

Client Alert.

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California Drops the Hammer on First Carbon Auction Despite New Lawsuit

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The California Air Resources Board (CARB) proceeded today with the inaugural carbon allowance auction for its impending “cap-and-trade” greenhouse gas (GHG) emissions regulation program, despite a lawsuit filed yesterday by the California Chamber of Commerce to challenge CARB’s auction authority.

CARB’s cap-and-trade program was developed pursuant to AB 32, the “California Global Warming Solutions Act of 2006,” which requires statewide reductions of GHG emissions to 1990 levels by 2020.¹ Currently, entities emitting more than 25,000 metric tons GHG per year in certain industries such as petroleum, electricity generation and heavy manufacturing must acquire allowances equivalent to their GHG emissions during specified compliance periods. Each allowance permits an entity to emit one metric ton of carbon dioxide equivalent, and those allowances can be traded. The total number of allowances in circulation—the emissions “cap”—will be gradually reduced by CARB until 2020 in order to achieve AB 32’s emissions reduction goals.

At today’s auction, CARB intends to sell approximately 10% of the carbon allowances issued for compliance periods beginning in January 2013. The remaining allowances will be distributed free of charge to regulated entities based upon a formula taking into account their past emissions. Under the governing regulations, CARB will hold quarterly auctions of a percentage of additional allowances that are issued. A portion of the revenue is allocated to the state’s general fund, and a portion to a Greenhouse Gas Reduction Fund created by the legislature to fund GHG reduction projects. Estimates of how much revenue will be raised by the initial auction have vastly differed, with some estimates as high as \$660 million to \$3.0 billion. Results from today’s auction will be released by CARB on its website on Monday, November 19. The next auction is scheduled for February 19, 2013.

The Chamber of Commerce’s lawsuit, *California Chamber of Commerce v. CARB*, filed in Sacramento County Superior Court, alleges that CARB lacks the authority to distribute any allowances through a revenue-raising auction, and must instead allocate them all free of charge. While AB 32 authorized CARB to use “market-based declining annual aggregate emission limits”—that is, cap and trade—and to “distribute” emissions allowances, it did not specify the mechanism by which allowances could be distributed. According to the Chamber, CARB’s revenue-raising authority is limited to the authority explicitly conferred by AB 32 for the collection of an administrative fee to fund the operation of the cap-and-trade program.

The Chamber also asserts that, even if AB 32 implicitly authorizes the distribution of allowances by auction, such an auction is unconstitutional. By forcing regulated entities to pay for allowances, the lawsuit alleges, the auctions impose a “tax” that was not passed by two-thirds of the legislature as required by the California Constitution. According to the Chamber, the revenue generated by auction constitutes a “tax” rather than a permissible regulatory fee because it lacks a

¹ See our prior alert “[California Adopts Historic Cap-and-Trade Program for Greenhouse Gas Emissions](#).”

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sufficient connection to the social and economic cost of the payers' activities.

Importantly, the lawsuit does not challenge the legality of CARB's entire cap-and-trade program, and instead focuses specifically upon CARB's sale of allowances at auction. The issue of whether an auction is an appropriate mechanism for allowance distribution was widely debated as CARB developed its regulatory program, and will now await the court's resolution. Because the Chamber did not seek an injunction halting CARB's auctions, the lawsuit did not delay today's auction, and future auctions will continue as scheduled until a court decision is issued.

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Morrison & Foerster and its Environment and Energy Group have more than four decades of experience in Clean Air Act and climate change issues, both nationally and in California. Along with our Cleantech Group, we are closely following the implementation of AB 32, including CARB's cap-and-trade program, and can provide additional detailed analysis upon request.

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