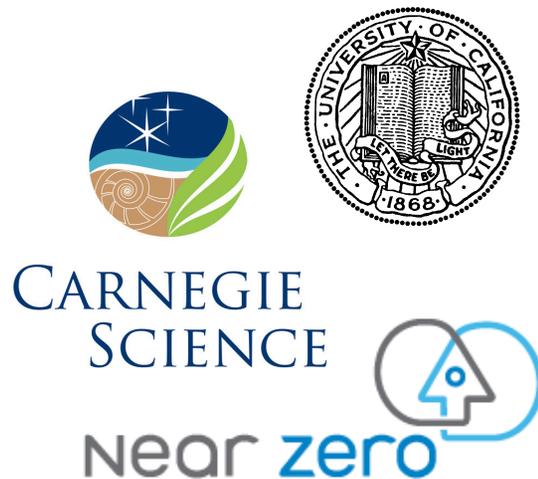

STATE CONSTITUTIONAL LIMITATIONS ON THE FUTURE OF CALIFORNIA'S CARBON MARKET



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FELJ Author Talk

Morrison & Foerster LLP

San Francisco, CA | February 9, 2017

AGENDA

- **California's climate policy regime**
- Propositions 13 and 26
- Options for post-2020 state policy

WHY FOCUS ON CALIFORNIA?

- For decades California has implemented innovative energy and environmental policies, experimenting with policy models that are frequently adopted by other states and the federal government.
- California's climate leadership offers a global high water mark for both ambition and results.
- Carbon pricing in California is essential to the future of western electricity markets (CAISO EIM and expansion).

CAISO ENERGY IMBALANCE MARKET (EIM)

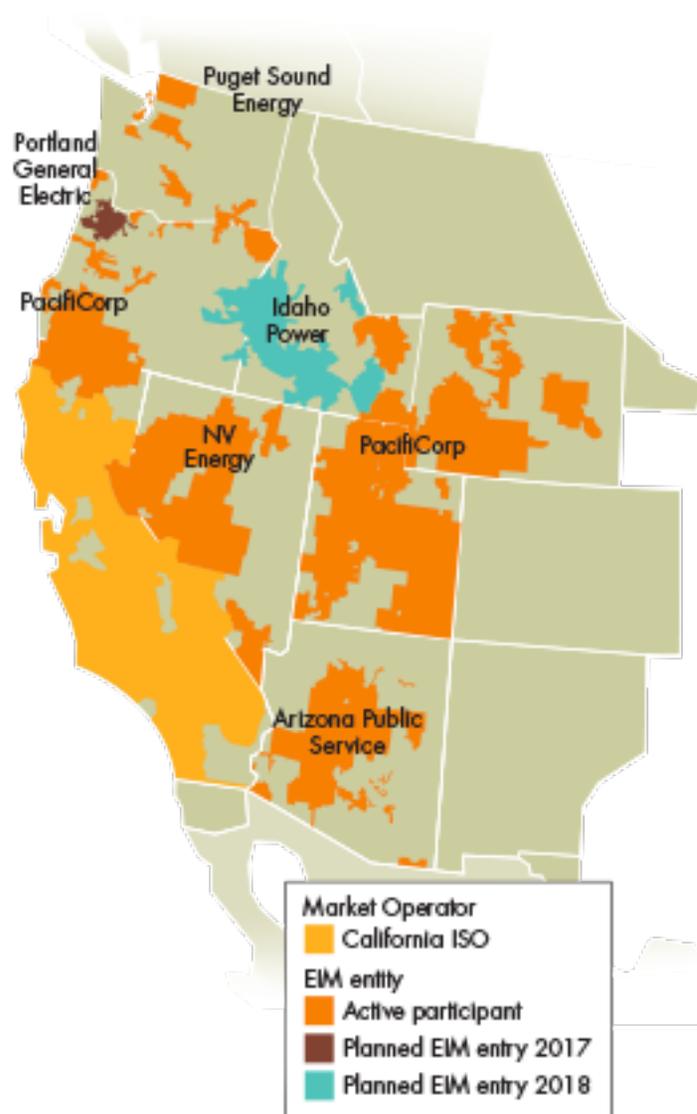


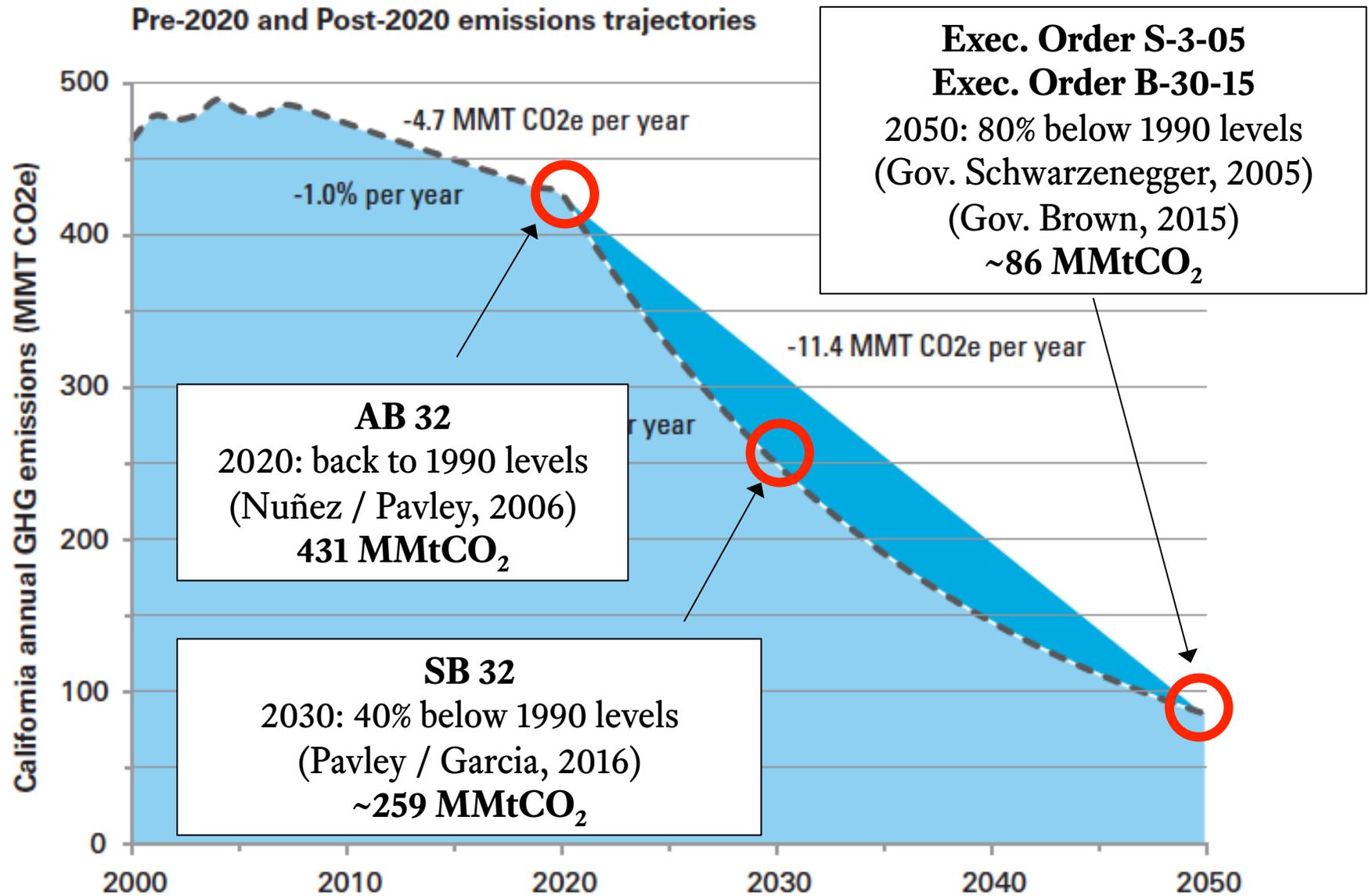
Image credit: CAISO

CAISO ENERGY IMBALANCE MARKET (EIM)

- Out-of-state generators include a GHG bid adder (\$/MWh) based on facility-specific GHG emissions rate multiplied by secondary California market price.
- If the out-of-state generator includes no GHG bid adder or bids zero quantity (0 MW), the out-of-state resource will not be deemed dispatched to California.

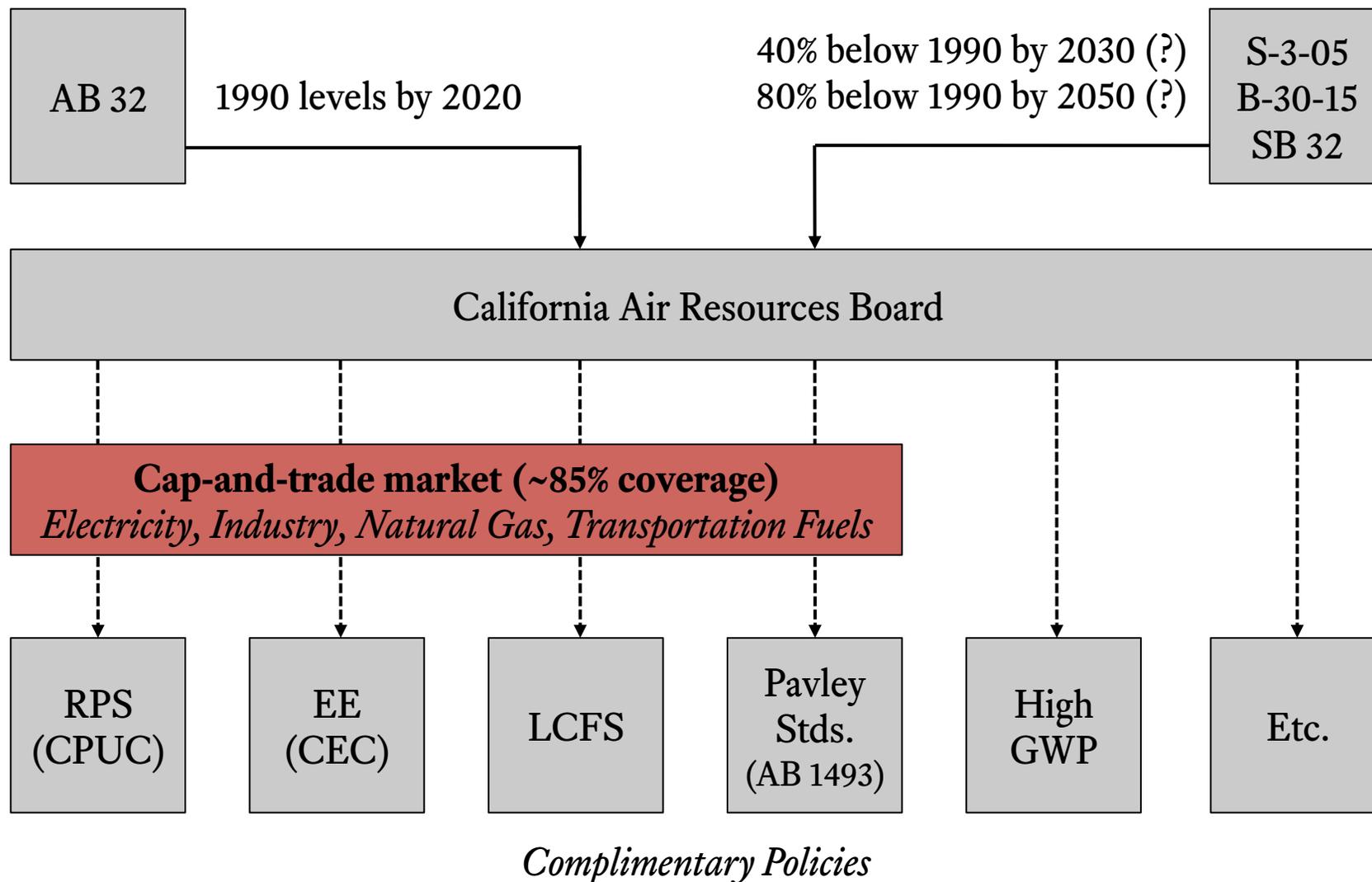
—CAISO Fifth Replacement Tariff § 29.32; *see also* California Indep. Sys. Operator Corp., 147 FERC ¶ 61,213 at P 240 (2014), *order on reh'g, clarification, and compliance*, 149 FERC ¶ 61,058 at P 18 (2014).

Figure 6: Framing the Path to 2050

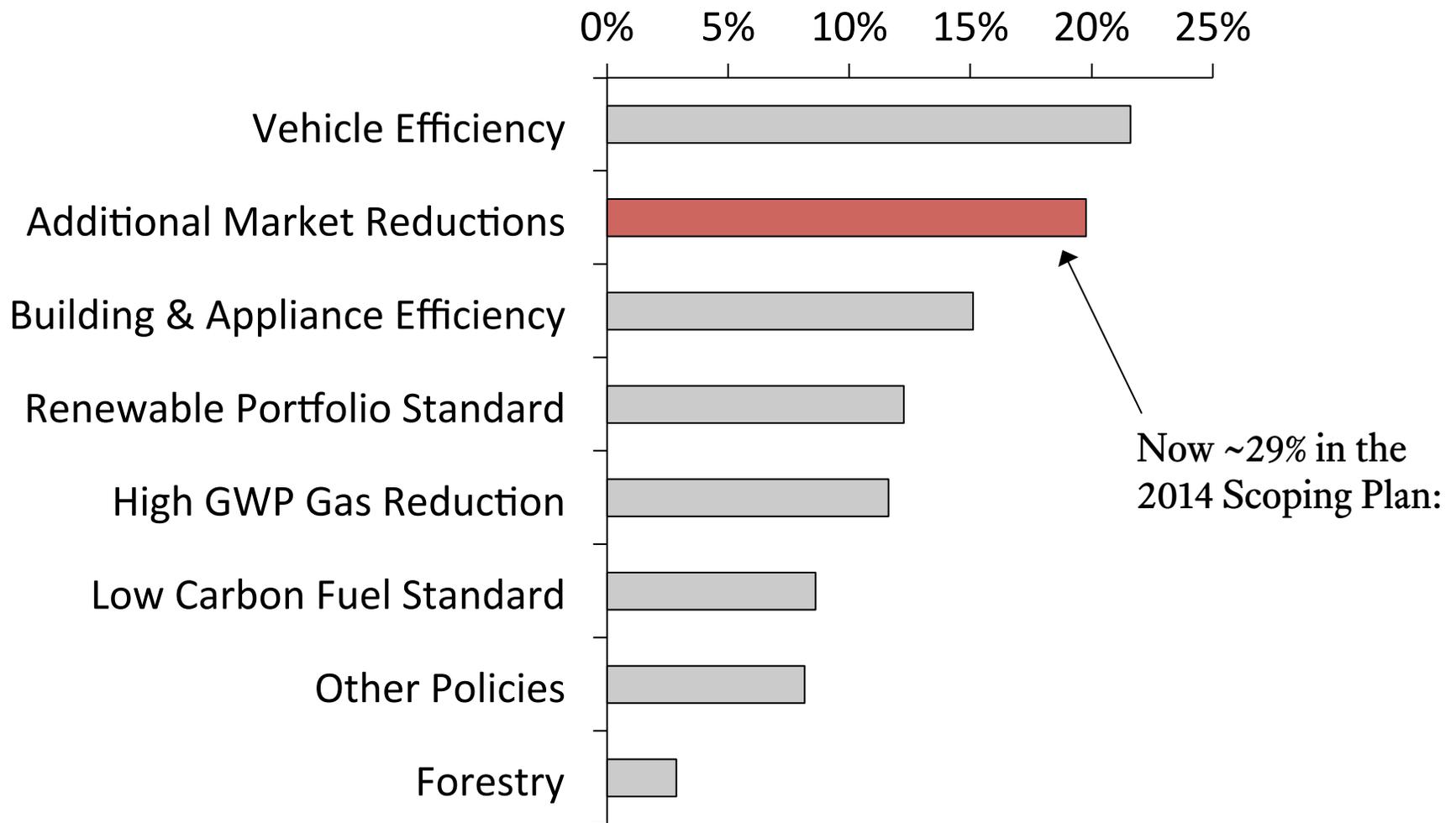


Source: CARB Updated Scoping Plan (2014)

CALIFORNIA'S CLIMATE POLICY SYSTEM

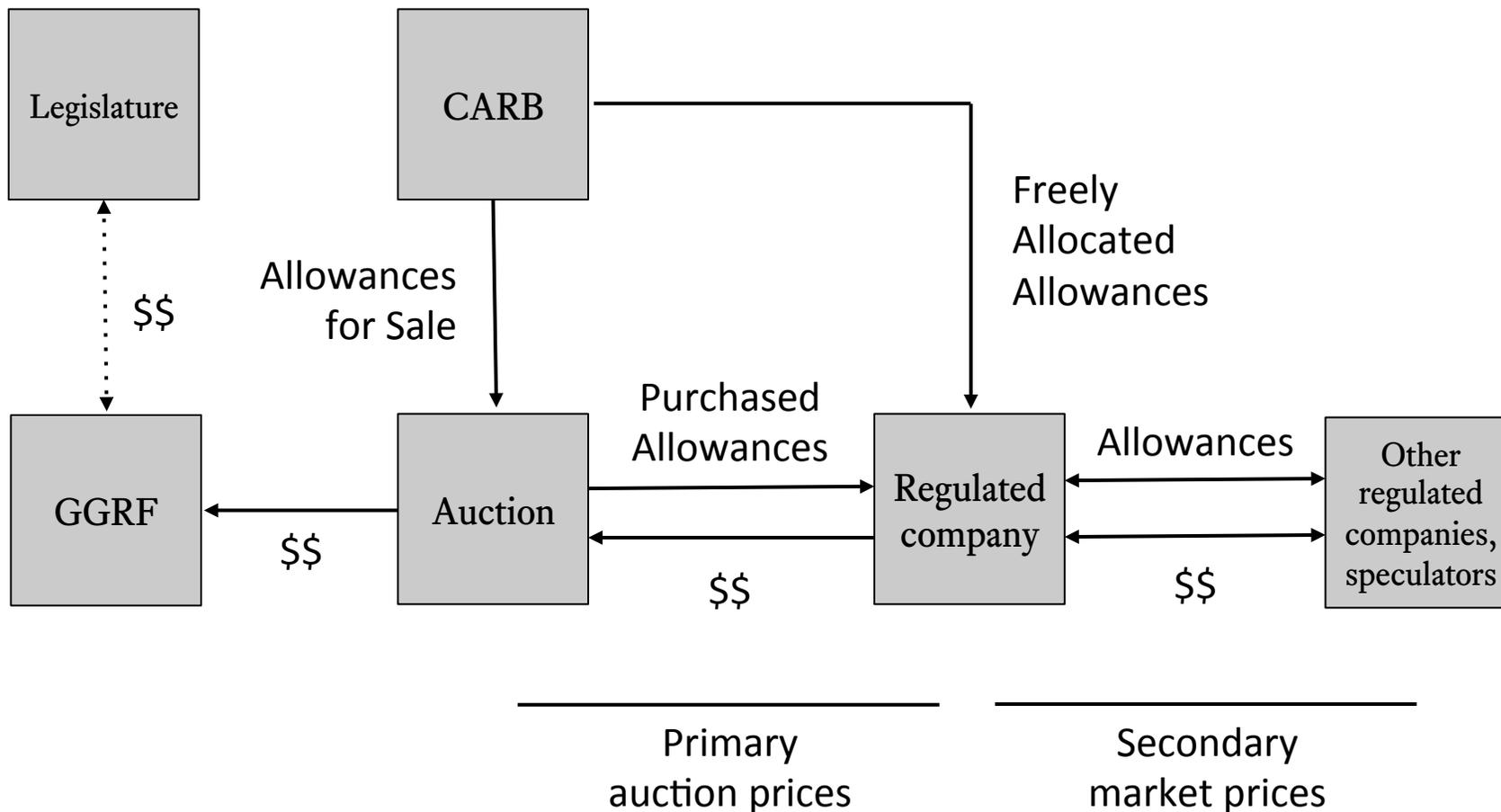


CALIFORNIA'S CLIMATE POLICY SYSTEM



Source: CARB Scoping Plan (2008); *see also* Wara (2014) and Cullenward (2014)

KEY CARBON MARKET TRANSACTIONS



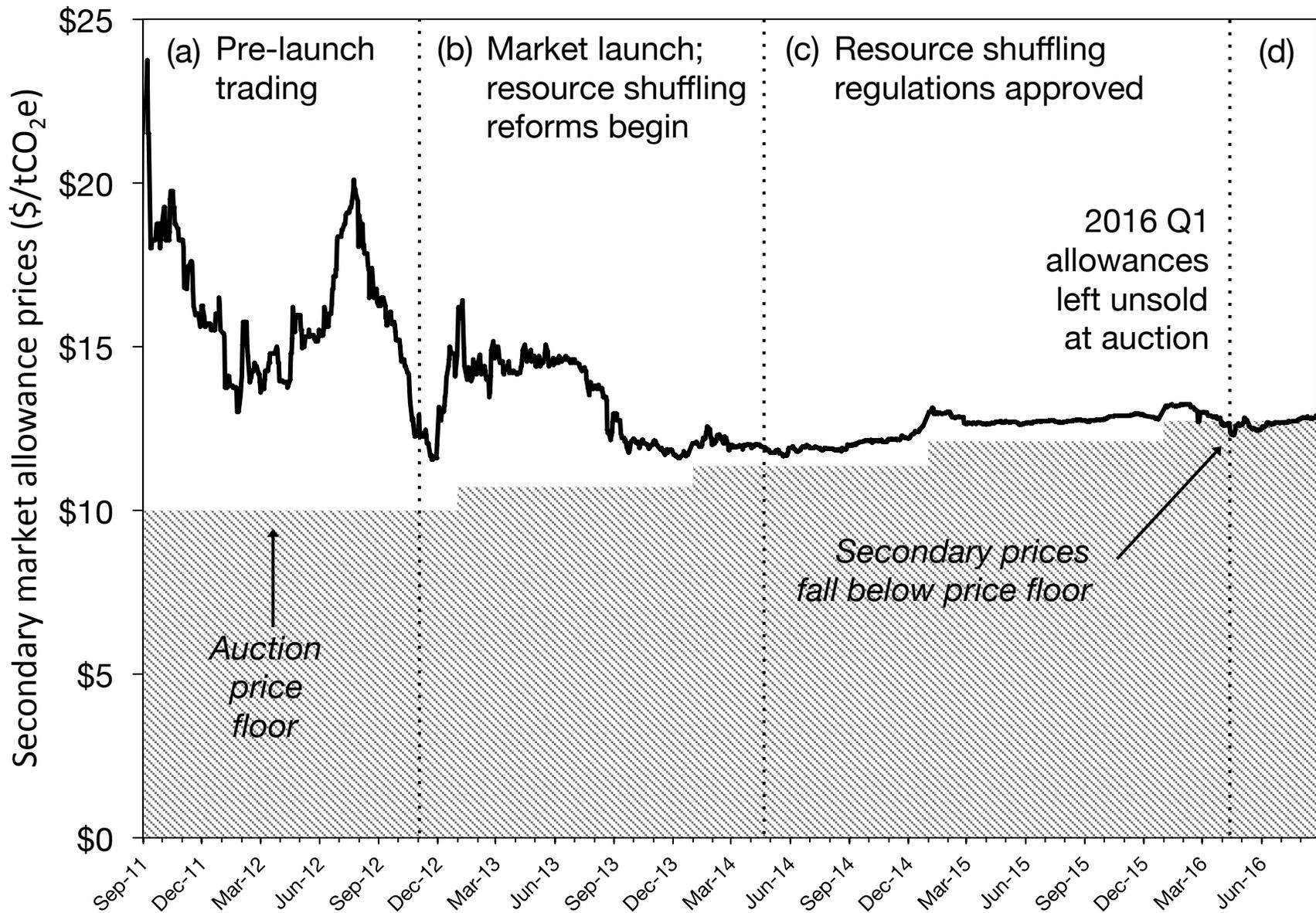
IS THERE LIFE AFTER 2020?



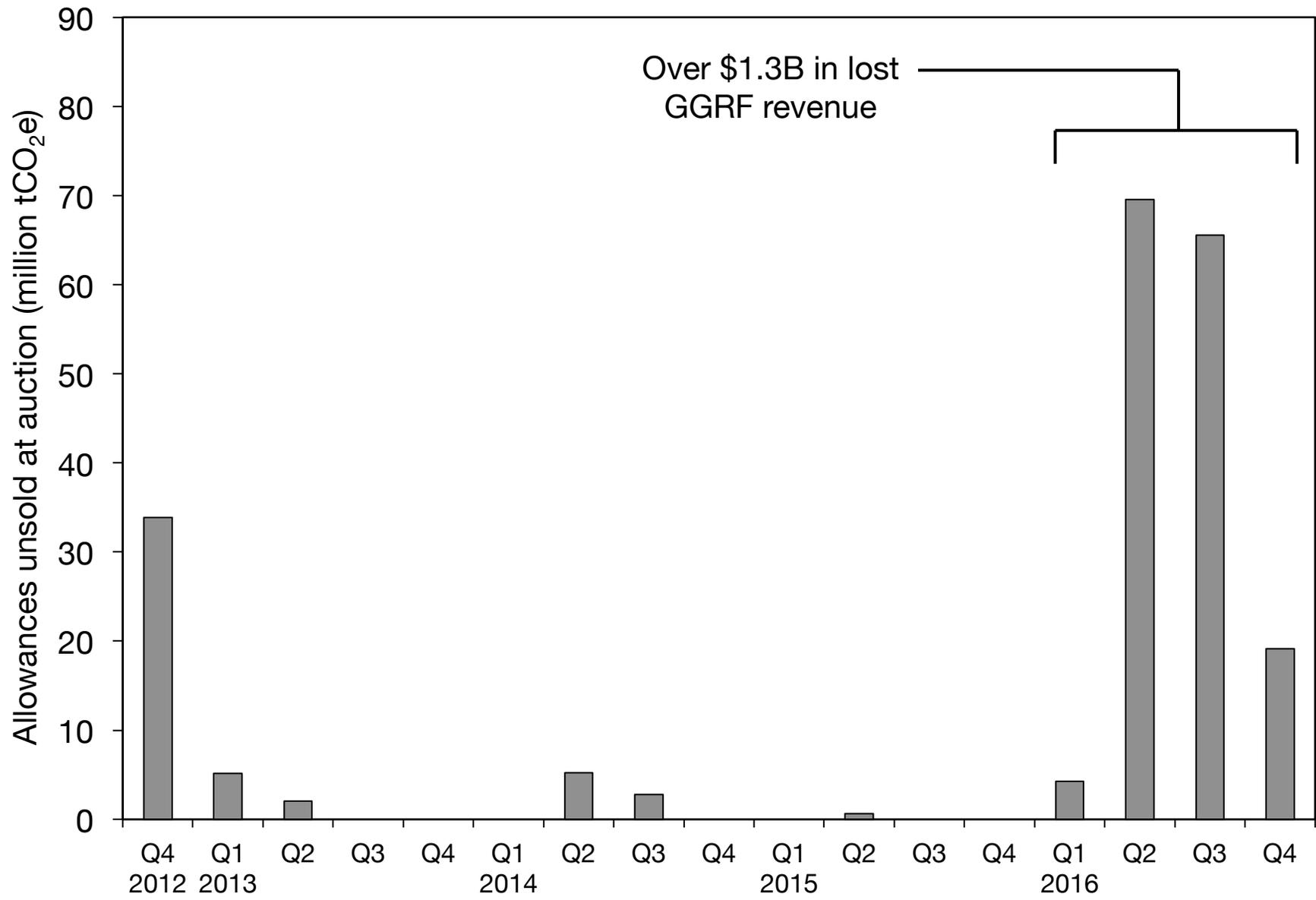
AB 32 “does not authorize the (California Air Resources Board) or the governor to set an emissions limit after 2020 that is lower than” the 1990 target, Boyer-Vine wrote.

State Sen. Jim Nielsen (R-Gerber), who referenced the legislative counsel’s opinion at a committee hearing Thursday, said, “Can the cap-and-trade program be applied or used beyond December 31, 2020? Answer: No.”

—David Siders, Legislature’s attorney says
Jerry Brown can’t set climate targets.
Sacramento Bee (Apr. 21, 2016)



Source: Cullenward & Coghlan (2016); see also www.calcarbondash.org



Source: Cullenward & Coghlan (2016); CARB auction data

DOES AB 32 AUTHORIZE A POST-2020 MARKET?

- ARB may “establish[] a system of market-based declining annual aggregate emission limits . . . applicable from January 1, 2012, to December 31, 2020, inclusive.”
 - Cal. Health & Safety Code § 38562(c)
(added by AB 32 in 2006)

DOES AB 32 AUTHORIZE A POST-2020 MARKET?

- Aug. 2016: CARB released proposed regulations to extend the cap-and-trade program through 2031.
- CARB's proposed regulation did not identify or discuss the legal authority to extend cap-and-trade, though it did make two general references to authority to “maintain and continue” emission reductions after 2020.
- Sept. 2016: SB 32 passes with a simple majority and is signed into law. SB 32 codified the State's 2030 climate target, but was silent on authority to use market-based policies.

DOES AB 32 AUTHORIZE A POST-2020 MARKET?

- (a) The [2020] statewide greenhouse gas emissions limit shall remain in effect unless otherwise amended or repealed.
- (b) It is the intent of the Legislature that the statewide greenhouse gas emissions limit continue in existence and be used to maintain and continue reductions in emissions of greenhouse gases beyond 2020.
- (c) The state board shall make recommendations to the Governor and the Legislature on how to continue reductions of greenhouse gas emissions beyond 2020.

— Cal. Health & Safety Code § 38551

DOES SB 32 AUTHORIZE A POST-2020 MARKET?

[CARB] shall ensure that statewide greenhouse gas emissions are reduced to at least 40 percent below the statewide greenhouse gas emissions limit [1990 emissions] no later than December 31, 2030.

— Cal. Health & Safety Code § 38566
(added by SB 32 in Sept. 2016)

RECENT DEVELOPMENTS

- Sept. 2016: CARB Chair Mary Nichols directed staff and public commenters to not discuss legal authority issues at its Board meeting, acknowledging concerns raised in comment letters but deferring discussion to future meetings.
- Dec. 2016: CARB staff acknowledged “different legal interpretations about authority” for a post-2020 market.
- Jan. 2016: Gov. Brown’s budget proposal acknowledges “perceived legal uncertainty” and calls for 2/3 vote to “confirm [C]ARB’s authority” for a post-2020 market.

AGENDA

- California's current climate policy regime
- **Propositions 13 and 26**
- Options for post-2020 state policy

PROPOSITION 13 (1978)

- Requires 2/3 legislative majority for new taxes
- Critically, the word “tax” was never defined
- Textual and judicial exemptions (\neq tax) allow simple legislative majorities to enable:
 - Special assessments
 - Development fees
 - User fees
 - Regulatory fees

“REGULATORY FEES” DEFINED

Sinclair Paint Co. v. State Board of Equalization,
15 Cal.4th 866 (Cal. 1997):

- Nexus between regulated product and its adverse effects;
- Primary purpose is regulation, not revenue collection;
- There must be a “reasonable relationship” between fees and burdens on payors / benefits from mitigation;
- Fees cannot exceed “reasonable cost” of supported regulatory activities.

IS THE CAP-AND-TRADE AUCTION A “TAX”?

- Government-sponsored allowance auctions collect revenue from regulated industries (although some receive free allocations).
- *Morning Star Packing Co. v. CARB* (2013):
 - Auctions are a valid regulatory fee, not a tax; therefore did not need 2/3 legislative majority.
 - But the tax/fee issue is a “close question” here;
 - On appeal as *California Chamber of Commerce*.

IS THE CAP-AND-TRADE SYSTEM A “TAX”?

- *California Chamber of Commerce v. CARB*:
 - Oral argument held on January 24, 2017.
 - Decision from Court of Appeals within 90 days.
 - CARB argued for a new category of exceptions to Prop. 13 (neither “tax” nor “fee”); in the alternative, that the auctions are permissible fees.
 - Cal. Chamber argued that the case must be evaluated under *Sinclair Paint*’s tax/fee distinction and that the auctions are taxes under that test.

PROPOSITION 26 (2010)

- “Any change in statute which results in any taxpayer paying a higher tax” must be passed by a 2/3 vote in both the State Assembly and State Senate.
- Prop. 26 defines “tax” as “any levy, charge, or exaction of any kind imposed by the State.”
- Five exemptions, no regulatory fee category.

— Cal. Constitution, Art. XIII A § 3

PROPOSITION 26 (2010): FIVE EXEMPTIONS

1. Charge for specific benefit to payor,
where charge < cost of conferring benefit
2. Charge for government service/product provided to payor,
where charge < cost of conferring service/product
3. Charge for licensing fees, permits, etc.,
where charge < cost of issuance
4. Charge for “entrance to or use of state property”
5. Fine or penalty for violating the law

— adopted from Cal. Constitution, Art. XIII A § 3(b)

A BIFURCATED LEGAL STANDARD

Proposition 13

- Applies to statutory changes enacted before 2010.
- Applies to all regulations enacted pursuant to pre-2010 statutory authority (*SCE v. CPUC*).
- Regulatory fees permissible when authority derived from statute passed with a simple legislative majority (*Sinclair Paint*).

Proposition 26

- Applies to statutory changes enacted in 2010 and after.
- Broad definition of tax.
- Regulatory fees not permitted, but some exemptions remain.

AGENDA

- California's current climate policy regime
- Propositions 13 and 26
- **Options for post-2020 state policy**

LEGISLATIVE OPTION #1: LEGISLATIVE SUPERMAJORITY

Pass enabling legislation to extend carbon pricing in any form—carbon markets, fees, or hybrid instruments— with a bicameral 2/3 supermajority.

LEGISLATIVE OPTION #2: ENFORCEMENT FEE

As used in this section, “tax” means any levy, charge, or exaction of any kind imposed by the State, except the following:

5. A fine, penalty, or other monetary charge imposed by the judicial branch of government or the State, as a result of a violation of law.

— Cal. Constitution, Art. XIII A § 3(b)

- Impose a Pigouvian fine? (Masur and Posner, 2015)
- Problems for private contracts?

LEGISLATIVE OPTION #3: DON'T COLLECT ANY REVENUE

A 10¢ plastic bag fee wasn't a tax because the government didn't collect any money.

Schmeer v. Cnty. of Los Angeles,
153 Cal. Rprt. 3d 352, 354 (2013)

Variations:

- Freely allocate all allowances
- Give all allowances to third parties to auction
- Green bank NGO subject to GGRF rules

LEGISLATIVE OPTION #4: STATE PROPERTY USE EXCEPTION

A charge imposed for entrance to or use of state property, or the purchase, rental, or lease of state property ...

— Cal. Constitution, Art. XIII A § 3(b)(4)

- Can California claim part of the global atmospheric commons as “state property”?
- Alternatively, perhaps the allowance itself is the state property. However, market regulations explicitly state that allowances “do not constitute property or a property right.” (Cal. Code Regs. tit. 17, § 95820(c))

REGULATORY OPTIONS ARE RISKIER

- Need authority to maintain C&T system at 2020 levels after 2020 under AB 32;
- Need existing C&T auction to survive legal challenge under Proposition 13;
(Morning Star / Cal. Chamber of Commerce)
- Need a technical mechanism to enable deeper effective reductions despite flat cap.

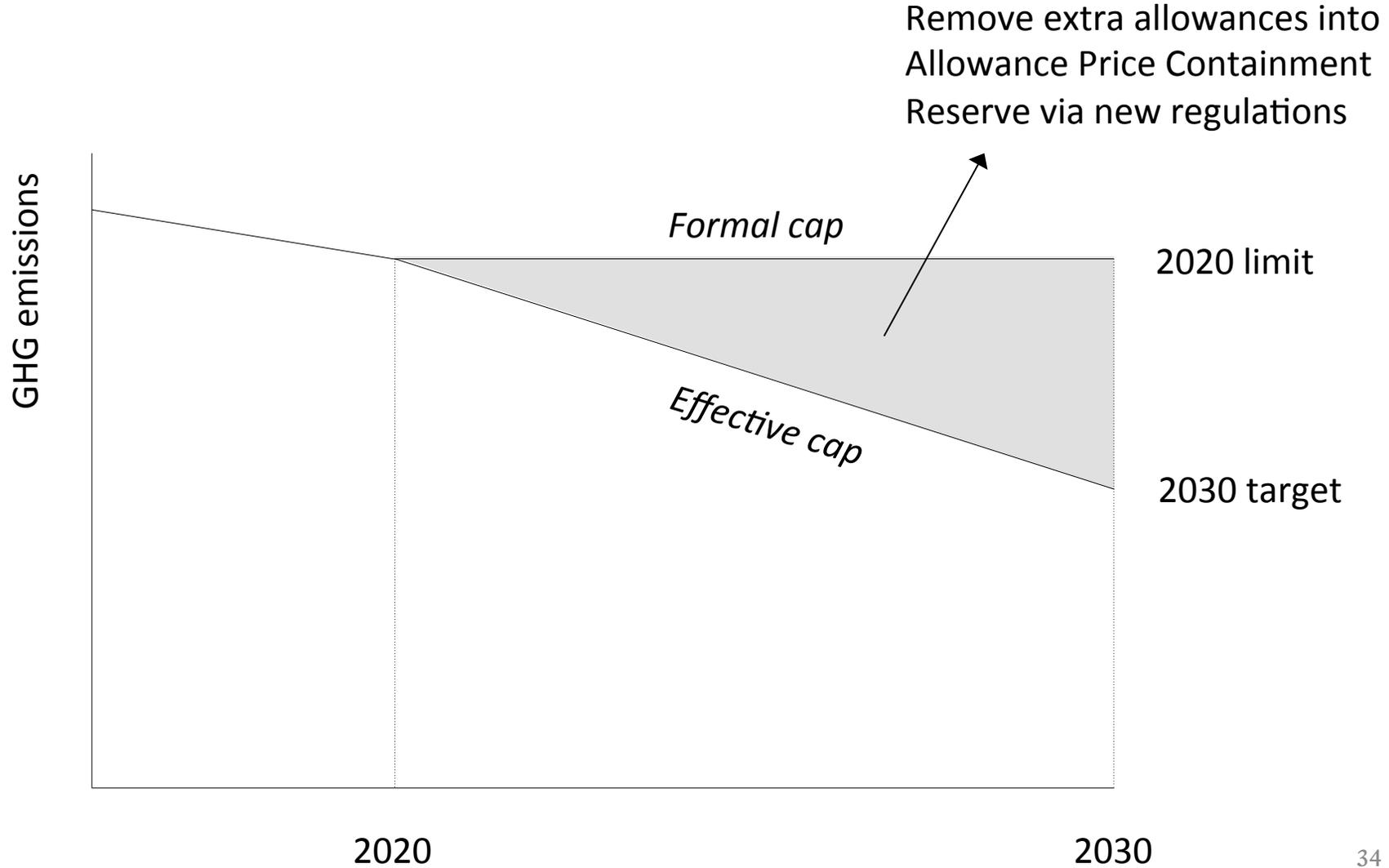
DOES AB 32 ENABLE A POST-2020 MARKET?

CARB may “establish[] a system of market-based declining annual aggregate emission limits . . . applicable from January 1, 2012, to December 31, 2020, inclusive.”

— Cal. Health & Safety Code § 38562(c)

- Could CARB argue that this is only a limit on *declining* annual aggregate emission limits, but that there is some other authority to maintain a constant market-based emission limit in perpetuity?

REGULATORY OPTION #1: FLAT CAP WITH APCR CARVEOUT



REGULATORY OPTION #2: DEFAULT CARBON TAX W/ 2020 CAP BACKSTOP

- Price floor: \$10 in 2010, 5%+CPI per year.
- Need to transition to 100% auction (or similar).
- With allowance supply >> demand, auctions won't sell out (*e.g.*, 2016 auctions).
- Result: effectively a carbon tax at market price floor with quantity backstop at 2020 cap.
- Caveat: use of CPs means that carbon price applies only to emissions left after effect of CPs (as in current system).

Type	Strategy	Legal risk	Legal issue(s)
Legislative	Legislative supermajority	None	None
	Enforcement fee	Relatively low	Would an enforcement fee cause problems for private contracts?
	Avoid revenue collection	Medium	Will courts extend the holding in <i>Schmeer</i> from a 10¢ bag fee to a \$10B economy-wide program?
	Green bank	Medium to medium high	Does green bank look too similar to GGRF to justify analogy to <i>Schmeer</i> ?
	State property	Relatively high	Can the State claim some portion of the global atmospheric commons?
Regulatory	Flat cap with expanded APCR	Relatively high	Does ARB have authority to continue C&T with flat cap after 2020?
	Default carbon tax w/ 2020 cap backstop		Is the existing C&T system a valid regulatory fee? (<i>Cal. Chamber</i>) Is spending revenue on mitigation below the AB 32 target ok? Adaptation?

THANKS!

QUESTIONS?

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- Cara Horowitz, M. Rhead Enion, Sean B. Hecht, and Ann Carlson (2012). **Spending California's Cap-and-Trade Auction Revenue: Understanding the *Sinclair Paint* Risk Spectrum.** Emmett Center on Climate Change and the Environment Report, UCLA School of Law.
- Jonathan and Eric Posner (2015), **Toward a Pigouvian State.** *U. Penn. Law Review* 164: 93-147.
- Michael Wara (2014), **California's energy and climate policy: A full plate, but perhaps not a model.** *Bulletin of the Atomic Scientists* 70(5): 26-34.

KEY COURT CASES

- **Sinclair Paint Co. v. State Board of Equalization**, 15 Cal.4th 866 (Cal. 1997) (recognizing a “regulatory fee” exception to Proposition 13 in the case of a mitigation charge related to lead paint and lead poisoning).
- **California Chamber of Commerce v. CARB & Morning Star Packing Co. v. CARB**, Superior Court of California, County of Sacramento, Case Nos. 34-2012-80001313 & 34-2013-80001464 (Aug. 28, 2013) (finding that California’s current cap-and-trade system is a regulatory fee under Proposition 13). Case is on appeal before the Third Appellate District, Case No. C075930; for briefing and trial court opinion, *see* <https://www.edf.org/california-cap-and-trade-auction-legal-resources>.
- **Southern California Edison v. California Public Utilities Commission**, 173 Cal. Rptr. 3d 120 (Cal. Ct. App. 2014) (finding that a regulation issued after 2010 under a pre-2010 statute could be upheld as a valid *Sinclair Paint*-type regulatory fee).
- **Schmeer v. County of Los Angeles**, 153 Cal. Rptr. 3d (Cal. Ct. App. 2013) (finding that a statute requiring merchants to impose a 10¢ plastic bag fee was not a “tax” under Proposition 26 because the government did not collect the charge, even though the charge existed only because of a statutory change).

CALIFORNIA CONSTITUTION, ARTICLE XIII A (AS MODIFIED BY PROP. 26)

SEC. 3. (a) Any change in state statute which results in any taxpayer paying a higher tax must be imposed by an act passed by not less than two-thirds of all members elected to each of the two houses of the Legislature, except that no new ad valorem taxes on real property, or sales or transaction taxes on the sales of real property may be imposed.

(b) As used in this section, "tax" means any levy, charge, or exaction of any kind imposed by the State, except the following:

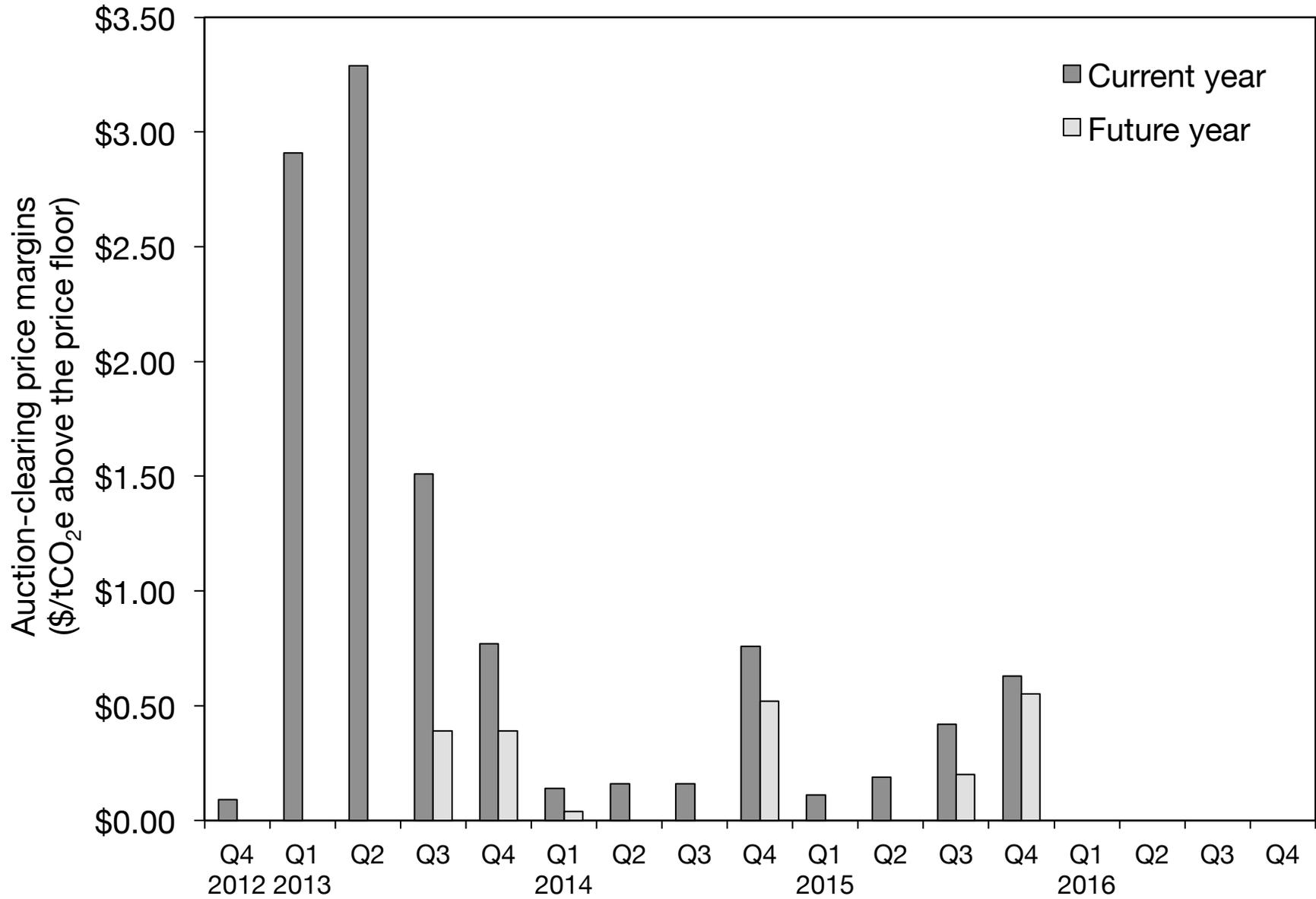
(1) A charge imposed for a specific benefit conferred or privilege granted directly to the payor that is not provided to those not charged, and which does not exceed the reasonable costs to the State of conferring the benefit or granting the privilege to the payor.

(2) A charge imposed for a specific government service or product provided directly to the payor that is not provided to those not charged, and which does not exceed the reasonable costs to the State of providing the service or product to the payor.

(3) A charge imposed for the reasonable regulatory costs to the State incident to issuing licenses and permits, performing investigations, inspections, and audits, enforcing agricultural marketing orders, and the administrative enforcement and adjudication thereof.

(4) A charge imposed for entrance to or use of state property, or the purchase, rental, or lease of state property, except charges governed by Section 15 of Article XI.

(5) A fine, penalty, or other monetary charge imposed by the judicial branch of government or the State, as a result of a violation of law.



Source: Cullenward & Coghlan (2016); CARB auction data