

SUPERIOR COURT OF CALIFORNIA

COUNTY OF SACRAMENTO

**CALIFORNIA CHAMBER OF
COMMERCE, et al.**

v.

**CALIFORNIA AIR RESOURCES
BOARD, et al.**

**MORNING STAR PACKING
COMPANY, et al.**

v.

**CALIFORNIA AIR RESOURCES
BOARD, et al.**

Case No.: 34-2012-80001313

Related Case No.: 34-2013-80001464

**JOINT TENTATIVE DECISION AND
ORDER FOR APPEARANCES**

Date: August 28, 2013

Time: 9:30 a.m.

Dept.: 29

Judge: Timothy M. Frawley

Proceedings: Petition for Writ of Mandate and Complaint for Declaratory Relief of Petitioners/Plaintiffs California Chamber of Commerce, et al.; and Petition for Writ of Mandate and Complaint for Declaratory Relief of Morning Star Packing Co., et al.

Tentative Ruling: Appearances Required

Background Facts and Procedure

In 2006, the Legislature enacted Assembly Bill 32 (AB 32), the California Global Warming Solutions Act of 2006. The purpose of AB 32 is to reduce greenhouse gas (GHG) emissions in California. AB 32's stated goal is to reduce GHG emissions in the State to 1990 levels by the year 2020. AB 32 designates the California Air Resources

Board (ARB) as the state agency to implement the statute and delegates to ARB the responsibility to design and implement a package of regulations to achieve the statewide GHG emissions limit by 2020. In adopting the regulations, AB 32 authorized ARB to include the use of a “market-based compliance mechanism” to reduce GHG emissions, such as a cap-and-trade program.

In 2011, ARB adopted regulations to implement AB 32. The regulations primarily rely upon a “market-based,” cap-and-trade approach to reducing GHG emissions. Under the cap-and-trade program, ARB establishes an enforceable, firm limit (or “cap”) on the total amount of GHG emissions that can be released by regulated sources. Regulated entities then must acquire a permit, known as an “allowance,” for every ton of GHG emissions they emit during the compliance period.

The total number of allowances available in any year is equal to the cap for that year. Thus, the cap limits the total number of allowances available to regulated entities during a compliance period. Over time, ARB lowers the cap, reducing the total number of allowances available to regulated sources, thereby guaranteeing a reduction in overall emissions.

Allowances are tradeable. Trading lets regulated sources buy and sell allowances and thereby creates a market for carbon allowances. The cap determines the supply of allowances, and the quantity of emissions generated by the regulated sources determines the demand. The interaction between supply and demand sets the market price.

If a covered entity does not have sufficient allowances to cover their GHG emissions, it may acquire additional allowances from other covered entities. Since the total number of allowances in circulation is capped at a specified level, this does not increase overall statewide GHG emissions. Conversely, if an individual entity does not need all of the allowances it has in a given compliance period, the entity may “bank” those allowances for later use, or sell the allowances to another covered entity.

As the cap declines, regulated sources must decide how they will cover their emissions. Some entities will find it less costly to reduce their emissions to match their allowances, whereas others will find it less costly to purchase additional allowances to cover their emissions. Either way, the less they emit, the less they pay, so there is an economic incentive to reduce emissions. As ARB reduces the supply of allowances, the market price for allowances should rise, and the incentives to reduce emissions should become even stronger.

Throughout the rulemaking process for ARB's regulations, the question of allowance allocation was a prominent and controversial topic. Allowance allocation refers to how ARB will distribute the available allowances to regulated sources. ARB ultimately settled on a mix of distribution methods. In the beginning, ARB will distribute most of the allowances to certain regulated sources free of charge, to help ease their transition into the cap-and-trade program.¹ ARB will sell the remainder of the allowances at public auctions.² The proportion of allowances distributed for free diminishes over time under the cap-and-trade program. By 2020, ARB plans to auction approximately 50% of GHG allowances.

ARB's regulations provide that auctions will consist of a single round of bidding, with sealed bids. Allowances will be sold in 1,000-unit bundles. There will be an "auction reserve price," which shall constitute the minimum acceptable bid price.

ARB's regulations provide that the proceeds from the sale of allowances at auction (excluding consignment sales) will be deposited into a special fund and available for appropriation by the Legislature for the purposes designated in AB 32. Several statutes enacted in 2012 give further direction on the expenditure of cap-and-trade proceeds.

The first bill, SB 1018, enacted on June 27, 2012, creates a new special fund, the Greenhouse Gas Reduction Fund, for monies collected by ARB from its auction of allowances. (See Cal. Health & Saf. Code §§ 16428.9, 16428.9.) To receive an appropriation from the Legislature, the bill requires state agencies to demonstrate how a proposed expenditure will further the regulatory purposes of AB 32 and how a proposed expenditure will contribute to achieving and maintaining GHG emission reductions pursuant to AB 32. (*Ibid.*) SB 1018 also authorizes the Controller to use moneys in the fund for cash flow loans to the General Fund, as provided in Government Code §§16310 and 16381.

The second bill, AB 1532, enacted on September 30, 2012, mandates that moneys collected from the State's sale of allowances be used to facilitate achievement of reductions in GHG emissions in California consistent with AB 32. AB 1532 directs the Department of Finance to develop a three-year investment plan that, among other things, will identify programmatic investments toward feasible and cost-effective GHG emissions reductions. Moneys in the fund shall be appropriated through the Budget Act consistent with the investment plan. (See Cal. Health & Saf. Code §§ 39712, 39716,

¹ The industrial sector, for example, will receive approximately 90% of the allowances needed to comply during the first two years of the program.

² In addition, a small percentage of allowances are set aside for a strategic price containment reserve and thereafter made available for sale at pre-established price or prices to buffer against higher than expected auction prices.

39718.) AB 1532 provides that upon appropriation, moneys in the Greenhouse Gas Reduction Fund shall be available to the state board and to administering agencies for administrative purposes in carrying out the investment plan. (*Ibid.*)

The third bill, SB 535, also enacted on September 30, 2012, requires the investment plan developed pursuant to Health & Safety Code §39716 to allocate a minimum of 25% of available monies in the Fund to projects that benefit disadvantaged communities and to allocate a minimum of 10% of the available monies to projects located within disadvantaged communities. (See Cal. Health & Saf. Code § 39713.)

The fourth bill, AB 1464, which is part of the Budget Act of 2012, enacted on June 17, 2012, makes up to \$500 million in proceeds derived from the sale of allowances in fiscal year 2012-13 available to ARB to assist in achieving the goal of reducing GHG emissions and furthering the "regulatory purposes" of AB 32. (AB 1464, §15.11 [Defendant/Respondents' Request for Judicial Notice, Exh. K].) The Budget Act assumes that these proceeds will be used to offset General Fund costs of existing GHG mitigation programs. (*Ibid.*) Although AB 1464 was enacted in 2012, the State contends it has not yet expended any proceeds from the sale of allowances in fiscal year 2012-13.

The Legislative Analyst's Office estimated that the fiscal year 2012-13 auctions would generate roughly \$660 million to upwards of \$3 billion in revenues for the State. Through May of 2013, the auctions raised approximately \$260 million in revenues for the State. Additional auctions have been or will be held in August and November of 2013. Over the life of the program, the LAO estimates that the auctions will raise as much as \$12 billion to \$70 billion in revenues for the State.

In addition to the auction revenues, AB 32 and the implementing regulations authorize ARB to collect a fee to recover the administrative costs of carrying out AB 32. (Cal. Health & Saf. Code § 38597; 17 C.C.R. § 95200 *et seq.*) The fees collected are intended to collect an amount of funds necessary to fully recover ARB's costs of AB 32 program expenditures for each fiscal year. The revenues collected pursuant to this section are deposited into the Air Pollution Control Fund and are available upon appropriation, by the Legislature, for purposes of carrying out AB 32

Petitioners/Plaintiffs California Chamber of Commerce, et al., and Morning Star Packing Company, et al., separately filed actions challenging ARB's cap-and-trade regulations. National Association of Manufacturers intervened in Case No. 34-2012-80001313 on the side of Petitioners/Plaintiffs. Environmental Defense Fund and Natural Resources Defense Council intervened on the side of Case Nos. 34-2012-80001313 and 34-2013-

80001464 on the side of Defendants/Respondents. The court ordered the cases related.

Arguments of the Parties

These lawsuits do not challenge the ARB's authority to regulate GHG emissions in California, or the ARB's decision to regulate GHG emissions using a cap-and-trade program. The only thing challenged in these lawsuits is the provisions of the ARB's regulations that permit the ARB to sell GHG allowances at auction.

Petitioners contend the auction provisions are void because they exceed the scope of authority conferred on ARB in AB 32. Although Petitioners concede that the Legislature authorized ARB to adopt a cap-and-trade program, Petitioners contend the Legislature never intended to authorize ARB to raise billions of dollars by auctioning GHG allowances.

Further, Petitioners contend, AB 32 cannot authorize the auctions because it was not passed by two-thirds of the members of the Legislature, as required by Proposition 13. Under Proposition 13, any act to increase state taxes for the purpose of increasing revenues must be passed by a two-thirds supermajority vote of the Legislature. Petitioners contend that to the extent AB 32 is construed to authorize ARB to sell allowances, it constitutes a revenue-generating tax that was required to be adopted by a two-thirds supermajority vote. Since AB 32 was not adopted by a two-thirds supermajority vote, Petitioners argue, AB 32 cannot lawfully authorize ARB to impose the tax.

Likewise, Petitioners argue, the post-AB 32 legislative enactments cannot supply after-the-fact authorization for the auctions because those enactments were not adopted by a two-thirds supermajority of the Legislature as required by Proposition 26.

Respondents/Defendants contend that the Legislature expressly delegated to ARB the authority to promulgate regulations to implement AB 32, including the choice of whether to adopt a cap-and-trade program and, if a cap-and-trade program is adopted, the choice of how to distribute emissions allowances as part of the program. Respondents argue that at the time AB 32 was adopted the Legislature understood that a cap-and-trade program requires the distribution of allowances, and that distribution may include the sale of allowances at auction. Since AB 32 does not expressly forbid this method of distribution, argue Respondents, the Legislature plainly intended ARB to have the discretion to include as part of a cap-and-trade program the sale of allowances by auction.

The administrative fee regulation does not restrict ARB's authority to "design" the "distribution" of allowances to include auction sales because the proceeds from the administrative fees are used for different purposes. Whereas the administrative fees will be used to cover the costs of administering AB 32 and the implementing regulations, the auction proceeds will be used for the broader purpose of reducing GHG emissions.

Moreover, even if AB 32 is deemed ambiguous, Respondents argue that ARB's interpretation is entitled to deference from this court and therefore should prevail.

Further, Respondents contend the Legislature removed any lingering doubt about whether it intended to allow the sale of allowances by enacting the post-AB 32 statutes addressing the use of the auction proceeds. According to Respondents, the post-AB 32 statutes unequivocally reflect the Legislature's understanding that ARB has the authority to sell allowances at auction.

Respondents also dispute that the auction of allowances authorized by AB 32 imposes a "tax" subject to Proposition 13. Respondents contend that Proposition 13 applies only to taxes "enacted for the purpose of increasing revenues." Respondents contend that the sale of allowances was enacted not for the purpose of increasing revenues, for regulatory reasons, namely to (1) ensure market prices remain sufficiently high to stimulate reductions and encourage investment and innovation; (2) treat new businesses fairly and avoid windfall gains to established businesses; (3) foster transparent market pricing and avoid market uncertainty and instability. Since the sale of allowances was enacted for regulatory reasons, and not for the purpose of increasing revenues, Respondents contend Proposition 13 does not apply.

In addition, Respondents assert that the auctions differ fundamentally from taxes in several respects. First, unlike taxes, auction participants pay a market price for a tradable benefit or privilege. Second, unlike taxes, the auction is not compulsory. Third, unlike tax revenues, auction sale proceeds will not be used for the general support of the government; under the post-AB 32 legislation, the auction sale proceeds must be used to further AB 32's goal of reducing GHG emissions. For these reasons, Respondents contend the sale of allowances is not subject to the two-thirds supermajority vote requirement of Proposition 13.

Discussion

The court tentatively agrees that the auction provisions of ARB's cap-and-trade regulations are within the broad scope of authority delegated to ARB in AB 32. The text and structure of AB 32 demonstrate that the Legislature intended ARB to have discretion to decide whether to adopt a cap-and-trade program and, if so, to "design" the method for distributing allowances. At the time AB 32 was enacted, both auctioning and free distribution were widely recognized methods of distributing allowances. In delegating to ARB the authority to "design" the "distribution of emissions allowances," the Legislature delegated to ARB the choice of distribution methods.

Moreover, if there were any lingering doubt, the post-AB 32 statutes addressing the use of auction proceeds confirm (or ratify) the Legislature's intent to allow distribution of allowances through auctions and reserve sales.

The court will entertain oral argument on the question of whether the sale of allowances constitutes a "tax" under Proposition 13. At the hearing, the parties are directed to be prepared to discuss the following questions, in addition to any other issues upon which they may wish to be heard. (The court will hear argument from each party on a particular question before proceeding to the next question.)

1. Does the auction component of the cap-and-trade program "regulate" GHG emissions in ways that freely distributing the allowances would not?

2. (a) In Respondents' view, does it matter how the auction proceeds can be used?
 - (b) Does it matter how the proceeds actually are used?

 - (c) Does it matter whether the restrictions on use of auction proceeds are contained in AB 32, ARB's regulations, or post-AB 32 legislation?

3. In what cases, if any, have courts found that "taxes" were not subject to Proposition 13 because they were not "enacted for the purpose of increasing revenues?"

4. Do Respondents contend that a tax (such as a gas, alcohol, cigarette, or carbon tax) is exempt from Proposition 13 so long as the purpose or motivation for the tax is to change people's behavior rather than generate revenues?

5. Aren't there a large number of "taxes" that are not strictly "compulsory" in the sense that the taxes are paid only if the payer engages in a certain activity, such as sales and excise taxes (purchased goods); income taxes (earned income); gas taxes (purchased gasoline); occupancy taxes (occupied a room); and utility surcharges (accessed or used utilities)?

6. In determining whether the auction proceeds are taxes, is it significant that a portion of the allowances are freely distributed to regulated sources?