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Court of Appeal Turns a Careful Eye Toward Challenges to California's Cap-and-Trade Auction System

A California Court of Appeal signaled it is moving closer to making what could be a far-reaching decision in the consolidated cases of California Chamber of Commerce v. California Air Resources Board (Case No. C075930) and Morning Star Packing Co. v. California Air Resources Board (Case No. C075954). Plaintiffs-appellants challenge California's cap-and-trade auctions of carbon allowances on grounds that the California Air Resources Board exceeded its statutory authority by selling the allowances, and that the allowances are invalid regulatory fees and an unconstitutional tax. Earlier this month, the court ordered the parties and interveners to submit supplemental briefing on seven narrowly tailored questions. Briefing is due May 23, 2016.

Challenges to CARB's Auction System It has been more than two years since the California Chambers of Commerce and Morning Star Packing Company separately appealed the Sacramento County Superior Court's decision (Case Nos. 34201280001313 and 34201280001464) to uphold the California Air Resource Board's (CARB) authority to generate revenues through the sale of greenhouse gas (GHG) emissions allowances through a cap-and-trade auction system. Recent activity by the California Court of Appeal, Third Appellate District, indicates it is carefully scrutinizing the issues on appeal, and is likely preparing to set a date for oral arguments within the next few months.

The appellate court will decide whether the trial court correctly upheld CARB's regulations on its sale of carbon allowances through the cap-and-trade auction system. Despite the fact that this case is colloquially referred to as the "unconstitutional tax" case, appellants actually challenge the legality of the regulations on three grounds: (1) that the auction exceeds the authority granted

to CARB by the state's climate change initiative (AB 32); (2) that the auction constitutes an invalid regulatory fee under *Sinclair Paint Co. v. State Board of Equalization*, 15 Cal.4th 866 (1997); and (3) that revenue from the auction sales results in an unconstitutional tax. In California, *Sinclair Paint* is the leading case on distinguishing valid and invalid regulatory fees, and determining whether an invalid regulatory fee is an unconstitutional tax.

In the past two weeks, the court filed two separate orders that move this case closer to oral argument. On April 7, 2016, it granted a motion filed by appellants for calendar preference. One day later, the court issued an order directing the parties (including interveners) to file simultaneous supplemental letter briefs by May 23, 2016, addressing seven narrowly tailored questions.

Calendar Preference Granted Appellants' motion for calendar preference requested that the court adopt an expedited schedule for evaluating the appellate briefs and setting the date for oral argument. The ground for appellants' motion was California Rule of Court, Rule 8.240, which grants discretion to the court to set calendar preference on a non-statutory ground, such as for economic hardship. In light of the next CARB auction on May 18, 2016, appellants argued that until the court issues a ruling, all affected California businesses "will – in order to stay in business – have to spend millions of dollars at forthcoming [C]ARB cap and trade auctions to purchase, from the State, GHG emissions allowances that, Appellants assert, are unauthorized and constitute unconstitutional taxes because they were not approved by a two-thirds vote of the Legislature."

Court of Appeal Directs Parties to File Supplemental Briefing In a rare occurrence, the court directed the parties to file simultaneous supplemental briefing on seven exceptionally detailed and narrow questions in an April 8, 2016, order, a copy of which can be found [here](#). A few of the questions raised by the court relate to issues or arguments that the parties did not directly raise in their briefs.

(1) Property Right

The court first asks the parties what the rationale and purpose is for the regulations stating that the auction credits confer no property rights. Under CARB regulations, a "Property Right" is "any type of right to specific property whether it is personal or real property, tangible or intangible." 14 Cal. Code of Regs. § 95802(a)(299). An auction credit "does not constitute property or a property right." 14 Cal. Code of Regs. § 95820(c). The issue of property rights arises under an analysis of whether CARB's auction of carbon allowances is a valid regulatory fee.

According to CARB, an auction bidder receives a commodity (much like a stock certificate) upon payment for a carbon allowance. The auction bidder is therefore not charged a "regulatory fee" since it gets something, a commodity, in return for its payment. Morning Star counters that because the carbon allowance is not a property right under the regulations, there is no "commodity" and therefore its payment for the allowance is just like a "fee," where nothing is received in return.

In other words, Morning Star is saying that if the allowance is not “property,” then there is no valuable consideration; instead, an invalid regulatory fee is charged to the bidder. Also worth noting is that the allowances expire and have no value if a holder of that allowance does not surrender it during the applicable compliance period.

(2) Reasonable Relationship Between Environmental Impact and Revenue

The court next asks the parties to “[d]escribe the relationship, if any, between the probable environmental impacts caused by covered entities and the revenue generated from the auctions, and whether the record shows [CARB] established a reasonable relationship between the two.” This question also arises under an analysis of whether CARB’s auction of carbon allowances is a valid regulatory fee.

Under the *Sinclair Paint* court decision, discussed above, there must, among other things, be a reasonable relationship between a regulatory fee and the burdens or benefits on the payor of that fee in order for the fee to be valid. Appellants argue there is no reasonable relationship between the auction allowances and the bidder’s regulatory burdens or benefits. In *Sinclair Paint*, the court considered whether there was a reasonable relationship between fees assessed on manufacturers or other persons contributing to environmental lead contamination, and programs funded by those fees for children allegedly exposed to lead, looking beyond a direct relationship between the fee and the fee payor’s benefits or burdens.

(3) and (4) Proposition 13 Defenses

The court poses questions regarding two possible defenses to the Proposition 13 challenge to the cap-and-trade auction system. In general, California’s Proposition 13 (California Constitution, Article XIII A, Section 3) requires that “changes in State taxes enacted for the purpose of increasing revenues” be passed by two-thirds of all members of the state legislature. Appellants argue the auction violates Proposition 13 because the allowances are an illegal tax not approved by a two-thirds vote.

The court inquires whether the auction system could be defended against the Proposition 13 challenge on the grounds that it is akin to a development fee. Under California law, a development fee would not be a tax subject to a two-thirds vote. The court also questions whether the auction system could defeat the Proposition 13 challenge on the grounds that the auction system sells to covered entities the “privilege to pollute.” Similar to questions 1 and 2, question 4 also arises under an analysis of whether CARB’s auction of carbon allowances is a valid regulatory fee.

(5) Expenditures of Auction Revenues

A three-pronged question proposed by the court demonstrates it is turning a careful eye toward the expenditures of auction revenues for purposes unrelated to the goals of AB 32. Although the court acknowledges that the “current petitions do not seek to invalidate any particular expenditures of the action revenue,” it notes that appellants “suggest that the auction proceeds—at least in part—are being used

to replace what otherwise would be general fund expenditures.” The court’s three-pronged inquiry is likely spurred from appellants’ discussion pertaining to what they classify as the second prong of the *Sinclair Paint* test, whether the charges are levied for “unrelated revenue purposes” – meaning revenue purposes that are unrelated to the activity of regulating the fee payers themselves. Appellants argue the auction revenues are spent on a wide array of general government purposes, such as the construction of a high-speed bullet train and affordable housing initiatives. CARB contends that the auction revenues are not taxes because the revenues are used for specified programs that, it alleges, have a sufficient *nexus* to the regulation of GHGs.

It should be noted that the court seems to raise a concern as to the claimed “nexus” of certain programs: it specifically directs the parties to discuss the remedy as a *practical* matter if the court were to find certain programs are “not sufficiently tethered” to the goals of AB 32.

(6) Voluntary or Compulsory Auction Payments

The court’s sixth question goes to the issue of whether the auction payments are voluntary or compulsory. CARB argues that the auction payments are not taxes or fees because the purchase of carbon allowances is not compulsory. Covered entities have the option of complying with AB 32 by reducing emissions to a level where the purchase of carbon allowances is not necessary; indeed, that is the ultimate goal of the cap-and-trade system. Appellants argue that purchasing carbon allowances is compulsory if a covered entity wants to stay in business in California.

(7) Remedy

The court’s final question raises a practical consideration and the million (or multi-million) dollar question: If the auction is an invalid regulatory fee or an unconstitutional tax, what is the remedy regarding the regulations? The court is particularly interested in remedies “other than a declaration invalidating the auction component,” and directs the parties not to discuss whether an auction component of the cap-and-trade system was authorized by the legislature.

This last question is in many ways the thorniest. It raises discussions regarding whether the court could shut down future auctions, or whether sales from past auctions would need to be “unwound” with monies refunded. The state could refund monies to past purchases of allowances and treat those allowances as free allocations, somewhat akin to what occurs with allocations to the utilities. However, that would provide significant windfalls to parties who purchased the original allowances. It also fails to distinguish CARB’s reasoning for giving free allowances to the utilities, as opposed to other sources or parties who simply bought allowances for speculative purposes.

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