Client Alert

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California's Cap-and-Trade Auction Is Not a Tax: Court Decides "Close Question"

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In a twin set of wins for the state, two lawsuits challenging California's flagship cap-and-trade auction system first implemented in November 2012 were rejected by Sacramento Superior Court Judge Timothy Frawley this week.

California's hallmark cap-and-trade program was developed pursuant to AB 32, the "California Global Warming Solutions Act of 2006," which requires statewide reductions of greenhouse gas (GHG) emissions to 1990 levels by 2020. The cap-and-trade program, implemented by the California Air Resources Board (CARB), requires that certain covered entities acquire allowances for each metric ton of GHG they emit during specified compliance periods. CARB's regulations provide that approximately half of the allowances, which are tradable, will be initially distributed to covered entities for free and that the other half will be distributed through a competitive auction process. The initial compliance period started nearly a year ago on January 1, 2013 and there have been four quarterly carbon allowance auctions to date, bringing in nearly $1.1 billion worth of carbon credits. The next carbon auction is scheduled for November 19.

The lawsuits,[1] filed by the California Chamber of Commerce (Chamber) and the Pacific Legal Foundation (PLF), raised two general claims aimed at CARB's carbon allowance auction process. First, they asserted that AB 32 does not permit CARB to hold a revenue-raising auction because AB 32 provides only for the collection of regulatory fees sufficient to cover the program's administrative costs. Second, the lawsuits asserted that the revenue-raising auction process, even if authorized by AB 32, is void as an unconstitutional "tax" that was not passed by two-thirds of the state legislature, as required by Propositions 13 and 26. For more information on the suits, please see our previous alerts (California Drops the Hammer on Carbon Auction Despite Lawsuit and Challengers Double Down on Opposition to California's Carbon Allowance Auctions).

Characterized as a "close question," Judge Frawley ultimately rejected both of petitioners' arguments, holding that the monies spent at the carbon auction are more akin to "traditional regulatory fees than taxes," such as hunting licenses or mineral extraction permits. A two-thirds majority vote is not necessary to impose fees. The court also recognized that although AB 32 does not "explicitly recognize the sale of allowances," it does provide CARB with wide discretion to "design" an appropriate allowance distribution system.

CARB welcomed the court's decision, contending that the auctions do not constitute a tax since purchasing carbon credits is optional and a company can reduce its carbon emissions instead. Environmental groups also hailed the decision as a win in the battle against climate change. The Chamber and PLF, concerned that the auctions will increase the cost of doing business in the state, have both stated that they will file appeals within the

[1] *California Chamber of Commerce, et al. v. California Air Resources Board, et al.*, Sacramento Superior Court, Case No. 34-2012-80001313; *Morning Star Packing Co., et al. v. California Air Resources Board, et al.*, Sacramento Superior Court, Case No. 34-2013-80001464.

60-day statutory window. So far, however, every lawsuit filed to date challenging CARB's authority under AB 32 has been denied and the longer the cap-and-trade program is in place, the more difficult it may be for future challenges to prevail.

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Morrison & Foerster's Environment and Energy Group has more than four decades of experience in Clean Air Act and climate change issues, both nationally and in California. Along with the firm's 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. To learn more about our Environment and Energy Group, click here.

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