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Classifying California Cap-And-Trade Revenue

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A California court of appeals is poised to rule on a potentially billion-dollar question about the constitutionality of California's cap-and-trade program after supplemental briefing on May 26, 2016. This program was enacted by the California Air Resources Board (CARB) in 2013 pursuant to its authority under the Global Warming Solutions Act (AB 32), which aimed to reduce California's greenhouse gas emissions to 1990 levels by 2020. If this program is found unconstitutional, the state could lose billions of dollars of auction revenue generated from the program. This decision could have a profound impact on businesses in the oil, gas, energy and manufacturing sectors.

The auction revenue has already been spent and earmarked for programs including the high-speed rail, weatherization upgrades and renewable energy measures, sustainable forests, and affordable housing and sustainable communities. For example, for the fiscal year 2015 to 2016, the Legislature appropriated $1.4 billion for programs including high-speed rail, sustainable communities, clean transportation, energy efficiency and clean energy programs, and natural resources and waste diversion programs.

The key issue on appeal is whether the auction revenues are best categorized as a tax, or as a regulatory or other type of fee. The distinction in how to classify the auction revenues is significant because if the revenues are categorized as a tax, then the cap-and-trade program will be found unconstitutional under Proposition 13 of the California Constitution. Proposition 13 requires new taxes to be enacted by two-thirds of the members of the Legislature. However, the California Supreme Court decision known as Sinclair Paint ruled that a super-majority vote is not required if the revenue-generating measure is a regulatory fee (and thus, not a tax). Sinclair Paint found that a regulatory fee is valid so long as:

1. The primary purpose of the fee is regulation, not revenue;

2. There is a reasonable relationship between the fee and the payers' burdens on or benefits from the regulatory programs the fees support; and

3. The amount collected does not exceed the reasonable costs of the regulatory programs for which the fees are charged.

The issue of whether the auction charges were a tax or a fee was vigorously argued at a trial court in Sacramento. Shortly after the program's launch, Morning Star Packing Company and 11 other parties,

including companies, trade associations and individuals (collectively, "Morning Star"), sued the CARB and certain individuals employed at the CARB. Morning Star's complaint requested a peremptory writ of mandate ordering the defendants to vacate and rescind the "revenue-generating auction provisions" of the cap-and-trade regulation because they were unconstitutional or not authorized by statute (or both). The complaint also requested a declaration that those provisions were not authorized by statute, or, to the extent they are authorized by statute, were illegal taxes under the California Constitution. Morning Star's case was later consolidated with a similar case brought by the California Chamber of Commerce in 2012 (collectively with Morning Star, "petitioners").

The petitioners challenged the auction process on two grounds. First, they argued that the revenue generated by the auction process is an illegal tax in violation of Proposition 13. As noted above, Proposition 13 requires a super-majority vote for all new taxes, and the cap-and-trade program was not subject to this requirement. Using the Sinclair Paint test, the petitioners claimed that the auction charges are unconstitutional taxes and not regulatory fees because (1) the cap-and-trade regulation does not prohibit the revenue from being used for unrelated revenue purposes; (2) the winning bids do not reflect a "fair or reasonable relationship" between the charges allocated to each payor, and the payor's burdens or benefits from the regulatory activity; and (3) the auction revenues are not limited to the reasonable costs of the regulatory program.

The petitioners also argued that the auction provisions are ultra vires and void because AB 32 does not authorize them. The court of appeals has instructed the parties to not address this issue, but the basic argument is that the legislature "did not intend to grant authority to the CARB to generate billions of dollars in revenue from the sale of greenhouse gas emissions allowances," and that, accordingly, the auction provisions are ultra vires.

Judge Timothy M. Frawley of the Superior Court of California, County of Sacramento, denied both challenges outright, stating that the sale of allowances is within the "broad scope of authority" delegated to the CARB in AB 32 and the auction provisions are not an illegal tax because the charges were more like regulatory fees than taxes because the primary purpose of the charges is regulatory.

The petitioners appealed the decision and in early April of this year, the appellate court granted the petitioners' motion for calendar preference and set a supplemental briefing date of May 26, 2016, concerning how to classify the auction charges. The court set forth the issues as follows:

> 1. What is the rationale for and purpose of regulations stating the auction credits confer no property right? (See Cal. Code Regs., tit. 17, §§ 95802(a)(299); 95820(c).)
>
> 2. Describe the relationship, if any, between the probable environmental impacts caused by covered entities and the revenue generated from the auctions, and whether the record shows the board established a reasonable relationship between the two.
>
> 3. Can the auction system be defended against the Proposition 13 challenge on the ground it is akin to a development fee? Address what standards apply when assessing the legality of such fees and how the auction system does or does not meet them.
>
> 4. Can the auction system be defended against the Proposition 13 challenge on the ground it essentially sells to covered entities the privilege to pollute?
>
> 5. Although the current petitions do not seek to invalidate any particular expenditures of the

auction revenue, the record shows the revenue is used for a wide variety of programs. The plaintiffs suggest that the auction proceeds — at least in part — are being used to replace what otherwise would be general fund expenditures.

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

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

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

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

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

The court instructed the parties not to discuss whether the auction component of the cap-and-trade system was authorized by the Legislature when enacting AB 32.

Several questions signal that the appellate court might consider classifying the auction charge as neither a regulatory fee nor a tax. Respondents have argued that auction charges are not taxes because successful auction bidders receive a valuable and legally cognizable benefit. In contrast, the petitioners have argued that successful bidders do not receive a value because they get no property rights in the allowances that they won. Rather, successful bidders only receive "protection from civil and criminal sanctions for the limited time for which the allowances are issued." While this protection is a "valuable and legally cognizable benefit," it is not necessarily a property right. Thus, the auction charge arguably is neither a regulatory fee nor a tax.

The issue of property rights is also relevant for the analysis of whether the CARB's auction allowances are special assessment fees (based on the value of benefits conferred on property) or development fees (amount of the fees bears a reasonable relation to the development's probable costs and benefits to the developer). Similarly, the court might consider classifying the auction charges as neither a regulatory fee nor a tax, but instead either a development fee or the privilege to pollute.

The appellate court is also seeking briefing on the Sinclair Paint analysis; namely, whether the auction charges are valid regulatory fees. Specifically, whether there is a reasonable relationship between the environmental impacts caused by the covered entities and the revenue generated from the auction, and whether the auction charges are being used for "unrelated revenue purposes."

Finally, the appellate court asks the billion-dollar question: if the auction is an invalid tax, what is the remedy being sought by the lawsuit? Other than invalidating the auction component of the cap-and-trade program, are there any other remedies proposed by the petitioners? Possibilities include refunding past allowance purchases or shutting down future auctions (either with or without refunding past purchases), or significantly modifying the auction process.

More than likely, regardless of the outcome at the appellate court level, this issue will make its way to the California Supreme Court for further review. In the interim, auctions are still proceeding as scheduled, with a joint auction set for May 18, 2016, and a reserve sale set for June 28, 2016. Companies participating in the auctions should keep a close eye on this case as it goes through California's court system, and be prepared to adapt their business structure as needed when the final judgment is rendered.

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