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Client Alert News Flash

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Court Upholds Auction of Allowances Under California Cap-and-Trade Program

The decision, which will almost certainly be appealed, allows the Air Resources Board to continue to auction emission allowances.

On November 12, 2013, a California trial court decided that the California Air Resources Board (ARB) has the power to auction emission allowances and that such auctions do not constitute an illegal tax that violates Proposition 13. As a result, the ARB may continue to hold allowance auctions. The petitioners already have announced their intention to appeal the trial court's decision to the California Court of Appeal.

Background

On November 13, 2012, the California Chamber of Commerce (Chamber) commenced litigation against ARB in Sacramento County Superior Court seeking a writ of mandate and declaratory judgment to invalidate ARB's auction regulations promulgated under the Global Warming Solutions Act of 2006 (AB 32). On April 16, 2013, the Pacific Legal Foundation filed a similar action against ARB on behalf of a group of businesses, trade associations and individuals (collectively with the Chamber, the Petitioners). The court subsequently consolidated the Chamber and Pacific Legal Foundation cases. The combined litigation focused solely on ARB's authority to auction emission allowances, and does not challenge other aspects of the program, including ARB's decision to implement a cap-and-trade program. An "emission allowance" is the limited authorization to emit one metric tonne of carbon dioxide equivalent under California's cap-and-trade program.

Petitioners asserted two primary arguments:

- The auction regulations exceed the statutory authority granted to ARB by AB 32 because the Legislature did not intend for ARB to raise billions of dollars by selling allowances.
- The auctions are an unlawful tax that was improperly authorized without a two-thirds vote of the Legislature, as required by Proposition 13.

In response, ARB proffered three main counterarguments:

- The Legislature left the method of allowance distribution to ARB's discretion, with full understanding that an auction was a possible method.
- The Legislature passed statutes that address the use of auction proceeds after ARB's adoption of an auction system, an implicit acknowledgement that an auction process was within ARB's authority.

- The auction of allowances is not an improper "tax" because:
  - Proposition 13 only applies to taxes "enacted for the purpose of increasing revenues," whereas ARB elected to sell allowances for regulatory reasons.
  - The selling of allowances fundamentally differs from a tax because, in buying allowances, market participants are "voluntarily" purchasing tradable benefits or privileges at a market price, with the auction proceeds being used only to further AB 32's goal of reducing greenhouse gas emissions.

The Court's Decision

ARB Has the Authority to Auction Emission Allowances

The court found that ARB's auction regulations "are within the broad scope of authority delegated to ARB in AB 32." The court stated that, in providing ARB with discretion regarding how to distribute allowances, the Legislature did not explicitly exclude the use of auctions, even though the Legislature was aware that one method for distributing allowances was through an auction. Moreover, the court pointed to the fact that legislation enacted following AB 32 addresses the expenditure of auction proceeds, which in the court's view illustrates the Legislature's understanding that AB 32 authorizes the use of auctions.

Auctioning Emission Allowances Does not Constitute an Illegal Tax

The court also held that the auction provisions do not constitute an illegal tax that violates Proposition 13. Proposition 13 requires that "any changes in State taxes enacted for the purpose of increasing revenues" be approved by two-thirds of the state Legislature. Over the years, courts have recognized four categories of charges that are not subject to the Proposition 13 supermajority requirement: special assessments and related business charges; development fees; user fees; and regulatory fees. In its analysis, the court did not find that auctions fit neatly into any one of those four categories. However, it ruled that, on balance, it is sufficient that the allowance charges are more comparable to regulatory fees than taxes. The court admitted that "it is a close question" as to which the allowances resemble the most, taxes or regulatory fees.

After determining that the allowance charges resemble regulatory fees more than taxes, the court then examined whether the charges satisfy a three-part test used to distinguish valid regulatory fees from taxes. Under the test, a "fee" is a valid regulatory fee if all three conditions are met:

- The primary purpose of the fee must be to regulate, not to generate revenue.
- The total amount of fees collected must not be greater than the cost of the regulatory activities that the fees support.
- There is a "reasonable relationship" between the fees and the regulatory burden of the fee payers' activities.

The court found that the allowance charges meet each prong of the test because:

- The primary purpose of auctioning allowances is to help achieve the regulatory goals of the cap-and-trade program.

- By definition, the total amount of money generated from the allowance sales will not exceed the costs of the regulatory programs they support since the allowance sale proceeds must be used only to advance the purposes of AB 32.

- A reasonable relationship exists between the allowance charges and the covered entities' collective responsibility for the harmful effects of greenhouse gas emissions.

The Applicability of Proposition 26 to AB 32 and Post-AB 32 Legislation

In addition to its two main holdings, the court also concluded that Proposition 26 (which expands Proposition 13's prohibition against "tax" increases without a two-thirds vote of the Legislature), adopted four years after the enactment of AB 32, does not apply to AB 32 because Proposition 26 is not retroactive. Moreover, the court concluded that Proposition 26 also does not apply to the aforementioned post-AB 32 enactments because this legislation only addresses the use of the auction proceeds, and does not cause any taxpayer to pay a higher tax, which is the trigger for application of Proposition 26.

Looking Forward

Petitioners already have said they plan to appeal the court's ruling, which would be before the 3rd District Court of Appeal. Petitioners have 60 days to file a Notice of Appeal. Below we identify issues that may arise on appeal.

If the State fails to repay the $500 million of auction revenue borrowed in order to balance the state budget, then this "loan" might affect the Court of Appeal's analysis of whether the charge for allowances is indeed a valid regulatory fee for a number of reasons.

First, in finding that the primary purpose of the auctions is to further the goals of the cap-and-trade system and not to generate revenues, the Superior Court relied on the fact that post-AB 32 legislation requires auction proceeds to be used to further the regulatory purposes of AB 32. The Court of Appeal could conclude that the transfer of $500 million in auction revenue to the General Fund suggests that the purpose of the auctions is to generate general revenue, and not to further the purpose of the cap-and-trade program.

Second, in deciding that the total amount of fees collected will not exceed the costs of the regulatory activities supported, the Superior Court again based its decision on the requirement that the auction revenue be used to advance the regulatory purposes of the cap-and-trade program. The Court of Appeal could conclude that since $500 million of auction revenue was used not to further the goals of AB 32, but rather to balance the state budget, the total amount of fees collected through the auctions will indeed exceed the costs of the cap-and-trade program. If the Court of Appeal reaches either conclusion, then it could find that the auction of allowances is an illegal tax in violation of Proposition 13. In short, this outstanding loan could prove to be a significant vulnerability for the State's case; however, if the loan is repaid and the funds are directed to greenhouse gas emissions reduction programs, the loan could be a significant asset.

Furthermore, the Court of Appeal could scrutinize the Superior Court's analysis of the third prong of the test used to identify valid regulatory fees, in which the court attempted to distinguish this case from a line of Court of Appeal cases. The Superior Court concluded that the instant case could be distinguished because of its unique circumstances — *i.e.*, the fact that "the allowance charges are not intended to shift the costs of a particular regulatory program to those responsible for the problem that the program was created to address." Due to these unique circumstances, the amount charged for the allowances does not need to be "closely linked to the payers' burdens on the specific regulatory programs that will be funded

by them." Instead, the Superior Court concluded that "all that is required is a reasonable relationship between the charges and the covered entities' (collective) responsibility for the harmful effects of GHG emissions." The Court of Appeal may revisit the Superior Court's analysis of the case law and reassess whether the amount charged for the allowances must be closely linked to the covered entities' individual greenhouse gas emissions.

Latham & Watkins will be closely tracking both the fate of the $500 million loan and any appeals filed by Petitioners.

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