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Court of Appeal, in split decision, upholds CARB cap-and-trade program

In a 2-1 decision, the Court of Appeal upheld the California Air Resources Board's cap-and-trade program for greenhouse gas allowances. [*California Chamber of Commerce v. State Air Resources Board*](#), No. C075954 (3rd Dist., April 6, 2017). In upholding the validity of the auction used by the California Air Resources Board to distribute a portion of the greenhouse gas allowances auction, the opinion created an important new test for assessing whether the auction should be considered a tax. The majority found that the allowance auction was not compulsory and provided a valuable commodity to the purchaser, and thus was not a tax requiring supermajority approval under Proposition 13.

Background on CARB's GHG Cap-and-Trade Program

In 2006, California enacted AB 32 with the goal of reducing greenhouse gas (GHG) emissions to 1990 levels by the year 2020. The California Air Resources Board (CARB) is the designated state agency charged with regulating sources of GHG emissions under AB 32. AB 32 directed CARB to adopt rules and regulations to achieve the maximum technologically feasible and cost-effective reductions in GHG emissions. Pursuant to AB 32's directives, CARB promulgated regulations that created a cap-and-trade-program. The program sets an aggregate emissions "cap" on covered entities and enforces the cap by issuing a limited number of allowances, the total value of which is equal to the cap. Covered entities must demonstrate compliance with the program by surrendering allowances that correspond to that entity's emissions requirements. Emissions allowances can be obtained in three ways: 1) Some allowances are distributed by CARB for free; 2) allowances are distributed by CARB through an auction; and 3) allowances can be obtained by trading on the secondary market. CARB's allowance auction takes place through a single round of sealed bidding, and winners pay the market clearing price. In 2012, the state legislature passed four bills specifying how the auction proceeds would be used to support the regulatory purposes of AB 32. Several corporations and industry groups challenged the auction mechanism as exceeding CARB's statutory authority under AB 32 and as an unconstitutional tax that violated the supermajority requirements of Proposition 13.

CARB's Delegation under AB 32

Petitioners argued that CARB's allowance auction exceeded the powers delegated to CARB by AB 32. According to the petitioners, CARB was limited to choosing a method of distributing the allowances that was either free of charge or revenue-neutral. Petitioners also raised an array of arguments for why AB 32 should be interpreted to preclude CARB from utilizing the auction mechanism. The *Chamber of Commerce* court (in the portion of the decision joined by the entire panel) recognized AB 32 as conferring "considerable discretion" to CARB to effectuate the goals of AB 32. The court noted that the AB 32 directives are "exceptionally broad and open-ended," leaving "virtually all decisions to the discretion of the Board." Given this discretion, CARB did not require specific statutory authorization to utilize the auction mechanism. The court further found that CARB's use of the allowance auction was ratified in 2012 by the legislation that directed how the auction proceeds were to be spent. Whatever defects or gaps there may have been with the original legislation regarding the authority to use an auction were, according to the court, clearly cured by this subsequent legislation.

Is The Allowance Auction a Tax?

Proposition 13 requires any change in state statute that results in a higher tax to be passed by two-thirds majority in each of the two houses of the Legislature. Neither AB 32 nor the 2012 ratifying legislation were passed by the requisite supermajority. In analyzing whether the allowance auction was a tax subject to the Proposition 13 supermajority requirement, the panel created a new legal standard. The panel found that the test used to

determine whether a regulatory exactions constitute a tax set forth in *Sinclair Paint v. State Board of Equalization* (and which was used by the trial court) was not appropriate because the auction was "a different system entirely" from the regulatory fee at issue in *Sinclair Paint*. The new test created in this case considered two criteria to determine whether the auction bore the "hallmark" characteristics of a tax. Under this test, a payment to the government is considered a tax subject to Proposition 13 if: 1) it is compulsory; and 2) it does not grant any special benefit to the payer. The panel, however, disagreed as to how these criteria applied to the cap-and-trade allowance auction. **Whether the auction is compulsory.** Petitioners argued that certain businesses would have to obtain a sufficient number of emissions to stay in business in California and that companies are, in effect, compelled to purchase allowances from the auction as it would be more expensive to buy allowances on the secondary market. The dissent found this reasoning persuasive, and maintained that the allowance auction was compulsory because it was a cost that would have to be borne if certain businesses want to continue operating in California. The majority, however, found that the auction was not compulsory because regulated entities could comply with the cap-and-trade program without participating in the auction by reducing emissions, purchasing allowances from third parties, and/or purchasing emissions credits. The majority acknowledged that the cap-and-trade program could result in a higher cost of doing business and that some companies might relocate out of the state as a result of the program. Nevertheless, the majority concluded that businesses do not have a vested right to pollute and that continuing to do business and polluting is a voluntary business decision. **Whether there was a special benefit.** The majority and dissent also disagreed as to whether the allowance purchased via auction conferred a specific benefit on the buyer. The majority found that the allowance auction conferred a valuable asset—the privilege to pollute the air—to the auction participants. The allowance could be used for current compliance, banked, or sold, each of which conferred value on the holder of the allowance. The specific, identifiable benefit associated with the purchased allowance thus distinguished it from a tax. The dissenting opinion, however, expressed skepticism regarding the value of the allowances. The dissent noted that the allowances could be terminated at the state's discretion and that CARB's regulations specifically state that the allowances do not constitute a property right. As such, the value of the allowance was ephemeral. Thus, the dissent maintained that the auction should properly be viewed as a revenue-generating vehicle for the state that businesses are compelled to pay into and thus bore the indicia of a traditional tax.

Conclusion

While this decision represents an important victory for proponents of the cap-and-trade program, there remains significant uncertainty clouding the future of the program. The decision is notable for its clear break with past precedent as to the appropriate method of determining whether regulations constitute taxes requiring supermajority approval. As shown in the sharply contrasting majority and dissenting opinions, there is uncertainty as to how this test should be applied. It appears likely that review will be sought in the California Supreme Court and, because of the novel legal standard used to assess whether a regulation constitutes a tax, the high court may be more inclined to grant review. Further, the California Legislature is now considering whether to extend the program past its 2020 expiration date, and CARB is in the midst of amending the cap-and-trade regulations.