

California cap and trade at the crossroads

By Allison C. Smith, Esq.
Stoel Rives LLP

The California Global Warming Solutions Act of 2006, also known as Assembly Bill 32, was California's first statutory greenhouse gas reductions mandate, requiring a statewide reduction in greenhouse gas emissions to 1990 levels by 2020.

The California cap-and-trade program was promulgated under AB 32 as a key component of the California Air Resources Board's greenhouse gas emissions reductions strategy.

The state Court of Appeal recently upheld the auction mechanism of the cap-and-trade regulation in two consolidated cases. By mid-May, we will know whether the appellants will seek review of the decision by the California Supreme Court, leaving the final word on the auctions in limbo as cap and trade edges toward its potential sunset under AB 32 in 2020.

Those with vested interests are already navigating what will happen after 2020 for cap and trade. Democratic Gov. Jerry Brown and the Legislature are making a push to avoid the current program's legal fault lines.

The ARB will vote on its proposed extension of the cap-and-trade program through 2030 later this year. At the Capitol, Brown's 2017 budget proposal calls for legislation to cement the ARB's authority to continue cap and trade, including the use of quarterly auctions, beyond 2020 to ensure that the billions of dollars pulled into the Greenhouse Gas Reduction Fund from the auctions remain available.

With the cap-and-trade auctions pending before the Court of Appeal until recently, and potentially facing California Supreme Court review, and moves to continue the program beyond 2020 still pending, the market for cap-and-trade allowances has been skittish — as evidenced by another low turnout at the February 2017 auction. Will all these moving pieces come together in 2017 to seal the long-term fate of California cap and trade?

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LEGAL CHALLENGES

AB 32, and the various regulatory programs enacted by the ARB to achieve the mandated greenhouse gas reductions, have seen their fair share of lawsuits since 2006. Oral argument was heard Jan. 24 in the last remaining lawsuits, and the 3rd District Court of Appeal issued its decision April 6. *Cal. Chamber of Commerce v. State Air Res. Bd.*, No. C075930; *Morning Star Packing Co. v. State Air Res. Bd.*, No. C075954, 2017 WL 1282055 (Cal. Ct. App., 3d Dist. Apr. 6, 2017).

In a 2-1 decision, the panel upheld a key element of the cap-and-trade program: the



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California state capitol building in Sacramento

ARB's quarterly auctions of greenhouse gas allowances to industry.

Regulated entities bid into the auctions to buy allowances to meet their cap-and-trade compliance obligations. One allowance is necessary for each metric ton of greenhouse gases emitted; at the last auction, an allowance was priced at \$13.57.

The Court of Appeal agreed with the trial court that AB 32 provided the ARB with broad discretion in designing a distribution system under a market-based emissions reduction system, and thus the sale of allowances at auction did not exceed the scope of legislative delegation to the agency. More significantly, the court found that the ARB's auctions do not constitute a tax on regulated entities.

Given that AB 32 was not passed with a two-thirds majority of the California Legislature as required for any new tax, a finding that the auctions amounted to a tax would have been fatal under California Constitution Article XIII.A, Section 3.

With the unique nature of the allowances and auctions, compared with the types of



Allison C. Smith is a partner in the Sacramento, California, office of **Stoel Rives LLP**, where she practices environmental and energy law. Smith counsels clients on compliance with federal and state air quality and greenhouse gas regulations. Her experience includes CEQA and land use litigation, conducting environmental due diligence, and permitting solar, wind, biomass, geothermal and gas-fired energy facilities.

fees and taxes courts have considered to date, these cases were far from clear-cut. The court explained that the auctions did not fit the “hallmarks” of a tax; a tax is compulsory, and the payer receives nothing of particular value for payment of the tax.

The court found that the purchase of allowances is a voluntary decision “driven by business judgments as to whether it is more beneficial to the company to make the purchase than to reduce emissions.”

Further, the court concluded that purchased allowances are valuable, tradable commodities. Justice Harry E. Hull Jr. wrote a vigorous dissent on the question of the auctions as a tax.

and also set the more ambitious goal of reducing emissions to 80 percent of 1990 levels by 2050.

While SB 32 made explicit the goal of reducing statewide greenhouse gas emissions to at least 40 percent below 1990 levels by 2030, it is silent on the use of cap and trade to meet the goal.

Similar to language throughout AB 32, SB 32 generically states that the ARB must meet the goal “in adopting rules and regulations to achieve the maximum technologically feasible and cost-effective greenhouse gas emissions reductions.”

The lack of specific authorization for cap and trade to meet the 2030 goal has added to

Until 2016, the ARB had sold every single allowance offered in each quarterly auction. Demand then dipped slightly in the first 2016 auction before plummeting in the second auction, where only 11 percent of offered allowances were sold.

A rebound in the third 2016 auction saw 35 percent of allowances sold, and 88 percent sold in the fourth quarterly auction for 2016. However, in the last auction, held in February, only about 18 percent of allowances offered were sold.

AB 151, introduced by California Assembly Members Mike Gipson, Timothy Grayson, Evan Low and Blanco Rubio, would remove the statutory time constraint for cap and trade that currently authorizes the ARB to establish a “system of market-based declining annual aggregate emissions limits” for sources of greenhouse gases emissions — a cap-and-trade scheme — “from Jan. 1, 2012, to Dec. 31, 2020, inclusive.” However, AB 151 has not been introduced as a measure requiring a two-thirds majority vote.

The California Court of Appeal recently upheld the auction mechanism of the cap-and-trade regulation in two consolidated cases.

Given the costs to industry to comply with cap and trade, the appellants have a significant motivation to petition the California Supreme Court for review of the decision.

LEGISLATIVE EFFORTS

Efforts are underway to eliminate the legal uncertainties surrounding the cap-and-trade program with a legislative fix, particularly to ensure the program’s continuity beyond 2020, but also to confirm the validity of the allowance auctions, given that *California Chamber of Commerce* could continue to the California Supreme Court.

The passage of Senate Bill 32 in 2016 approved additional statutory greenhouse gas reductions for California past 2020. SB 32 built not only on AB 32 but also on prior gubernatorial executive orders creating greenhouse gas emission reduction targets for 2010, 2020, 2030 and 2050.

Executive Order B-30-15, issued by Brown in 2015, set a target to reduce statewide greenhouse gas emissions to 40 percent below 1990 levels by 2030. SB 32 codified this 2030 target, which acts as an interim goal for the 2050 target set in Republican Gov. Arnold Schwarzenegger’s Executive Order S-3-05.

In 2005, Executive Order S-3-50 set the original goal of reducing greenhouse gas emissions to 1990 levels by 2020, codified in statute with the passage of AB 32 in 2006,

the uncertainty hovering over the long-term outlook for the program. In April 2016 the Legislative Counsel Bureau issued an opinion that AB 32 did not authorize a cap-and-trade program beyond 2020, even if the statute authorized the greenhouse gas cap to remain in place past that year.

Fast-forward to actions underway in 2017. Brown’s current budget proposal includes a \$2.2 billion expenditure plan for revenues from the cap-and-trade auctions, “to be allocated after legislation confirming the Air [Resources] Board’s authority to administer the cap-and-trade program beyond 2020 is enacted through a two-thirds vote.”

With two-thirds approval, the long-term survival of cap and trade would be ensured regardless of a ruling adverse to the ARB on the constitutional tax question, if the California Supreme Court were to review the decision in *California Chamber of Commerce*.

Given the cost of cap and trade to regulated entities, industry may seek other ways to challenge greenhouse gas reduction measures after 2020 if the unconstitutional tax argument becomes unavailable.

Brown expressly pointed in his budget summary to the issue of swings in allowance demand at the cap-and-trade auctions in 2016. He cited the “perceived legal uncertainty about cap and trade beyond 2020” as one of the factors that may have contributed to auction volatility.

ARB’S EXTENSION OF CAP AND TRADE

Executive Order B-30-15 provided the 2030 greenhouse gas reductions target of 40 percent below 1990 greenhouse gas emission levels (later codified with the passage of SB 32), and directed the ARB to update the climate change scoping plan to express the 2030 target in million metric tons of carbon dioxide equivalent.

The scoping plan was first drafted in 2008 and acted as the agency’s template to achieve the greenhouse gas reduction goals of AB 32. The ARB updated the scoping plan, as required by AB 32, in 2014.

Since Executive Order B-30-15, the ARB has moved forward with another update to the plan to incorporate the 2030 goal of Executive Order B-30-15 and SB 32. The ARB has had two public hearings on the draft scoping plan to date, with a third scheduled for June 22 and 23.

The scoping plan update proposes a scenario to reach the 2030 goal with a continuation of the cap-and-trade program beyond 2020, along with additional reductions in greenhouse gas emissions from other programs, including additional regulation of the refinery sector.

