participation in the auctions is not limited to covered sources. Anyone able to complete the auction application and satisfy the financial qualifications may participate. (*Id.*, § 95912, subd. (d).) All winning bidders pay the same clearing price (the price at which supply matches demand). (*Id.*, § 95911.) The regulation establishes a reserve price (which rises over time) for allowances sold at auction, and if there are not sufficient bids at or above the reserve price, some allowances will go unsold, to be offered at a subsequent auction. (*Ibid.*)

ARB's regulation provides that "[t]he proceeds from the sale of these allowances will be deposited into the Greenhouse Gas Reduction Fund ... and will be available for appropriation by the Legislature for the purposes designated in [AB 32]...." (Cal. Code Regs., tit. 17, § 95870, subd. (b)(3).)[10] Several statutes enacted in 2012 (discussed in part I.F. below) give further direction on the expenditure of cap and trade proceeds.

D. ARB Reviews Public Comments and Selects a Three-Pronged System for Distributing Emissions Allowances

ARB invited discussion of the means of distributing emissions allowances that best comports with the statutory criteria at no less than 40

[10] In its Statement of the Case, NAM focuses on a board resolution adopted early in the rulemaking process which requested staff to consider and take public comment on a broad range of expenditure options. (NAM 7.) That board resolution has been superseded by the regulation itself.

public meetings,[11] and stakeholders offered a wide range of opinions. Comments from CalChamber stated that all allowances should be "freely allocate[d] ... primarily to mitigate emissions and economic leakage." (AR F-2386.) On the other hand, comments from the Union of Concerned Scientists (AR F-2530 to F-2531), California Interfaith Power and Light (AR C-16385), the Climate Protection Campaign (AR C-3792), and more than 10,000 individual CREDO Action members (AR C-5302 to C-12600 and C-22072 to C-25643) called for auctioning 100 percent of allowances.

Recommendations from two panels of experts favored auctioning a significant portion of the allowances. The Market Advisory Committee found that "cost-effectiveness, fairness and simplicity ... favor a system in which California ultimately auctions all of its emissions allowances." (AR C-1576 to C-1577.) The Economic and Allocation Advisory Committee—composed largely of economists and policy makers—recommended that ARB:

> rely principally, and perhaps exclusively, on auctioning as a mechanism for distributing allowances ... [and] should rely on free allocation as a distribution mechanism only where necessary to address "emissions leakage."

(AR C-1850.)

The price containment reserve drew broad support from stakeholders and experts. (See, e.g., AR H-890 [comment letter from Dow Chemical].) Notably, although CalChamber opined that ARB's proposed reserve prices were too high, the organization expressly stated several times that it "agrees that an allowance reserve is *necessary*, especially if intended as a cost-

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[11] See, e.g., AR B-1366 to B-1367, B-1582 to B-1583, B-1646 to B-1647, B-2669 to B-2670, B-2760 to B-2761, B-5178 to B-5179, B-5279 to B-5280, B-5362 to B-5363, and C-703.

containment mechanism to moderate allowance prices." (AR C-12644 to C-12647, F-2386 to F-2389, and F-4213 to F-4215, italics added.)

After considering the best available information and all of the comments and recommendations submitted, ARB adopted the three-pronged system of distributing allowances for the reasons described below.

1. ARB allocates a majority of allowances for free to assist industry and protect utility ratepayers

For industrial sources such as oil refineries, glass manufacturers and cement producers, ARB determined that a high percentage of free allocation in the program's early stage would "help smooth the imposition of a carbon price on California industry and ... minimize leakage as required by AB 32." (AR C-70, C-1724; see also § 38562, subd. (b)(8).) ARB described at length "a methodology for identifying industries at risk of emissions leakage, and a mechanism to minimize leakage risk." (AR C-1789.) For the electricity and natural gas sectors, ARB found that providing a significant percentage of free allocation would protect ratepayers from sudden increases in their electricity and natural gas bills. (AR C-72, C-1724.)

2. ARB sells allowances from a price containment reserve to moderate prices

ARB borrowed the concept of a price containment reserve from federal cap and trade legislative proposals. (AR C-1489.) ARB found that by making a pool of allowances available only to regulated sources at known fixed prices, a price containment reserve would moderate the effect of high allowances prices due to an unexpected supply shortage (AR C-1726) and would "reduce the risk that substantially higher than anticipated compliance costs are incurred." (AR C-1489; see also AR C-68 to C-69.)

3. ARB auctions allowances to serve multiple regulatory objectives

In determining that some of the allowances should be distributed by auction, ARB considered the following factors related to the criteria established by the Legislature in section 38562.

Maximum technologically feasible and cost-effective emission reductions. ARB found that the auction—with a minimum reserve price (Cal. Code Regs., tit. 17, § 95911, subd. (c)(3))—would play a vital role in "achiev[ing] the maximum technologically feasible and cost-effective reductions" called for by section 38562, subdivision (b). ARB concluded that an auction with a reserve price "will ensure that allowance prices do not get too low to stimulate emissions reductions" or to encourage the development of new low carbon technologies. (AR H-898.) Without an adequate market price for allowances, ARB concluded that the program would not "foster innovative technology or promote a change in consumer behavior." (AR H-897.)[12] Further, ARB found that if all allowances were given away at no cost, the auction's automatic correction for oversupply would be lost, leaving the cap and trade program vulnerable to the excess allowance supply problems experienced in other programs. (AR H-897 to H-899.)

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[12] As noted in economic studies included in ARB's rulemaking file, in the European Union, the lack of significant auctioning between 2005 and 2007 had distorted the incentives for investment in emission reductions. One study found that reliance on free allocation "offset some incentive to invest in the future low CO_2 plant." (Point Carbon, EU ETS Phase II—The Potential and Scale of Windfall Profits in the Power Sector (2008), AR Add-A-10244.) Another study concluded that "[i]n addition to its distributive effects, as indicated the very high level of free allocation creates various incentive problems." (Carbon Trust, EU ETS Phase II allocation: implications and lessons (2006), AR Add-A-13508.)

Equitable distribution. In accordance with the Legislature's direction in AB 32 to design an "equitable" distribution of allowances, ARB found that "[a]uctioning allowances would treat ... potential new businesses equitably relative to previously established firms." (AR C-1776.) As ARB noted, some new businesses "may be directly regulated under the cap and trade program and be responsible for acquiring and surrendering allowances." (*Ibid.*) In an auction, new and established businesses are on identical footing, and the allowances will go to the businesses that place the highest value on them. (AR C-48.)

Minimizing costs to California through transparency, efficiency and protection against manipulation. ARB found that quarterly auctions that publish the prices at which current and future allowances have been sold create a transparent market, allowing firms to plan and to assess the cost of emissions against their reduction opportunities. (AR C-1724, C-1727; see, e.g., 5 JA 1265-1266, 1267-1276.) Here, ARB learned from U.S. EPA's experience, noting that "[i]n the early days of the U.S. Acid Rain cap and trade program the existence of an allowance auction helped reduce volatility and transaction costs by establishing a single market price." (AR C-1775.)

In addition, ARB concluded that auctions are an efficient means of distributing allowances, because they provide a known venue for purchasing allowances, thereby eliminating the cost of locating a seller or paying an intermediary, such as a broker, to locate a seller. (AR C-1775.) ARB also found that distribution of emissions allowances through an auction can "minimize the opportunities for manipulation" (AR H-880), because auctions provide pricing information that is equally accessible to all market participants and a forum in which all bidders have the same opportunity to procure allowances. (See AR C-1775 to C-1776.)

Moreover, consistent with both equitable distribution and "minimiz[ing] costs and maximiz[ing] the total benefits to California," as specified in section 38562, subdivision (b)(1), ARB found it important to avoid the "windfall gains" to firms that occurred at consumers' expense during the pilot phase of the European Union's cap and trade program. (AR C-1721.) The scientific literature ARB included in its rulemaking file confirms that in Europe prices of electricity and other goods and services rose to reflect the market price of allowances, even though in most cases firms received those allowances for free. (See NCEP, Allocating Allowances in a Greenhouse Gas Trading System (2007), AR Add-A-8261 to Add-A-8262; see also Pew Center on Global Climate Change, Climate Change 101, Cap and Trade (2009), AR Add-A-8300.) "Firms that receive free allowances and experience increased revenues from higher prices get reimbursed twice—once by the government and once by the consumer." (NCEP, Allocating Allowances in a Greenhouse Gas Trading System, AR Add-A-8261 to Add-A-8262.) And, the value of free allowances "can easily exceed any net costs that companies experience as a result of implementing emissions reductions and charging higher prices." (*Ibid.*)

During ARB's rulemaking, several organizations and members of the public voiced similar concern about preventing windfall gains to firms. (AR H-692, H-759 to H-762, H-770 to H-780.) Experts advising ARB agreed, recommending that "California avoid windfall profits, where they would occur, by limiting the free allocation of allowances." (AR C-1576.) Consistent with AB 32's requirement that ARB's regulations reflect the best available information, including lessons learned from other cap and trade programs, ARB staff found that "[a]uctioning allowances will prevent windfalls...." (AR C-1722.)

Early action to reduce emissions. Consistent with section 38562, subdivision (b)(1)'s instruction to "encourage[] early action to reduce

greenhouse gas emissions," ARB found that auctioning at least some allowances rewards those firms that reduce emissions in order to avoid purchasing allowances. (AR C-1776.) Here, again, experts advising ARB agreed. As one advisory committee concluded:

> Allowance auctions, whether partial or full, provide the strongest incentives for early action. Entities that reduce emissions early will not have to purchase as many allowances at auction. Free allocation systems, whether grandfathering or output-based, do nothing to encourage early action.

(AR Add-A-7772.)

E. ARB Implements the Cap and Trade Program

The first compliance period for California's cap and trade program ended on December 31, 2014. By November 1, 2015, all sources must retire allowances or offsets sufficient to cover one hundred percent of their emissions for 2013 and 2014. (Cal. Code Regs., tit. 17, § 95856, subd. (d)(1).) As of January 2015, California has allocated approximately 500 million 2013-2015 allowances for free to sources regulated under the program, and auctioned a total of about 19.5 million 2013-2014 allowances and 65 million 2015-2017 allowances. (See ARB's Motion for Judicial Notice [filed herewith] ("MJN") Exs. A & B.) To date, no allowances have been purchased from the price containment reserve. (*Ibid.*)

F. The Legislature Adopts Post-AB 32 Legislation Governing the Expenditure of Cap and Trade Proceeds

In 2012 the Legislature enacted three bills to require all expenditures of proceeds from the sale of allowances go towards reducing greenhouse gas emissions, in furtherance of the goals of AB 32. The first bill,

SB 1018,[13] created a special fund—the Greenhouse Gas Reduction Fund—exclusively for "monies collected by the State Air Resources Board from the auction or sale of allowances." (Gov. Code, § 16428.8, subd. (b).) As a prerequisite to any expenditure of these funds, the bill requires that state agencies describe "how a proposed expenditure will further the regulatory purposes of [AB 32]" and "how a proposed expenditure will contribute to achieving and maintaining greenhouse gas emission reductions pursuant to [AB 32]." (*Id.*, § 16428.9, subds. (a)(2), (a)(3).) SB 1018 expressly does not "alter[], amend[], or otherwise modif[y] in any manner [AB 32]." (*Id.*, § 16428.9, subd. (b).)

The second bill, AB 1532,[14] mandates that monies collected from the auction or sale of allowances "be used to facilitate the achievement of reductions in greenhouse gas emissions in this state consistent with [AB 32]...." (§ 39712, subd. (b).) AB 1532 directs the Department of Finance, in consultation with ARB and any other relevant state agency, to develop a three-year investment plan that will "[i]dentify programmatic investments of moneys that will facilitate the achievement of feasible and cost-effective greenhouse gas emissions reductions...." (§ 39716, subd. (a)(3).) Monies in the fund shall be appropriated through the budget act consistent with the investment plan. (§ 39718, subd. (a).) In 2013, the administration finalized an Investment Plan for 2013 through 2016. (5 JA 1184-1264.)

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[13] SB 1018; Committee on Budget and Fiscal Review, Stats. 2012, ch. 39, commencing in pertinent part with Gov. Code, § 16428.8. (5 JA 1170-1174.)

[14] AB 1532, Perez; Stats. 2012, ch. 807, commencing with Gov. Code, § 12984, and Health & Saf. Code, § 39710. (5 JA 1175-1178.)

The third bill, SB 535,[15] requires that the Investment Plan allocate a portion of the Greenhouse Gas Reduction Fund monies to be used in, and benefit, the state's disadvantaged communities—which was one of the legislative priorities of AB 32. (See SB 535, § 1, subds. (c) and (d) [5 JA 1180]; cf., §§ 38562, subd. (b)(2) & 38570, subd. (b)(1).) These monies, like all monies from the Fund, must facilitate the achievement of greenhouse gas emission reductions. (See SB 535, § 7 [tying SB 535 to enactment of AB 1532] [5 JA 1181].)

Consistent with the above statutes and the recommendations of the first three-year Investment Plan, the 2014-15 budget and 2015-16 proposed budget appropriate proceeds from the cap and trade auctions for expenditures that will reduce the state's greenhouse gas emissions through investment in three principal areas:

(1) sustainable communities and clean transportation;

(2) energy efficiency and clean energy; and

(3) natural resources and waste diversion.

(SB 852, Leno; Stats. 2014, ch. 25; ARB's MJN Ex. C.)[16] The sustainable communities expenditures go largely toward projects that reduce vehicle miles traveled, an important effort because transportation is California's single largest source of greenhouse gas emissions. Clean transportation measures include funding for high-speed rail, expanded bus and local rail services and corresponding capital improvements, and support for California's zero emissions vehicle program. (*Ibid.*) Energy efficiency and

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[15] SB 535, De Leon; Stats. 2012, ch. 830, commencing with Health & Saf. Code, § 39711. (5 JA 1179-1181.)

[16] As the appellants note, the Legislature also provided for a loan of up to $500 million to the General Fund in 2013, to be repaid with interest. Because those repaid funds, along with any interest earned, will be used for expenditures consistent with the statutory requirements and AB 32, the loan is irrelevant.

clean energy expenditures—such as projects that reduce the need for using fossil fuel to generate electricity or heat water and homes—include residential weatherization and expanding renewable energy projects, increasing the energy efficiency of public buildings, and improving agricultural energy and operational efficiency. (*Ibid.*) Natural resource investments include projects that increase greenhouse gas absorption from wetlands and forests and waste diversion projects that would, among other things, reduce emissions of methane (a potent greenhouse gas) from landfills. (*Ibid.*) Agencies receiving funding will be required to report and quantify the benefits of their expenditures in accordance with guidance developed by ARB. (Cal. Code Regs., tit. 17, § 16428.9, subd. (5)(b).)

II. THE DECISION BELOW

In their petitions below CalChamber and NAM challenged ARB's auction and reserve sales of allowances, while Morning Star challenged only the auction. All three petitions asserted that the challenged aspect(s) of the cap and trade program are outside the scope of the authority granted to ARB in AB 32 and violate Proposition 13. Morning Star also alleged that the three 2012 statutes regarding the expenditure of auction proceeds violate Proposition 26. The trial court issued a ruling denying the petitions in both cases. (7 JA 1566-1588.) The court issued two separate judgments. (7 JA 1589-1645.)

The court denied the plaintiffs' statutory claim, concluding that "the sale of allowances is within the broad scope of authority delegated to ARB in AB 32." (7 JA 1576.) The court also denied the plaintiffs' constitutional claims (7 JA 1576-1587), determining that "the primary purpose of [ARB's] charge is regulatory" (7 JA 1584) and that multiple factors distinguished the auction and reserve sales from the plaintiffs' cases (7 JA 1586). In addition, the court held that Proposition 26 does not govern AB 32, because the Legislature enacted AB 32 prior to November 3, 2010.

The court ruled that because the Legislature's post-AB 32 enactments "only concern the *use* of the auction/sale proceeds," Proposition 26 does not apply to those statutes. (7 JA 1577-1578, italics added.)

STANDARD OF REVIEW

The statutory question of whether AB 32's delegation of authority encompassed the distribution of allowances by auction or reserve sales "is one in which the judiciary, although taking ultimate responsibility for the construction of the statute, accords great weight and respect to the administrative construction." (*American Coatings Assn., Inc. v. South Coast Air Quality Dist.* (2012) 54 Cal.4th 446, 461, quoting *Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 12; see also *California Assn. of Psychology Providers v. Rank* (1990) 51 Cal.3d 1, 11; *Citizens to Save California v. California Fair Political Practices Com'n* (2006) 145 Cal.App.4th 736, 747.) As the trial court correctly observed, "when an agency, acting pursuant to statutory authority adopts regulations, the regulations are presumed valid and a court will interfere only when the agency has clearly overstepped its statutory authority." (7 JA 1573, citing *Ford Dealers Assn. v. Department of Motor Vehicles* (1982) 32 Cal.3d 347, 356.)

The constitutional question of whether the auction and reserve sales violate Proposition 13 is ultimately a question of law subject to the court's independent judgment. (*California Farm Bureau Federation v. State Water Resources Control Bd.* (2011) 51 Cal.4th 421, 436 ("*California Farm Bureau*").) However, in determining whether ARB's method of distributing allowances was "enacted for the purpose of increasing revenues," the court should give substantial deference to ARB's expert determination that the auction and reserve sales advance the regulatory purposes of AB 32. A court applies "the arbitrary and capricious standard to review quasi-legislative decisions resulting from an agency's exercise of

its statutorily delegated policymaking discretion." (*American Coatings Assn., Inc. v. South Coast Air Quality Dist.*, *supra*, 54 Cal.4th at p. 461.) This deferential standard applies even when a regulation is being challenged on constitutional grounds. (*20th Century Ins. Co. v. Garamendi* (1994) 8 Cal.4th 216, 279, fn. 13; *California Bldg. Industry Ass'n v. San Joaquin Valley Air Pollution Control Dist.* (2009) 178 Cal.App.4th 120, 133-135 [concluding that the plaintiff's criticisms of a regulatory fee were in most instances merely "a difference in expert opinion"].)

A party challenging a measure under Proposition 13 bears the burden of proof with respect to all facts essential to its claim for relief. (*California Farm Bureau*, *supra*, 51 Cal.4th at p. 436.) "The burden of proof *does not shift* ... it remains with the party who originally bears it. [Citation.]" (*Ibid.*; see also *Homebuilders Ass'n of Tulare/Kings Counties, Inc. v. City of Lemoore* (2010) 185 Cal.App.4th 554, 562.)

ARGUMENT

I. THE LEGISLATURE DELEGATED TO ARB AUTHORITY THAT ENCOMPASSES SALES OF EMISSIONS ALLOWANCES

The trial court correctly concluded that "the sale of allowances is within the broad scope of authority delegated to ARB in AB 32." (7 JA 1576.) This court should affirm that holding.

A. Both the Plain and Technical Meanings of Section 38562's Delegation of Authority Include Sales of Allowances

When construing a statute to determine the scope of an agency's legislative mandate, the court "must 'ascertain the intent of the Legislature so as to effectuate the purpose of the law.' [Citations.]" (*State Farm Mut. Auto. Ins. Co. v. Garamendi* (2004) 32 Cal.4th 1029, 1043.) The court "'look[s] first to the words of the statute themselves, giving to the language its usual, ordinary import and according significance, if possible, to every

word, phrase and sentence in pursuance of the legislative purpose.' [Citation.]" (*Ibid.*) Here, the words of section 38562 demonstrate the Legislature's intent to authorize ARB to exercise its expertise in choosing among multiple methods of allowance distribution.

The Legislature expressly delegated to ARB the discretionary authority to consider and "design" market-based compliance mechanisms. (§§ 38562, subd. (c), 38570.) The plaintiffs do not dispute that cap and trade is one such market-based compliance mechanism. (Morning Star 34; CalChamber 1; NAM 10; see also 7 JA 1573.) As the trial court determined, even without any additional authority, "ARB would have faced an inevitable choice of how to allocate the allowances." (7 JA 1574.)

But AB 32 also contains a second express delegation of authority on this point. Section 38562, subdivision (b)(1), authorizes ARB to:

> [d]esign 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.

Both the ordinary meaning of the words "design" and "distribution" and the technical meaning of the phrase "design the ... distribution of emissions allowances" in the cap and trade context unambiguously support ARB's interpretation that section 38562, subdivision (b)(1), encompasses both the free allocation and the sale of allowances. As NAM admits, "[t]o be sure, the sale of allowances is one form of distribution." (NAM 26.)

The ordinary meaning of the term "design" includes "to plan and make decisions about (something that is being built or created)" and "to create, fashion, execute or construct according to plan." (ARB MJN Ex. D; see also *id.*, at Ex. E.) The ordinary meaning of the term "distribution" or "distribute" includes both commercial transactions in commodities—such as a sale—and the giving away of something. Dictionary definitions of

"distribution" include "the marketing, transporting, merchandising, and selling of any item." (See ARB MJN Ex. E.) Cases interpreting the word "distribution" hold that sales are within the plain meaning of "distribution." For example, Morning Star relies on *Miller Brewing Co. v. Department of Alcoholic Beverage Control* (1988) 204 Cal.App.3d 5, where the court held that the definition of "distribution" includes "selling, shipping and advertising." (*Id.* at p. 15, citing Webster's New World Dict. of the American Language (2d ed. 1968) p. 410; see also Morning Star 40.) Similarly, in *Arcade County Water Dist. v. Arcade Fire Dist.* (1970) 6 Cal.App.3d 232, the court held that a statute giving fire districts power to contract "for supply and *distribution* of water" did not entitle them to water for free. (*Id.* at p. 239, italics added.)

The plaintiffs focus on other language in section 38562, including subdivision (b)(1), arguing that section 38562 limits ARB's authority by providing statutory criteria ARB must meet. (See NAM 23-24, fn. 7; Morning Star 43-44.) The plaintiffs, however, do not even argue, let alone establish, that the Legislature's criteria prohibit auctions or favor allocating all allowances for free. Indeed, the plaintiffs' argument relies on the same criteria in section 38562, subdivision (b)(1)—to consider equity, minimize costs and maximize benefits to California, and encourage early action—that ARB found weigh in favor of selling some allowances. (See, e.g., AR H-898, C-1721 to C-1722, C-1775 to C-1776; see also 7 JA 1575.)

Beyond plain and ordinary meanings "[i]t is a familiar rule of statutory construction ... that technical terms are to be allowed their technical meaning and effect, unless ... the context indicates that such construction would frustrate the real intention of the law-making power." (*In re Smith* (1928) 88 Cal.App. 464, 467-468; accord, *Eel River Disposal and Resource Recovery, Inc. v. Humboldt* (2013) 221 Cal.App.4th 209, 233; see also Civ. Code, § 13.) In the context of cap and trade, the

technical meaning of "design the ... distribution of emissions allowances" includes giving away allowances for free *and* selling allowances. As early as 1995, the Intergovernmental Panel on Climate Change noted that: "[t]he initial *distribution* [of emissions allowances] may be made by an auction or allocation according to benchmarks ...." (5 JA 1283, italics added.) U.S. EPA's 2003 guide to designing a cap and trade program states that:

> The first major step in the *allowance distribution* process is to decide whether the allowances will be allocated at no cost to the emission sources ..., sold by the regulating authority through an auction or direct sale, or distributed by some combination of these systems.

(Tools of the Trade, AR Add-A-8513, italics added). And, in its March 2006 report to the Legislature, months prior to AB 32's enactment, California's Climate Action Team used the term "distribution of allowances" to mean that "[e]mission allowances can be auctioned (i.e., sold) or given away." (AR Add-A-6120.) As these technical documents demonstrate, choosing the method of distributing allowances is a major design decision for cap and trade programs and encompasses multiple options, including allowance sales.

The plaintiffs do not offer an alternative technical meaning of the phrase "distribution of emissions allowances." CalChamber rejects the trial court's reliance on technical meaning, claiming that the Legislature's chosen language is vague and that the Legislature knew too little to have understood the technical meaning of "distribution of allowances" in the cap and trade context. (CalChamber 31-32.) This argument is belied by the Legislature's own decision to expressly call out, in technical terms, the

"distribution of emissions allowances" as a "design" decision ARB would have to make. (§ 38562, subd. (b)(1).)[17]

Further, the express language of AB 32 demonstrates the Legislature's awareness of the ongoing regulatory efforts occurring in other jurisdictions, including those starting cap and trade programs. (§ 38561, subd. (c) [referencing programs in the European Union and northeastern states].) The Legislature's direction that ARB take several years to study and consider other programs as they developed underscores the discretion granted to ARB and cannot be understood as *confining* ARB's design options, or, as the plaintiffs would have it, specifically requiring one option. (*Ibid.*)[18]

Finally, CalChamber's cases on this point are irrelevant because they do not involve the "technical" (i.e., scientific or field specific) meaning of a word or phrase. (See CalChamber 31-32; citing *Ste. Marie v. Riverside County Regional Park and Open-Space District* (2009) 46 Cal.4th 282, 288 [concluding that "dedicated" and "actually dedicated" have different meanings]; and *Moran v. Murtaugh Miller Meyer & Nelson, LLP* (2007) 40 Cal.4th 780, 783 [considering whether the phrase "no reasonable probability" allowed courts to weigh evidence].)

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[17] Further, despite CalChamber's suggestion to the contrary (CalChamber 32-33), the Legislature was aware of the Climate Action Team's March 2006 Report, as copies were delivered to key legislators and staffers. (ARB's MJN Ex. F, at pp. 1-4.) The Legislature's awareness of the Climate Action Team's responsibilities is also reflected in the text of AB 32 (§ 38501, subd. (i)), and two Senate committee bill analyses. (See JA 0128, JA 0143.)

[18] The Legislature's express reference in section 38561, subdivision (c) to the "northeastern states of the United States" and "the European Union" as specific jurisdictions ARB should look to undermines the appellants' contention that, at best, the Legislature might have known of the Federal Acid Rain Program's revenue neutral cap-and-trade auction. (CalChamber 32-33; NAM 26; Morning Star 41-44.)

CalChamber also argues that courts favor a narrow construction of statutory language conferring government authority. (CalChamber 31.) But the federal cases relied on by CalChamber do just the opposite: they construe the government's statutory authority broadly, by narrowly interpreting *exemptions* from that authority. (See *FCC v. AT & T Inc.* (2011) 562 U.S. 397, __ [131 S.Ct. 1177, 1180] [addressing whether corporations are entitled to a "personal privacy" exemption from regulation]; *Dolan v. U.S. Postal Service* (2006) 546 U.S. 481, 486 [narrowly construing an exemption to Postal Service immunity].) There is no such exemption to interpret narrowly here.

Accordingly, the meaning of "distribution of emissions allowances" in section 38562, subdivision (b)(1), under its plain and its technical meaning, unambiguously includes both giving away allowances and selling them via an auction or a reserve.

B. Read in the Context of AB 32, ARB's Authority to "Design" and "Distribute" Includes the Power to Sell Allowances

At the same time that the court examines the plain and technical meanings of a specific statutory provision, it will "'examine the entire substance of the statute in order to determine the scope and purpose of the provision, construing its words in context and harmonizing its various parts.' [Citation.]" (*State Farm Mut. Auto Ins. Co. v. Garamendi, supra,* 32 Cal.4th at p. 1043.) Contrary to the plaintiffs' argument, applying these principles to AB 32 provides further support for the above described interpretation of the authority the Legislature delegated to ARB.

The plaintiffs cite section 38597 of AB 32—granting ARB the authority to impose a fee to cover its administrative costs—which they argue cannot be harmonized with a grant of authority to distribute allowances through sales. (CalChamber 21-23; NAM 21-23; Morning Star

33.) As the trial court found, however, "the fact that AB 32 includes an administrative fee provision does not prove the Legislature intended to require ARB to distribute allowances for free or in a revenue-neutral manner." (7 JA 1575.)

Section 38597 is housed in part 7 of the statute (Miscellaneous Provisions [§§ 38590-38599]) and does not speak to the core authority delegated to ARB in part 4 (Greenhouse Gas Emissions Reductions [§§ 38560-38565]) and part 5 (Market-Based Compliance Mechanisms [§§ 38570-38574]). Moreover, the money raised by the administrative fee and the proceeds from the distribution of emissions allowances are deposited into different funds and used for different purposes. (Gov. Code, §§ 16428.8, 16428.95.) The administrative fee, which is subject to the limitations of section 57001, is used to pay for the cost of activities directly related to state agencies' development, administration and implementation of AB 32 regulations, including such things as rulemaking and enforcement (§ 38597; see also Cal. Code Regs., tit. 17, § 95200 et seq.), whereas the revenue from the sale of allowances must be invested in programs to reduce the emission of greenhouse gases pursuant to the Investment Plan. (§§ 39712, 39718, subd. (a).) Thus, "[c]onstruing AB 32 as authorizing the sale of allowances does not render the administrative fee provision surplusage." (7 JA 1576.)

The plaintiffs' focus on section 38597 obscures the many other parts of AB 32 which confirm the gap-filling authority the Legislature delegated to ARB. Although the Legislature clearly established an initial regulatory objective, it delegated determination of the regulatory means to ARB. (§ 38501, subd. (h) ["It is the intent of the Legislature that the State Air Resources Board *design emissions reduction measures* ...." (italics added)].) Throughout AB 32, the Legislature delegated to ARB the authority to plan, design, and adopt emission reduction measures. (See

§ 38560 ["The state board shall adopt rules and regulations ... subject to the criteria and schedules set forth in this part"]; see also § 38561, subd. (a) ["the state board shall prepare and approve a scoping plan as that term is understood by the state board"]; § 38562, subd. (a) ["the state board shall adopt greenhouse gas emission limits and emission reduction measures by regulation"]; § 38570 ["The state board may include ... the use of market-based compliance mechanisms"].) Notably, while the Legislature included a definitions section, it did not define "design" or "distribution." (§ 38505.) And, contrary to Morning Star's argument, the broad definition of "market-based compliance mechanism" in section 38505, subdivision (k)—specifying, for example, that such mechanisms would be "governed by the rules and protocols established by [ARB]"—cannot be read to alter the plain or technical meanings of the term "distribution of emissions allowances." (Morning Star 35-37.) Consistent with AB 32's general approach, in subdivision (b)(1) of section 38562 the Legislature set forth policy criteria to be considered by ARB in designing the distribution of emissions allowances, and it left the determination of the methods of distribution to ARB's expertise. (See *Credit Insurance General Agents Ass'n of Cal. v. Payne* (1976) 16 Cal.3d 651, 656 ["Courts have long recognized that the Legislature may defer to and rely upon the expertise of administrative agencies"].)

Further, the Legislature's repeated direction to ARB to collect and review a broad array of empirical, economic, and scientific information is consistent with ARB having been delegated the responsibility to choose among multiple options for the distribution of allowances. Precisely because it left such a wide range of options open to ARB—including whether to adopt a market-based mechanism at all—the Legislature expressly directed ARB to "consider all relevant information pertaining to greenhouse gas emissions reduction programs in other states, localities and

nations" and to consult with a broad range of stakeholders and experts before making the decisions the Legislature had delegated to ARB. (§§ 38561, subd. (c), 38564.) The Legislature also directed ARB to "rely on the best available economic and scientific information" in making those decisions. (§ 38562, subd. (e).) These sections of AB 32 demonstrate the Legislature's intent to delegate to ARB authority to "fill up the details" of a complex and multi-pronged regulatory program. (See *Ford Dealers Assn. v. Department of Motor Vehicles*, *supra*, 32 Cal.3d at p. 362 [finding the Department of Motor Vehicles had authority to "fill up the details" of the statutory scheme].)

Finally, the Legislature directed ARB to adopt its rules and regulations "in an open and public process." (§ 38560.) As discussed above, ARB hosted multiple public meetings, and received hundreds of oral and written comments, and at least two reports from panels of experts, addressing the distribution of emissions allowances. (See Statement of the Case, part I.D. above.) ARB's decision to employ a three-pronged system for allowance distribution—a system that includes auctions—was based on this mandatory process and reflects the elements the Legislature directed ARB to consider. (*Ibid.*)

C. None of Plaintiffs' Panoply of Legal Doctrines Call Into Question ARB's Authority to Sell Allowances

The plaintiffs rely heavily on four arguments in favor of their implausible reading of AB 32: (1) the observation that the Legislature does not hide elephants in mouseholes; (2) the "implied powers" doctrine; (3) the "unlawful delegation" doctrine; and (4) the "constitutional avoidance" doctrine. None of these observations or doctrines, however, have any application here.

1. In delegating to ARB the authority to use market-based mechanisms to achieve AB 32's goals the Legislature did not hide an elephant in a mousehole

The plaintiffs argue that if the Legislature had intended to authorize ARB to create a cap and trade program that would sell allowances, it would have included statutory language controlling the expenditure of auction proceeds. (CalChamber 13-14, 22-24; NAM 26-27; Morning Star 39.) As the plaintiffs put it, AB 32 is a mere "mousehole," insufficient to encompass the delegation of authority to sell allowances, i.e., the plaintiffs' "elephant." (CalChamber 21-22, 28-29; NAM 2, 24.) Aside from the metaphor failing because the authority to establish a cap and trade program (the existence of which the plaintiffs concede) is not a "mousehole," this argument suffers from at least two fundamental flaws.

First, the Legislature's general grant of authority to pursue the specific statutory mandate of AB 32 does not suggest that the Legislature meant to limit ARB's options. To the contrary, it "indicates only that the Legislature did not itself attempt to determine the proper relationship between the special problems ... and various methods of regulating it." (*Ralphs Grocery Co. v. Reimel* (1968) 69 Cal.2d 172, 182-183 [department's general authority encompassed prohibitions on quantity discounts on the sale of beer]; see also *Credit Insurance General Agents Ass'n of Cal. v. Payne*, *supra*, 16 Cal.3d at pp. 656-657 [commissioner's general authority included placing limits on insurance agent commissions for certain sales]; *Holloway v. Purcell* (1950) 35 Cal.2d 220, 231 [State Highways Act delegated to agency the authority to construct a road system to reach statutorily defined endpoints]; *Engine Manufacturers Association v. California Air Resources Board* (2014) 231 Cal.App.4th 1022, 1039-1041 [ARB's general authority to reduce air pollution from motor vehicles allowed it to require compliance testing of in-use heavy-duty engines].)

In AB 32, the Legislature's delegation of authority to ARB to tackle the problem of climate change is "exceptionally broad and open-ended." (*Our Children's Earth Foundation v. California Air Resources Board* (Feb. 23, 2015, A138830) __ Cal.App.4th __ [2015 WL 757708, *10], quoting *Association of Irritated Residents v. California Air Resources Bd.* (2012) 206 Cal.App.4th 1487, 1495.) Rather than limiting the tools in ARB's toolbox, AB 32 directs ARB to "consider all relevant information pertaining to greenhouse gas reduction programs in other states, localities and nations...." (§ 38561, subd. (c); see also § 38564) and to "rely upon the best available economic and scientific information...." (§ 38562, subd. (e)). The lack of specification of a single method of distribution of allowances indicates only that the Legislature did not itself attempt to determine the best method. It is "hardly dispositive that AB 32 did not specify how auction proceeds would be spent since, at the time AB 32 was enacted, it was unknown whether there would be a cap and trade program at all." (7 JA 1575.)

Second, in each case cited by the plaintiffs, a long track record under existing law had established the scope of the government's authority in a specific area, and therefore the courts questioned whether the Legislature expanded that authority through vague terms or ancillary provisions. (See, e.g., *Garcia v. McCutchen* (1997) 16 Cal.4th 469, 481 [question of whether statute created "a significant change in the law" that would "override [California Code of Civil Procedure] section 575.2(b)'s limits on a court's sanctioning powers"]; see also *California Redevelopment Assn. v. Matosantos* (2011) 53 Cal.4th 231, 260 [question of whether voter proposition created a "profound change in the structure of state government" that would constitutionalize redevelopment agencies]; *State Bldg. and Const. Trades Council of California v. Duncan* (2008) 162 Cal.App.4th 289, 323; *Ailanto Properties, Inc. v. City of Half Moon Bay*

(2006) 142 Cal.App.4th 572, 589; *Whitman v. American Trucking Associations* (2001) 531 U.S. 457, 468.)

By contrast, in AB 32, the Legislature created an entirely new statutory scheme rather than altering part of an existing one. (§ 38500 et seq.) There is no earlier track record to speak of with respect to defining ARB's authority to distribute allowances in a cap and trade program, and therefore, the plaintiffs' cases are inapplicable. Further, one of NAM's cases is not good law. (NAM 24, quoting *Clayworth v. Pfizer, Inc.* (2008) 165 Cal.App.4th 209, 240, revd., *Clayworth v. Pfizer, Inc.* (2010) 49 Cal.4th 758.) In sum, AB 32's authorization for a cap and trade program is not a "mousehole," and, when viewed in context, the sale of a subset of emissions allowances under that program (a distribution approach favored by experts and supported by real world experience in other jurisdictions), is not, relatively speaking, an "elephant."

2. ARB's authority to create a cap and trade program and sell allowances is express, making the implied powers doctrine irrelevant

Similar to their inapt "elephants in mouseholes" argument, the plaintiffs contend that absent the use of the word "auction" in the statute, this court must apply the "implied powers doctrine." (CalChamber 24-25; NAM 27-29; Morning Star 37-41.) That doctrine states that for a power to be implied "it must be essential to the declared objects and purpose of the enabling act—not simply convenient, but indispensable." (*Addison v. Department of Motor Vehicles* (1977) 69 Cal.App.3d 486, 498.) The plaintiffs' argument suffers several major flaws.

First, ARB is not relying on the implied powers doctrine, because the Legislature expressly delegated to ARB the authority to "design ... [the] distribution of emissions allowances." (§ 38562, subd. (b)(1).) Where quasi-legislative rulemaking authority has been established, the court's

"inquiry is confined to whether the rule is arbitrary, capricious, or without rational basis [citation] and whether substantial evidence supports the agency's determination that the rule is reasonably necessary [citation]." (*Western States Petroleum Assn. v. Board of Equalization* (2013) 57 Cal.4th 401, 415.) Here, the plaintiffs do not attempt to make either showing.

Second, the plaintiffs' interpretation of AB 32 would produce an absurd result, requiring ARB to prove that every design choice it made in the cap and trade regulation was "indispensable," in the sense that it could not be done any other way. This would include, for example, decisions about which sources to cover, whom to allow to participate in the cap and trade market, and whether to allow non-capped sources to generate offset credits. Imposing that burden on ARB cannot be what the Legislature intended when it delegated authority to ARB to place California in a leadership role in combatting climate change. (§ 38501, subd. (c).)

Third, as illustrated by the plaintiffs' cases, the implied powers doctrine applies when a statute contains an enumerated list of powers and the agency seeks to include powers not on the list or to exclude powers that appear on the list. (See, e.g., *American Federation of Labor v. Unemployment Ins. Appeals Bd.* (1996) 13 Cal.4th 1017, 1023 [administrative law judge improperly varied from an enumerated list of remedies in the statute]; see also *Dyna-Med, Inc. v. Fair Employment & Housing Com.* (1987) 43 Cal.3d 1379, 1387 [commission's proposed remedy varied from statute's list of remedies that "are exclusively corrective and equitable in kind"]; *Peralta Community College Dist. v. Fair Employment & Housing Com.* (1990) 52 Cal.3d 40, 49 [same].) AB 32 contains no such narrowly enumerated list of authority.

Even if the implied powers doctrine applied, the plaintiffs offer no argument whatsoever to meet their burden of showing why the auction and

reserve are not indispensable to many of the declared objects and purposes of AB 32, including equity, minimizing costs and maximizing the total benefits to California, and encouraging early action to reduce emissions. (See § 38562, subd. (b)(1).) In fact, ARB expressly found that the auction and reserve were necessary to achieve these stated goals. (See Statement of the Case, part I.D. above.)

3. The Legislature has not unlawfully delegated its authority to ARB

CalChamber also argues that the Legislature authorizing ARB to choose the method of distribution of allowances would constitute an unlawful delegation. (CalChamber 27.) CalChamber is simply wrong. In rejecting a recent challenge to another ARB regulation, this court found that "[o]nly in the event of a total abdication of [legislative] power, through failure to either render basic policy decisions or to assure that they are implemented as made, will this court intrude on legislative enactment because it is an 'unlawful delegation'...." (See *Engine Manufacturers Association v. California Air Resources Board, supra*, 231 Cal.App.4th at p. 1041, quoting *Hess Collection Winery v. California Agr. Labor Relations Bd.* (2006) 140 Cal.App.4th 1584, 1605; 7 JA 1572-1573.) There is no such abdication in AB 32. The Legislature made certain basic policy decisions regarding the need for a reduction in greenhouse gas emissions and the appropriate maximum statewide limit on emissions for 2020. (§§ 38501, 38550.) It then expressly delegated the "design" of regulations to achieve those emission reductions and subjected ARB's efforts to a number of policy criteria. (§§ 38501, subd. (h), 38560, 38562, subds. (b)(1) to (b)(9).)

NAM makes a variant of CalChamber's argument, claiming that a delegation of authority to ARB to sell allowances would "divest" the Legislature of its "particular" constitutional power over collection and

appropriation of revenue. (NAM 25.) Not so. The Legislature can delegate the authority to collect revenue to the executive or judicial branch, as when it delegates authority to set and charge a fee. (See, e.g., § 39612; Wat. Code, §§ 1525 et seq., 13260; see also *In re Attorney Discipline System* (1998) 19 Cal.4th 582, 596.) Nor is there any argument that ARB has usurped appropriation powers, which the Legislature has exercised through the 2012 enactments and subsequent budget acts.

4. The principal of constitutional avoidance does not dictate the statutory construction of AB 32 nor allow the court to avoid the constitutional issue

The plaintiffs repeatedly assert that the principle of constitutional avoidance provides a basis for this court to hold that allowance sales are unauthorized. (See NAM 2, 16, 19, 31-34; CalChamber 11, 36; Morning Star 31-32, 50.) The plaintiffs ask this court to avoid deciding whether allowance sales are unconstitutional taxes under Proposition 13, urging the court instead to see that constitutional challenge as "serious." (See NAM 16 [asserting that California law *requires* this court "to *avoid* addressing serious constitutional questions"]; see also NAM 2.) The plaintiffs then ask this court to adopt their preferred interpretation of AB 32 in order to avoid that purportedly serious constitutional question. (E.g., NAM 2; CalChamber 11; Morning Star 31-32.) Under this theory of constitutional avoidance, litigants may obtain desired statutory constructions, including those that are implausible and would invalidate expert agency actions, simply by raising purportedly serious constitutional questions. That is not the law. (See *U S ex rel Attorney General v. Delaware & Hudson Co* (1909) 213 U.S. 366, 406, 415 [noting that court "may not avoid determining the following grave constitutional questions"].)

In fact, the constitutional avoidance principle is not implicated here because AB 32 unambiguously tasks ARB with "design[ing] regulations,

including distribution of emissions allowances," and the design options for such distributions unambiguously include auctioning some or all of the allowances. (See, Argument, part I.A above; see also *People v. Leiva* (2013) 56 Cal.4th 498, 506-507 [explaining that courts apply constitutional avoidance principle only "'when faced with an ambiguous statute'"], quoting *Young v. Haines* (1986) 41 Cal.3d 883, 898.) This is not a case where the statutory language "is reasonably susceptible to two interpretations." (See *People v. Gutierrez* (2014) 58 Cal.4th 1354, 1387.) Rather, the plaintiffs' constitutional avoidance argument would require this court to adopt a reading of AB 32 that contradicts its plain text *and* to invalidate three separate statutes that govern expenditures of allowance sale proceeds. This principle, which often simply validates interpretations already derived from the plain text, cannot bear that weight. (E.g., *Myers v. Philip Morris Companies, Inc.* (2002) 28 Cal.4th 828, 831-832, 846-847; *Harrott v. County of Kings* (2001) 25 Cal.4th 1138, 1149, 1151; *Perkey v. Department of Motor Vehicles* (1986) 42 Cal.3d 185, 194.)

The constitutional avoidance principle is also inapplicable here because the plaintiffs' statutory argument relies on their constitutional challenge and is not parallel or independent. (*People v. McKay* (2002) 27 Cal.4th 601, 608, fn. 3 [noting that courts avoid deciding constitutional questions when those "constitutional issues ... are *parallel* to the statutory issues"].) In cases like this one, courts do *decide* the constitutional question and, as necessary, construe the statute to maintain its constitutionality. Thus, when asked to read article XIII A of California's Constitution "in order to avoid a construction that would permit [unconstitutional] takings," the California Supreme Court rejected the takings argument on its merits and then noted that the constitutional avoidance principle was "beside the point." (*Ventura Group Ventures, Inc. v. Ventura Port Dist.* (2001) 24 Cal.4th 1089, 1101-1103.) And when confronted with constitutional

challenges to a city ordinance governing news rack placement, the court decided the constitutional issues surrounding the ordinance and interpreted it accordingly. (*Kash Enterprises, Inc. v. City of Los Angeles* (1977) 19 Cal.3d 294, 304-305.)

This court should interpret the text of AB 32 in accordance with its plain and technical meanings, declining the plaintiffs' invitation to adopt their preferred interpretation, regardless of how implausible it may be, simply to avoid addressing squarely presented constitutional issues. (See part II. below.)

D. AB 32's Legislative History Does Not Contradict or Override the Legislature's Unambiguous Delegation of Authority to ARB

As discussed above, the text of AB 32 clearly delegates to ARB discretion to distribute allowances through a mix of free allocation, auctions and direct sales. In this circumstance, the court should "look no further," and need not engage the plaintiffs' lengthy legislative history arguments. (See *Regents of University of California v. East Bay Mun. Utility Dist.* (2005) 130 Cal.App.4th 1361, 1372-1373; *Kaufman & Broad Communities, Inc. v. Performance Plastering, Inc.* (2005) 133 Cal.App.4th 26, 29 ["resort to legislative history is appropriate only where statutory language is ambiguous"].)[19] Should the court reach the plaintiffs'

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[19] Even if this court were to find ambiguity in the language of the statute, it should give great weight to ARB's interpretation because AB 32's directives "are exceptionally broad and open-ended" (*Association of Irritated Residents v. California Air Resources Bd.*, *supra*, 206 Cal.App.4th at p. 1495), particularly with respect to "design" authority, and because the subject matter of allowance distribution is highly technical, complex and "entwined with issues of fact, policy and discretion." (*American Coatings Assn., Inc. v. South Coast Air Quality Dist.*, *supra*, 54 Cal.4th at p. 461.)

legislative history arguments, they are easily defeated through two broad categories of response.

First, the plaintiffs argue that for the Legislature to have intended for ARB to auction allowances, the legislative history would have to be replete with analysis and debate over the amount of money to be raised through auctions and how that money would be expended. (CalChamber 11-15; NAM 29-30; Morning Star 49.) However, such debate and discussion would have pre-judged the outcome of a multi-year process AB 32 put in place to design a market-based compliance mechanism. As the trial court found, "at the time AB 32 was enacted, it was unknown whether there would be a cap and trade program at all." (7 JA 1575; see also § 38562, subd. (a) [giving ARB until January 1, 2011 to adopt regulations].) An examination of the legislative history shows that as late as June 2006—18 months into the 21 month history of legislative consideration of AB 32—the Senate was engaged in an ongoing debate over whether to give ARB the option to rely on market based mechanisms, like cap and trade, at all. (1 JA 129-130.) It would have been premature for this June 2006 committee report or any of those before it to delve into the details of the distribution of allowances or the expenditure of auction proceeds, and, as the trial court correctly held, there is no reason to read anything into the absence of that discussion. (7 JA 1575.)

Second, the plaintiffs argue that the legislative history regarding a wholly separate provision of AB 32—section 38597, authorizing an administrative fee to cover ARB's costs—limits the delegation of authority in section 38562, subdivision (b)(1). (See CalChamber 16-21; NAM 29-30; Morning Star 45-47.) But the legislative history cited by the plaintiffs goes to the limitations of the administrative fee and has no bearing on the scope of ARB's authority to design methods to distribute allowances. (*Ibid.*) As the trial court found, the legislative history "simply confirms that fees

collected under the administrative fee provision would be used solely for the direct administrative costs incurred in administering the statute," and "[t]here is no suggestion, as Petitioners claim, that 'the only funds to be generated by AB 32 were those required to administer the program.'" (7 JA 1575-1576.)

E. The 2012 Statutes Confirm the Legislature's Intent in AB 32 to Authorize the Sale of Allowances

In 2012, the Legislature enacted three bills pertaining to the appropriation and expenditure of the moneys from the auction of allowances and reserve sales of allowances. (See Statement of the Case, part I.F. above.) These statutes set forth criteria for the expenditure of funds from the cap and trade program and mandate that moneys collected from the auction or reserve sales "be used to facilitate the achievement of reductions in greenhouse gas emissions in this state consistent with [AB 32]...." (§ 39712, subd. (b).) The trial court correctly found that "[p]ost AB 32 legislation ... also reflects a legislative understanding that AB 32 authorized the sale of allowances. [Citations.]" (7 JA 1575.) A long line of Supreme Court cases establishes that:

> "While 'subsequent legislation interpreting [a] statute ... [cannot] change the meaning [of the earlier enactment,] it [does supply] an indication of the legislative intent which may be considered together with other factors in arriving at the true intent existing at the time the legislation was enacted.' [Citation.]"

(*People ex rel. Lockyer v. R.J. Reynolds Tobacco Co.* (2006) 37 Cal.4th 707, 724-725, quoting *Russ Bldg. Partnership v. City and County of San Francisco* (1988) 44 Cal.3d 839, 852-853, in turn quoting *West Pico Furniture Co. v. Pacific Finance Loans* (1970) 2 Cal.3d 594, 610; see also *Clayworth v. Pfizer, Inc.* (2010) 49 Cal.4th 758, 775 [looking to "the Legislature's subsequent amendments to related parts of the Cartwright

Act"].) The contrary cases cited by CalChamber are easily distinguished. (CalChamber 30, citing *Peralta Community College Dist. v. Fair Employment & Housing Com., supra*, 52 Cal.3d at pp. 51-52 [legislative statement of intent failed to become law]; *People v. Cruz* (1996) 13 Cal.4th 764, 775 [rejecting argument that subsequent statute changed meaning of another statute]; *Shaw v. People ex rel. Chiang* (2009) 175 Cal.App.4th 577, 595 [legislative intent not at issue].) In addition, as the trial court found, Morning Star's "reliance on a 2009 bill (SB 31) that did not become law is misguided." (7 JA 1575, citing *Apple Inc. v. Superior Court* (2013) 56 Cal.4th 128, 146 [unpassed bills are generally regarded as having little interpretive value]; see Morning Star 47-48.) Here, the subsequent legislation—providing for the appropriation and expenditure of the proceeds from ARB's sale of allowances—unequivocally reflects the Legislature's understanding that ARB has the authority to distribute allowances though sales.

II. ARB'S AUCTION AND RESERVE SALES DO NOT VIOLATE PROPOSITION 13

The auction and reserve sales are integral components of the cap and trade program and were designed to advance the regulatory objectives of AB 32. The sales differ from a fee, because they were not created for the purpose of funding a governmental program. However, they are not "taxes" and were not "enacted for the purpose of increasing revenues," so they do not violate Proposition 13.

A. Proposition 13 Restricts the Legislature from Enacting Taxes, Not from Enacting Regulatory Programs that Incidentally Increase Revenues

1. Proposition 13 only affects "taxes enacted for the purpose of increasing revenues"

The plaintiffs rest their constitutional challenge on Proposition 13, yet they never discuss the language of the initiative itself. They disregard that section 3 of Proposition 13 affects only "changes in state taxes enacted for the purpose of increasing revenues":

> From and after the effective date of this article, 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....

(Former Cal. Const., art. XIII A, § 3, added by initiative, Primary Elec. (June 6, 1978), commonly known as Prop. 13, italics added; amended by initiative, Gen. Elec. (Nov. 2, 2010), commonly known as Prop. 26.) Proposition 26 did not amend Proposition 13 until after the Legislature adopted AB 32, so Proposition 26 is not relevant. (See part II.F. below.)

In ascertaining the intent of a constitutional provision added by initiative, the court must "'turn first to the language of the [initiative], giving the words their ordinary meaning.' [Citation.]" (*Professional Engineers in California Government v. Kempton* (2007) 40 Cal.4th 1016, 1037, quoting *People v. Rizo* (2000) 22 Cal.4th 681, 685; accord, *Greene v. Marin County Flood Control and Water Conservation Dist.* (2010) 49 Cal.4th 277, 290.) Because the requirement of a two-thirds vote is "inherently undemocratic," the language of Proposition 13 "must be strictly construed and ambiguities therein resolved so as to limit the measures to which the two-thirds requirement applies." (*City and County of San Francisco v. Farrell* (1982) 32 Cal.3d 47, 52 [interpreting art. XIII A,

§ 4]; accord, *Los Angeles County Transportation Com. v. Richmond* (1982) 31 Cal.3d 197, 204 ["'any departure from strict majority rule gives disproportionate power to the minority'"].)

2. A regulatory program may generate revenue without constituting a "tax" that is "enacted for the purpose of increasing revenues"

The starting point for the plaintiffs' constitutional challenge is that the auction and reserve sales generate revenue, and Proposition 13 restricts the state's ability to generate revenue. However, Proposition 13 does not restrict every kind of measure that may result in revenue. "[I]f regulation is the primary purpose" of a measure, "the mere fact that the measure also generates revenue does not make the imposition a tax." (*Sinclair Paint Co. v. State Bd. of Equalization* (1997) 15 Cal.4th 866, 880 ("*Sinclair Paint*").)

This principle rests on the state's broad power to regulate under the police power. The "'police power is simply the power of sovereignty or power to govern—the inherent reserved power of the state to subject individual rights to reasonable regulation for the general welfare.'" (*Sinclair Paint*, *supra*, 15 Cal.4th at p. 878, quoting 8 Witkin, Summary of Cal. Law (9th ed. 1988) Constitutional Law, § 784, p. 311.) The police power "'is an extensive one'" to which "'a very wide discretion as to what is needful or proper for the purpose is necessarily committed to the legislative body....'" (*Plumas County v. Wheeler* (1906) 149 Cal. 758, 762 [upholding a county's license fee], quoting *Ex parte Whitwell* (1893) 98 Cal. 73, 78.) Restrictions on the state's power to tax should not be applied in a manner that intrudes improperly on the state's fundamental power to govern.

Fees represent one application of the principle that a regulatory program may generate revenue without violating Proposition 13. All fees—such as regulatory fees, development fees, special assessments, user

fees, and license fees—are designed to shift the costs of a governmental program from the taxpaying public to those who benefit or who are responsible for making the program necessary. (*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"].) Fees are designed to generate revenue, yet they are permissible because their cost-shifting purpose is deemed regulatory, consistent with the police power. (*Sinclair Paint*, *supra*, 15 Cal.4th at p. 879 [the "shifting of costs" of a regulatory program "from the public to those persons deemed responsible" for the regulatory burden is a "reasonable police power decision" and not a tax]; accord, *Mills v. County of Trinity* (1980) 108 Cal.App.3d 656, 662 [Proposition 13 does not restrict a county from imposing a reasonable license fee as an exercise of the police power].)

As explained below, the auction and reserve sales differ from fees, because they are not designed to shift the costs of a governmental program. Like fees, however, the auction and reserve sales were created to regulate, rather than to increase revenues, and they differ fundamentally from any tax. The sales are valid exercises of the police power and are not the sort of measures Proposition 13 was intended to affect.

B. The Issue Is Not Whether the Auction and Reserve Sales Are Fees, but Whether They Are Taxes Enacted for the Purpose of Increasing Revenues

1. California courts have considered and rejected the view that all revenue-generating measures are either "taxes" or "fees"

The plaintiffs contend that the auction and reserve sales violate Proposition 13 unless they satisfy the same requirements that govern fees. (CalChamber 36-50; NAM 36-51; Morning Star 10-23.) But where a charge does not satisfy all the same requirements as a fee, the courts do not

automatically conclude that the charge is an unconstitutional tax. The courts instead examine whether the charge is consistent with the language and purpose of Proposition 13.

For example, in *California Taxpayers' Ass'n v. Franchise Tax Bd.* (2010) 190 Cal.App.4th 1139, CalTax challenged the constitutionality of a charge imposed on corporate taxpayers that had understated their tax liability by over $1 million for any taxable year. (*Id.* at p. 1143.) The statute identified the charge as a penalty, rather than a tax or a fee. (*Ibid.*) Like the plaintiffs here, CalTax argued that the penalty was presumptively a tax and required a two-thirds legislative majority unless the state showed that the penalty satisfied the requirements for a fee. (*Id.* at pp. 1145-1146.) The court disagreed, holding that a different "analytical framework" was required:

> We are not persuaded by CalTax's argument as to the analytical framework that applies here. We do not deal with a legal context in which a "tax" is the general rule and a "fee" the limited exception.... Instead, we deal with a statutory "penalty" that applies only if a "tax" has not been fully paid.

(*Id.* at pp. 1146.) The court did not attempt to classify the penalty as either a tax or a fee, but instead "employ[ed] the traditional analytical framework for determining a statute's constitutionality," under which "[a] statute is presumed to be constitutional and the burden is on the challenger to show otherwise." (*Ibid.*) The court characterized CalTax's binary "tax/fee argument" as "misguided." (*Id.* at p. 1148.)

The court also noted that "whether an imposition is a 'tax' is not simply a question of raising revenue." (*California Taxpayers' Ass'n v. Franchise Tax Bd.*, *supra*, 190 Cal.App.4th at pp. 1148-1149.) Instead, the court must consider "*how* that revenue is raised." (*Id.* at p. 1149.) After distinguishing the design of the penalty from the usual design of a tax, the

court held that the penalty was not a tax restricted by Proposition 13. (*Id.* at pp. 1147-1150.)

The plaintiffs' assumption that all governmental charges are taxes unless they fit the mold of a fee has also been rejected in cases involving charges imposed by local governments. Those cases are generally governed by section 4 of Proposition 13, which restricts local governments from imposing "special taxes" and allows only a limited statutory exception for fees. (See *California Taxpayers' Ass'n v. Franchise Tax Bd.*, *supra*, 190 Cal.App.4th at pp. 1145-1146; Gov. Code, § 50076 ["'special tax' shall not include any fee which does not exceed the reasonable cost of providing the service or regulatory activity for which the fee is charged and which is not levied for general revenue purposes"].) Where a local charge does not fit within the statutory exception for fees, the courts refuse to conclude that the charge is necessarily an unconstitutional tax. Instead, as in *California Taxpayers' Ass'n*, the courts consider the nature of the charge to determine whether it is the type of measure Proposition 13 was intended to address.

For example, in *Brydon v. East Bay Mun. Utility Dist.* (1994) 24 Cal.App.4th 178, the plaintiff challenged a water district's decision to impose higher water rates on residents who used too much water. The plaintiff argued that the rate structure imposed a tax because rates were not related to the water district's reasonable costs. (*Id.* at p. 190.) Rejecting the plaintiff's reliance on "reverse logic," the court disagreed, noting that every consumer had the option of reducing consumption instead of paying higher rates. (*Id.* at p. 194.) The court held that the rate structure bore "none of the indicia of taxation which [Proposition 13] purported to address." (*Ibid.*)

In *Alamo Rent-A-Car, Inc. v. Board of Supervisors* (1990) 221 Cal.App.3d 198, a county helped support an airport by imposing a charge on car rental companies that used shuttle buses to serve the airport from

offsite. (*Id.* at pp. 200-202.) The trial court held that the charge was not a permissible fee because it was not related to the reasonable cost of allowing the car rental companies to use airport roads. (*Id.* at p. 202.) The appellate court reversed, concluding that the charge was "not the type of exaction which [Proposition 13] was designed to reach." (*Id.* at pp. 205-206.) The court reasoned that the companies operated at the airport voluntarily and that airports differed from ordinary county services. (*Id.* at p. 205; see also *Barratt American Inc. v. City of Rancho Cucamonga* (2005) 37 Cal.4th 685, 700 [court rejected the use of reverse logic, noting that "[s]imply because a fee exceeds the reasonable cost of providing the service or regulatory activity for which it is charged does not transform it into a tax"]; *Isaac v. City of Los Angeles* (1998) 66 Cal.App.4th 586, 597-598 [lien imposed by ordinance for the purpose of collecting delinquent utility bills was "far removed from the revenue-raising devices of assessments and taxes" and therefore "does not implicate" the tax limitations of Proposition 13]; *Carlsbad Mun. Water Dist. v. QLC Corp.* (1992) 2 Cal.App.4th 479, 485, fn. 5 [citing *Alamo Rent-A-Car* with approval].)

More recently, in *Schmeer v. County of Los Angeles* (2013) 213 Cal.App.4th 1310, the court upheld a county ordinance that required retailers to collect 10 cents for each carryout paper bag provided to customers. (*Id.* at p. 1314.) The ordinance also dictated how the retailers could use the revenue. (*Ibid.*) Even though the county both imposed the charge and controlled its use, the court held that the voters did not intend the definition of a "tax" to "include ... charges payable to a nongovernmental entity or person." (*Id.* at pp. 1327-1328.) Applying Proposition 26, the court found it unnecessary to determine whether the ordinance imposed a permissible fee. (*Id.* at pp. 1329-1330.)

These decisions demonstrate that the auction and reserve sales need not fit the mold of a fee to be constitutional. Unless the auction and reserve

sales are "taxes" and were "enacted for the purpose of increasing revenues," Proposition 13 does not apply.

2. The requirements that govern fees are not useful for reviewing other exercises of the police power

The courts have good reason for their refusal to review other kinds of charges by applying the same requirements that govern fees. Those requirements were specially designed to determine whether a fee reasonably shifts the costs of a governmental program to those who benefit or who are responsible for making the program necessary. If a charge is not imposed for a cost-shifting purpose, the reasons for applying those requirements no longer exist.

Whether a fee is reasonably designed for its cost-shifting purpose logically depends on the total amount of revenue generated by the fee and the manner in which the fee is apportioned among the fee payers. Thus, the first requirement for a fee is that the total revenue "cannot ... exceed the reasonable cost of regulation with the generated surplus used for general revenue collection." (*California Farm Bureau*, *supra*, 51 Cal.4th at p. 438; accord, *Sinclair Paint*, *supra*, 15 Cal.4th at p. 878.) Second, the fee must be apportioned reasonably among those who benefit or are deemed responsible for making the program necessary. (*California Farm Bureau*, at p. 437; *Sinclair Paint*, at p. 878.) But where a charge is not designed to shift the costs of a governmental program, the same requirements are no longer useful. The court must therefore return to the language of Proposition 13 and consider whether the charge is a "tax" and was "enacted for the purpose of increasing revenues."

The trial court's decision is consistent with those principles. The court recognized that the auction and reserve sales are not designed to serve the same cost-shifting purpose as a fee. (7 JA 1586.) Accordingly, the court did not attempt to determine whether revenues would exceed the

estimated costs of particular programs. Instead, the court acknowledged that revenues would be used to carry out the purposes of AB 32 in ways that were not yet entirely known. (7 JA 1585.) The court also did not attempt to determine whether payments made in the auction and reserve sales were apportioned reasonably among those responsible for making particular programs necessary. Instead, the court found it sufficient that payments were reasonably related to the collective responsibility of covered entities for the harmful effects of greenhouse gas emissions. (7 JA 1587.) Rather than holding that the auction and reserve sales must fit the mold of a fee, the court simply observed that the auction and reserve sales are "more like a regulatory fee/charge than a traditional tax." (7 JA 1583.)

3. A binary "fee or tax" rule would call into question a variety of accepted governmental actions that produce revenue

By assuming that a regulation cannot generate revenue unless it fits within the same mold as a fee, the plaintiffs overlook that many other governmental actions generate revenue without fitting the mold of a fee and yet do not constitute taxes.

For example, the state obtains revenue by entering into leases of public lands for commercial, industrial, and recreational purposes, including oil, gas, and mineral leases. (See Pub. Resources Code, §§ 6501 to 7062.) The state also obtains revenue by selling or leasing excess real and personal property. (See Gov. Code, § 11011 et seq.) None of these transactions fit within the plaintiffs' definition of a permissible fee. However, like the purchase of allowances through the auction and reserve, each of these transactions represents an exchange for equal value and cannot reasonably be classified as a tax.

The state also obtains revenue from measures that hold parties who set fires responsible for fire suppression costs. (See §§ 13009, 13009.1.) In

Ventura County v. Southern Cal. Edison Co. (1948) 85 Cal.App.2d 529, one such measure was challenged under a constitutional rule that prohibited state taxes from being imposed for municipal purposes. Despite the measure's revenue-producing effect, the court held that the measure was not a tax, because the purpose of the measure was "not to secure revenue but to compel compensation." (*Id.* at pp. 533-534.)

These charges show that constitutional invalidity "cannot be founded upon a mere difficulty of categorization, but rather must be based upon a clear, substantial, and irreconcilable conflict with the fundamental law." (*Pajaro Valley Water Mgmt. Agency v. Amrhein* (2007) 150 Cal.App.4th 1364, 1380 [applying Cal. Const., art. XIII D, to review the constitutionality of a groundwater extraction fee], quoting *Orange County Water District v. Farnsworth* (1956) 138 Cal.App.2d 518, 530, in turn quoting *Ventura County v. Southern Cal. Edison Co.*, *supra*, 85 Cal.App.2d at p. 534.) The proper inquiry under section 3 of Proposition 13 is whether the auction and reserve sales are "taxes enacted for the purpose of increasing revenues." That question cannot be answered merely by asserting that the auction and reserve sales differ from fees.

C. The Auction and Reserve Sales Were Not Enacted for the Purpose of Increasing Revenues

1. ARB created the auction and reserve sales to advance the stated objectives of AB 32

The plaintiffs argue that ARB did not create the auction and reserve sales for the purpose of regulation, because the "cap" in the cap and trade program would reduce emissions even if all the allowances were distributed without any auction or reserve sales. (NAM 49.) However, the plaintiffs have never disputed ARB's determination that the auction and reserve sales advance the stated objectives of AB 32 by making the cap and trade

program more fair, efficient, stable, and predictable. ARB created the sales to regulate.

AB 32 is itself a regulatory statute intended to address "a serious threat to the economic well-being, public health, natural resources, and the environment of California." (§ 38501, subd. (a).) One of the key regulatory measures implementing AB 32 is the cap and trade program. (See Cal. Code Regs., tit. 17, § 95801.)

AB 32 directs ARB to design its regulations, "including distribution of emissions allowances," not merely to reduce emissions but to 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, subd. (b)(1); see also §§ 38562, subds. (b)(2) to (b)(9), and 38570 [setting forth additional policy criteria to be considered in the regulations].) To ensure the cap and trade program achieves those regulatory goals, and having learned from the pitfalls encountered in other programs, ARB decided to distribute some allowances for free, some through the auction, and some through reserve sales. (See Statement of the Case, part I.D. above.) ARB's reasons for creating the three-pronged distribution system had nothing to do with generating revenue. Instead, the findings upon which ARB based its decision include:

- The auction and reserve sales would help avoid allowance prices from becoming too low, unpredictable, or unstable to encourage investment and innovation. (See Statement of the Case, part I.D.3.)
- The auction would make the distribution of allowances more equitable, because unlike an entirely free distribution, the auction would treat new sources the same as existing sources. (*Ibid.*)

- The auction would create a transparent short-term and long-term price signal, and thereby reduce price volatility and transaction costs. (*Ibid.*)
- The auction would make the distribution of allowances more efficient, because the auction establishes a single forum in which all bidders have the same opportunity to procure allowances, minimizing the opportunities for market manipulation and further reducing transaction costs. (*Ibid.*)
- The auction would avoid windfall gains to firms at consumers' expense, where some firms may enjoy gains from increased market prices without bearing any increased costs. (*Ibid.*)
- The auction would do more than an entirely free distribution to encourage businesses to act promptly, because it imposes an immediate price on emissions. (*Ibid.*)
- Providing some free allowances to industrial sources would allow for a smooth transition to the cap and trade program and would minimize leakage. (See Statement of the Case, part I.B.1.)
- Providing free allowances to utility sources would help protect utility ratepayers from sudden increases in their natural gas and electricity bills. (*Ibid.*)
- The price containment reserve would provide entities with an alternative source of allowances should supplies become restricted or prices rise unexpectedly. (See Statement of the Case, part I.B.2.)

Some commentators advocated other approaches for distributing allowances. (See Statement of the Case, part I.B.) However, ARB's assessment of the evidence was part of ARB's quasi-legislative rulemaking decision and was based on ARB's technical expertise, and it is entitled to

the highest level of deference. (See *American Coatings Assn., Inc. v. South Coast Air Quality Dist.*, *supra*, 54 Cal.4th at p. 461.)

Exercising the discretion granted under AB 32, ARB reasonably determined that distributing allowances through ARB's three-pronged system would best achieve the stated objectives of AB 32. ARB designed the auction and reserve sales to regulate, consistent with the police power.

2. The incidental production of revenue does not negate the regulatory purpose of the auction and reserve sales

ARB always understood that revenues would be a byproduct of distributing some of the allowances through the auction and reserve. (AR C-73.) ARB also discussed options for how the revenues might be used. (E.g., AR J-64 to J-65.) But ARB could not reasonably have proposed the auction and reserve sales without considering the foreseeable consequences of those sales. ARB made clear that the cap and trade program was "designed to reduce [greenhouse gas] emissions, not to raise money." (AR C-139.) ARB's careful planning does not demonstrate a revenue-related purpose; it only demonstrates responsible government and logical forethought.

Morning Star asserts that a revenue-related purpose is established whenever there is a revenue-producing effect. (Morning Star 26-27.) *Sinclair Paint* itself disposes of any such argument, because every fee is designed specifically to produce revenue, yet the purpose of the fees is deemed regulatory. (*Sinclair Paint*, *supra*, 15 Cal.4th at p. 880 ["*all* regulatory fees are necessarily aimed at raising 'revenue' to defray the cost of the regulatory program in question"].)

The plaintiffs also argue that the amount of revenue produced by the auction sales establishes a revenue-related purpose. (See, e.g., NAM 39-41.) However, the plaintiffs' argument under Proposition 13 assumes that it is

unconstitutional to generate any revenue at all. As long as Proposition 13 allows ARB to sell allowances, ARB's judgment as to how many allowances to sell and how many to give away at no cost is subject to review only for abuse of discretion. (See *American Coatings Assn., Inc. v. South Coast Air Quality Dist.*, *supra*, 54 Cal.4th at p. 461.)

Furthermore, the plaintiffs disregard that ARB's method of distributing the allowances—whether by auction, by giving them away at no cost, or by some combination of the two—is not what gives the allowances their economic value. That economic value results instead from the "cap" on emissions, the demand for allowances, and the ability of emitters to "trade" for allowances. (AR C-1719 to C-1720.) And the cap is itself set at the level ARB found necessary to meet the Legislature's ambitious target for reductions in greenhouse gas emissions. (AR C-27.) The only way ARB could avoid generating revenue is to create what ARB concluded would be an inferior cap and trade program. Proposition 13 does not require such an intrusion on the police power.

The auction and reserve sales are regulatory measures enacted to advance the stated objectives of AB 32. Unless the sales are "taxes," they are not prohibited by Proposition 13.

D. The auction and reserve sales bear none of the indicia of a tax

Proposition 13 was enacted to give effective property tax relief. (*Sinclair Paint*, *supra*, 15 Cal.4th at p. 872.) Sections 3 and 4 of Proposition 13 were designed to prevent state and local governments from attempting to replace lost property tax revenues through increases in other taxes. (*Id.* at p. 873.) If a measure is not a tax, it does not violate Proposition 13.

Despite noting that the term "'tax' has no fixed meaning," the courts have identified various characteristics commonly associated with taxes.

(*Sinclair Paint*, *supra*, 15 Cal.4th at p. 874, citations omitted; accord, *California Farm Bureau*, *supra*, 51 Cal.4th at p. 437.) None of those characteristics is determinative, but collectively they demonstrate that auction and reserve sales differ fundamentally from taxes. Those who buy allowances are not paying a tax—they are merely participating in a market-based regulation.

1. Unlike taxpayers, auction and reserve participants acquire a valuable benefit that is tradable

Participants in the auction and reserve sales acquire allowances in exchange for their payment of the sales price. The allowances provide a valuable benefit or privilege that the auction participants would not otherwise have, because California law provides no right to pollute. (See *Communities For A Better Environment v. South Coast Air Quality Management Dist.* (2010) 48 Cal.4th 310, 324; accord, *Hardesty v. Sacramento Metropolitan Air Quality Management Dist.* (2011) 202 Cal.App.4th 404, 427.) The allowances also have an economic value, and allowances obtained through the auction can be resold or traded. (AR C-27.) Auction participants can potentially even make a profit by reselling their allowances in the secondary market.

In contrast, taxpayers generally contribute only toward the general support of the government. They do not receive any valuable, tradable benefit in return for their payment, and they have no potential to make a profit. (*California Farm Bureau*, *supra*, 51 Cal.4th at p. 437.) Morning Star asserts that consumers receive a tangible item whenever they pay sales tax to a retailer. (Morning Star 29.) But sales tax is owed by the retailer, not the consumer. (Rev. & Tax. Code, § 6051 et seq.) Consumers do pay use tax, but use tax is charged *in addition to* the sales price; payment of the tax itself provides no tangible benefit. (Rev. & Tax. Code, § 6201 et seq.)

The trial court observed that the allowances are only valuable because of the cap and trade program. (7 JA 1581.) However, the emission of greenhouse gases has always been a valuable privilege and not a right. (See *Communities For A Better Environment v. South Coast Air Quality Management Dist.*, *supra*, 48 Cal.4th at p. 324.) Proposition 13 does not prohibit the state from charging companies for privileges that they previously enjoyed for free. (See *San Diego Gas & Electric Co. v. San Diego County Air Pollution Control Dist.* (1988) 203 Cal.App.3d 1132, 1148-1149 [upholding a fee designed to "shift the costs" of controlling air pollution "from the tax-paying public to the pollution-causing industries themselves"].) Those who purchase allowances are receiving something of value that they would not receive with the payment of a tax.

2. Auction payments are determined by the bidding process, rather than by the government

Purchasing allowances through the auction also differs from paying a tax because the amount of the payment is not determined by any tax rate, tax schedule, or other act of the government. Instead, the price for each allowance is determined by the operation of the market, subject to the reserve price established by ARB. (AR C-80 to C-81.) The reserve price exists for its own regulatory purpose, to address a potential oversupply of allowances and to provide a more stable incentive for investment in innovation; the reserve price is not designed to generate a minimum amount of revenue. (Cal. Code Regs., tit. 17, § 95911; see Statement of the Case, part I.C above.) Emitters pay a market price, not a government-calculated tax.

The significance of this distinction is affirmed by the language of section 3 of Proposition 13, which only restricts changes in taxes "by increased rates or methods of computation." Payments made in the auction are not determined by any governmental "rates" or "methods of

computation," but by the auction participants' own offers and bids. (See generally, *California Taxpayers' Ass'n v. Franchise Tax Bd.*, *supra*, 190 Cal.App.4th at p. 1149 [concluding that a penalty is not a tax and does not violate Proposition 13 because it "does not impose an increase in the tax rate or a change in the method of tax computation"].)

Since the sales prices are determined by operation of the market, auction participants pay the true market value of the benefit or privilege that they acquire. As CalChamber acknowledges, "the very nature of an auction is that the price paid for the allowance ... will fluctuate based on factors affecting the competitive demand for the limited number of allowances available." (CalChamber 39.) In contrast, taxes are determined by the government's tax rate.

3. Unlike the payment of taxes, participation in the auction and reserve is not compulsory

Most taxes are compulsory, rather than being imposed in response to a voluntary decision to develop or to seek other government benefits or privileges. (*Sinclair Paint*, *supra*, 15 Cal.4th at p. 874.) In contrast, many kinds of fees "are not compulsory" because "fee payers have some control both over when, and if, they pay any fee." (*California Bldg. Industry Ass'n v. San Joaquin Valley Air Pollution Control Dist.*, *supra*, 178 Cal.App.4th at p. 132.) For example, fee payers may be able to "modify their conduct to pollute less or consume less water" and thereby reduce or eliminate their fees. (*Ibid.*; see also *Brydon v. East Bay Mun. Utility Dist.*, *supra*, 24 Cal.App.4th at p. 194 [rate structure penalizing excessive water consumption provided consumers the option of reducing consumption instead of paying higher rates and therefore "was not compulsory" and bore "none of the indicia of taxation which article XIII A purported to address"]; cf. *Citizens for Fair Reu Rates v. City of Redding* (2015) 233 Cal.App.4th 402 [182 Cal.Rptr.3d 722, 730-731] [the rates of a municipally owned

electric utility are "imposed" on rate payers for purposes of Proposition 26, even though ratepayers could theoretically obtain electricity by other means].)

In the same way those fees are not compulsory, payments made through the auction and reserve sales are not compulsory. Emitters may comply with the law by reducing their emissions to the point where they do not need to purchase any allowances at all. (Cal. Code Regs., tit. 17, §§ 95850, 95853, 95855, 95856.) As Morning Star admits, auction bids are determined by each emitter's opportunity costs; i.e., "the cost of reducing emissions ... instead of purchasing CARB's allowances at auction." (Morning Star 18.) Emitters also may purchase allowances from each other in the secondary markets, rather than through the auction or reserve sales. (Cal. Code Regs., tit. 17, § 95856.) And emitters may purchase "offset credits" from private parties to fulfill up to eight percent of their regulatory compliance obligation. (*Id.*, §§ 95802, subd. (a)(177), 95820, subd. (b), & 95854 [AR A-39, A-64, and A-104].) Many of the auction participants may even buy allowances as investments or to hold for other reasons, and not because they need to surrender allowances to comply with the cap and trade program. (AR C-27.)

The plaintiffs point out that for some businesses, purchasing allowances may be the only way to remain viable. But the same could be said of many fees that are not considered compulsory. For example, development fees are considered voluntary "[e]ven though the developer cannot legally develop without satisfying the condition precedent." (*Trent Meredith, Inc. v. City of Oxnard* (1981) 114 Cal.App.3d 317, 328.) The fees are voluntary because the developer "voluntarily decides whether to develop or not to develop," and because "[d]evelopment is a privilege not a right." (*Ibid.*) In the same way, participants in the auction and reserve sales voluntarily decide what business to engage in, whether to reduce their

greenhouse gas emissions, and whether to buy offsets or allowances from private entities. (See *Communities For A Better Environment v. South Coast Air Quality Management Dist.*, *supra*, 48 Cal.4th at p. 324.) And just as development is a privilege and not a right, businesses have no right to pollute. (*Ibid.*)

Every purchase of an allowance has a voluntary component not associated with the ordinary concept of a tax. The non-compulsory nature of the auction and reserve sales confirms that they are regulatory devices and further distinguishes them from taxes.

4. Auction and reserve proceeds, unlike tax revenues, cannot be used for the general support of the government but can only be used to advance the purposes of AB 32

The plaintiffs assert that the proceeds of the auction and reserve sales are like tax revenues because they may be used for a wide variety of purposes. (See, e.g., NAM 52-53, CalChamber 40-42.) However, as NAM concedes, the Legislature requires auction proceeds to be deposited into the Greenhouse Gas Reduction Fund and used to facilitate the reduction of greenhouse gas emissions, with special emphasis on reductions within disadvantaged communities. (NAM 53; see Statement of the Case, part I.F. above.) This post-AB 32 legislation prohibits auction proceeds from being treated as general revenues, distinguishing the auction and reserve sales even further from a tax.

Morning Star asserts that the post-AB 32 legislation does not identify particular projects that will qualify for funding and therefore does not prohibit the use of auction proceeds for unrelated revenue purposes. (Morning Star 20-23.) Not so. The legislation expressly mandates that all expenditures must facilitate the reduction of emissions. (§ 39712, subd. (b); see also Gov. Code, § 16428.9, subds. (a)(2), (a)(3).)

Morning Star also questions SB 535's allocation of a percentage of the Greenhouse Gas Reduction Fund to projects that benefit or are located in disadvantaged communities. (Morning Star 22.) However, SB 535 is not divorced from the mandates imposed by AB 1532. Rather, SB 535 merely influences the choice among greenhouse gas reduction projects, consistent with the Legislature's additional objective to protect low income communities from any adverse effects of the cap and trade program. (See § 38562, subd. (a)(2); SB 535, § 1, subds. (c) and (d) [5 JA 1180].)

The plaintiffs complain that the auction proceeds might be used to fund activities unrelated to the auction participants' own emissions. (NAM 54-55; CalChamber 46-48.) They overlook that even with a fee, the government may set spending priorities unrelated to the fee payers' own activities. (See *Equilon Enterprises v. State Bd. of Equalization* (2010) 189 Cal.App.4th 865, 883-886 [rejecting contention that a fee must be charged in proportion to "the burdens actually addressed by the regulatory program, as evidenced by the program's activities and expenditures"].) The relevant point is that auction proceeds must be used to facilitate the reduction of greenhouse gas emissions and cannot be used for unrelated purposes.

NAM also complains that the restrictions on the use of auction proceeds are not contained in AB 32 itself. (NAM 51-52.) However, the Legislature did not know when it enacted AB 32 whether ARB would adopt a cap and trade program or distribute any allowances through an auction. The Legislature reasonably deferred imposing any restrictions on the use of auction proceeds until it knew the proceeds would materialize. The restrictions were timely imposed before any auction proceeds were collected or spent. (See Statement of the Case, part I.F. above.) And ever since ARB first created the auction, ARB's regulations have specified that all auction proceeds must be deposited in a special fund and made available

to the Legislature for purposes consistent with AB 32. (AR H-3099; Cal. Code Regs., tit. 17, § 95870, subds. (b)(3), (i)(2).)

The plaintiffs correctly observe that the Legislature may make loans from the Greenhouse Gas Reduction Fund to the state's general fund under some conditions. (Morning Star 31; see § 39718, subd. (c), Gov. Code, § 16428.8, subd. (b).) However, loans to the general fund are permissible even in the context of fees. (See *Tomra Pacific, Inc. v. Chiang* (2011) 199 Cal.App.4th 463, 488 ["Regulatory fees paid to the Recycling Fund were not converted into taxes when the Recycling Fund made loans to the General Fund."].)

It is also not dispositive that proceeds of the cap and trade program may have some indirect effect on the state's general fund. Even a fee can reduce demands on the general fund by "shifting the costs" of a program from the taxpayers. (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]; *San Diego Gas & Electric Co. v. San Diego County Air Pollution Control Dist., supra*, 203 Cal.App.3d at p. 1148.)

NAM and CalChamber rely on *Morning Star Co. v. Board of Equalization* (2011) 201 Cal.App.4th 737 (*Morning Star*), to assert that the post-AB 32 legislation allows such a wide range of expenditures that the auction and reserve sales must be classified as taxes. (NAM 53-54; CalChamber 49-50.) However, *Morning Star* concerned a wholly different kind of charge that did "not seek to regulate" but only "to raise money." (*Id.* at p. 755.) Since the auction and reserve sales were designed to regulate, *Morning Star* is not instructive.

Furthermore, *Morning Star* presented no issue under Proposition 13. The charge in *Morning Star* was enacted by a two-thirds majority of the Legislature—a sufficient majority to impose a tax—and was imposed on

virtually all California businesses with at least 50 employees. (*Morning Star*, *supra*, 201 Cal.App.4th at pp. 747-748.) The charge was designed to support a wide range of governmental services and programs related to hazardous waste control; it was also designed to "call attention to the fact that virtually *all* corporations, in some way, contribute to the generation of hazardous materials and hazardous waste." (*Id.* at pp. 747, 755.) The claimant did not argue that the charge was a "tax" that violated Proposition 13; instead, the claimant argued that the charge was a "regulatory fee" that violated principles of equal protection and due process. (*Id.* at p. 750, fn. 5.) In upholding the charge as a constitutional tax, the court found that the statutory language "reveal[ed] a specific intention to impose a tax." (*Id.* at p. 751.)

Unlike the auction and reserve sales, the charge in *Morning Star* was imposed specifically to generate revenue, not to regulate. (*Morning Star*, *supra*, 201 Cal.App.4th at p. 755.) *Morning Star* is relevant only to show that if a charge is not intended to serve the purpose of a fee, it need not fit the mold of a fee.

5. Unlike taxes, the auction and reserve sales operate as integral components of a regulatory program

The distinction between taxes and the auction and reserve sales is also strongly evident from the integral role the sales play within the cap and trade program. Taxes may "regulate" by discouraging the behavior that is subject to the tax (such as buying cigarettes), but most taxes can regulate without other working parts. Even a fee is generally designed only to provide revenue for a program and not to affect how the program operates. (See *Northwest Energetic Services, LLC v. California Franchise Tax Bd.* (2008) 159 Cal.App.4th 841, 857 ["A 'regulatory fee' is an imposition that funds a regulatory program"].)

The auction and reserve sales, in contrast, are integral components of the cap and trade program. Choosing a distribution system is an essential design choice for any cap and trade program; without some system to distribute allowances, the program could not exist at all. And ARB included the auction and reserve sales in its distribution system so that the entire program would operate in a manner that more fully advanced the objectives of AB 32. (See Statement of the Case, part I.D. above.) The sales fundamentally change how the program regulates; they do not tax.

Proposition 13 was intended only to restrict taxes. It should not be used to dictate the design of a program that ARB created as a legitimate exercise of the police power.

E. Proposition 26 does not apply

Proposition 26 modified the language of Proposition 13 in 2010, but the amended language does not apply retroactively to statutes like AB 32 that were adopted before 2010. (*Brooktrails Township Community Service District v. Board of Supervisors of Mendocino County* (2013) 218 Cal.App.4th 195, 205-206.)

As modified by Proposition 26, section 3 of article XIII A now restricts "[a]ny change in state statute which results in any taxpayer paying a higher tax." The only relevant "change in state statute" since 2010 merely limited how the revenues produced by the auction and reserve sales may be used. (See Statement of the Case, part I.F. above.) Since those changes in statute did not affect the payments made in the auction and reserve sales, they do not bring Proposition 26 into play.

The cap and trade regulation was enacted after Proposition 26 but does not constitute a "change in state statute," so the regulation could not possibly violate Proposition 26. (*Western States Petroleum Assn. v. Board of Equalization*, *supra*, 57 Cal.4th at pp. 423-424; *Southern California*

Edison Company v. Public Utilities Commission (2014) 227 Cal.App.4th 172, 198.)

CONCLUSION

ARB respectfully requests that the trial court's judgments be affirmed.

Dated: February 25, 2015

Respectfully submitted,

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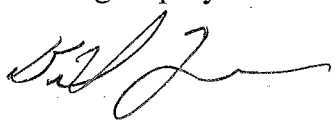

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CERTIFICATE OF COMPLIANCE

I certify that the attached Respondents' Brief of California Air Resources Board, et al., uses a 13 point Times New Roman font and contains 18,364 words.

Dated: February 26, 2015

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DECLARATION OF SERVICE BY E-MAIL AND U.S. MAIL

Case Name: **California Chamber of Commerce, et al. v. California Air Resources Board, et al.**
No.: **C075930;**

Case Name: **Morning Star Packing Company, et al. v. California Air Resources Board, et al.**
No.: **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; my business address is 1300 I Street, 10th Floor, Sacramento, CA 95814.

On February 26, 2015, I served the attached **RESPONDENTS' BRIEF OF CALIFORNIA AIR RESOURCES BOARD, ET AL.** by transmitting a true copy via electronic mail and by placing a true copy thereof enclosed in a sealed envelope with postage thereon fully prepaid, in the United States Mail at Oakland, California, addressed as follows:

SEE ATTACHED SERVICE LIST

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 February 26, 2015, at Sacramento, California.

Michele Warburton
Declarant


Signature

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