Update on the Implementation of AB 32: Cap and Trade in Focus

Testimony of Cara Horowitz

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Thank you, Senator Pavley and members of the Senate Select Committee on the Environment, the Economy and Climate Change. It is my honor to be here today on this critical topic. My name is Cara Horowitz and I am on the faculty at the UCLA School of Law, where I serve as the executive director of the Emmett Center on Climate Change and the Environment. We are an academic, nonpartisan law school center focused on climate law and policy analysis.

I am here today to report on two studies I have undertaken, along with colleagues at UCLA Law School and elsewhere, on aspects of California's cap-and-trade program relevant to today's hearing. In the first study, we assessed the potential for market manipulation and gaming in California's cap-and-trade program design. In the second study, to be released later this week, we look at the legal constraints on using revenue derived from the state's cap-and-trade auctions. Today I will give a summary of the main findings of these studies.

To begin, I will address our report entitled "Rules of the Game: Examining Market Manipulation, Gaming and Enforcement in California's Cap-and-Trade Program." For this analysis, we partnered with Dr. Bowman Cutter, an economist at Pomona College, and examined CARB's program design, looking especially at the adequacy of the program to limit risks from market manipulation and rules violations. I believe that each of the Committee members has received a copy of this report.

Here's a summary of what we found. In general, my colleagues and I conclude that CARB has designed a program that incorporates the best practices and lessons learned from other allowance trading programs. We therefore think it is unlikely that the program will experience market manipulation significant enough to affect efficiency or fairness, or to cause unwarranted price volatility.

Because Dr. Burtraw has already addressed many of these questions about program design and shares our view that CARB's program is strong, I will not spend more time on those issues here. I will say a bit more about enforcement authority, which Dr. Burtraw did not address. CARB has designed a system of monitoring and enforcement that should allow it to detect foul play, enforce its rules, and impose adequate penalties to deter noncompliance. Its bases for asserting jurisdiction over program participants are strong, and available penalties include significant fines as well as criminal liabilities.

Moving on to my second topic, I will address some of the legal constraints on spending California's cap-and-trade auction revenue. We have looked closely at these restrictions, including at California's restrictions on spending regulatory fees. Here are our main conclusions.

First, on statutory constraints: While AB 32 authorizes the use of market-based mechanisms for achieving greenhouse gas reductions, it does not dictate how to spend auction revenue.

The statute does contain limited direction to CARB about the establishment of other fees. Section 38597 of AB 32 authorizes CARB to adopt a "schedule of fees" to be paid by regulated greenhouse gas emitters, and requires that those revenues be deposited into the Air Pollution Control Fund to be made available, upon appropriation by the Legislature, "for purposes of carrying out [AB 32]."

We conclude that this fee schedule provision, however, likely does not constrain or relate to the use of auction revenue proceeds, for the following reasons. The authority to enact these fees is set forth separately from the authority to enact a "market-based compliance mechanism" to achieve the statewide greenhouse gas limit. A cap-and-trade program with auction is a well-known example of a market-based compliance mechanism, and nothing in the statute suggests that the Legislature's grant of additional authority to enact fees to implement AB 32 was meant to constrain separately-granted authority to enact a market-based program. Indeed, Section 38597 is explicitly limited to directing the use of only those revenues "collected pursuant to this Section"—i.e., not to any other revenues that might be generated by other sections of AB 32, such as under a market-based program.

Second, on constitutional constraints: Several observers and analysts, including recently the Legislative Analyst's Office, have noted that California's constitution might limit AB 32 auction revenue allocation in significant ways. The AB 32 auction may be viewed as generating a type of revenue known as "regulatory fees," which can be spent only for limited purposes under Article XIII of the state constitution.

With the passage in 1978 of Proposition 13, California law held that a majority vote is insufficient to enact a tax increase. Instead, no tax proposed for the purpose of increasing revenue could be adopted without the approval of two-thirds of the Legislature or of the people.

AB 32 passed the California legislature by a majority, but not with a 2/3 supermajority, and therefore it cannot have authorized the collection of tax revenue. The law, however, distinguished between taxes and regulatory fees, allowing the government to impose charges on some businesses and products in order to help to offset the public health or environmental impact of those businesses' activities. Those fees could be passed with a simple majority vote. The main California Supreme Court case distinguishing between regulatory fees and taxes is known as *Sinclair Paint.*

If AB 32's cap-and-trade program is challenged in court as an illegal tax, questions about the reach of *Sinclair Paint* will be ones of first impression. The AB 32 cap-and-trade program and auctions are novel, and California courts have not been called on before to try to classify such a program under the *Sinclair Paint* regime. Moreover, the cap-and-trade program and its auctions have characteristics that make them unlike either a traditional tax or a traditional regulatory-fee mechanism, such that a court may conclude that they are neither.

Nevertheless, the program does raise state money as part of a program to regulate and reduce pollution. Thus, it is arguable that the cap-and-trade program imposes something akin to a regulatory fee. To minimize its legal vulnerability, then, the state should consider its revenue allocation decisions in light of the *Sinclair* regime, keeping in mind the spectrum of risk associated with different revenue allocation decisions being considered.

Which revenue allocation decisions are riskiest? Courts have set forth no precise test or formulation, but to successfully defend an exaction as a regulatory fee, rather than a tax, the Supreme Court has held that the state should be able to show – among other things – that fees raised have not been used "for unrelated revenue purposes."[1] In other words, regulatory-fee revenue must be used to further the purposes of the regulatory program authorizing that revenue.

As recently summarized by the Supreme Court, a regulatory fee cannot "exceed the reasonable cost of regulation *with the generated surplus used for general revenue collection.* An excessive fee that is used to generate general revenue becomes a tax."[2]

Here, that likely means restricting revenue use to programs that further AB 32's goals.

What are AB 32's goals? We discern three potential sets of legislative goals.

(a) Reduction of greenhouse gas emissions

The first of the three goals is unquestionably central to AB 32 and to the cap-and-trade program: reduction of GHG emissions to achieve the 2020 state limit. Using AB 32 revenue to help achieve direct reductions in GHGs on that timeline is the safest way to show that auction proceeds are not being used for "unrelated revenue purposes."

Potential difficulties arise if the GHG reductions are unlikely to occur until after 2020, because of AB 32's specific 2020 mandate. However, the statute calls for the greenhouse gas limit to remain in effect past 2020 and to "be used to maintain and continue reductions in emissions of greenhouse gases beyond 2020."[3] Because California's economy and population will presumably grow beyond 2020, but the statewide GHG limit will remain static, the limit effectively becomes more stringent over time—justifying the funding of GHG reduction efforts even beyond 2020.

(b) Advancement of other goals set by the Legislature

The second set of goals consists of those enumerated by the Legislature itself in its statutory directions to CARB for designing a regulatory program. The Legislature gave CARB significant discretion to figure out how to reduce the state's climate emissions, but also urged the agency to consider and prioritize a set of secondary goals along the way. The most relevant of these goals direct CARB, to the extent feasible and "in furtherance of achieving the statewide greenhouse gas emissions limit," to:

- design the regulations in a manner that is equitable;[4]
- ensure that activities undertaken to comply with the regulations do not disproportionately impact low-income communities;[5]
- ensure that activities undertaken pursuant to the regulations complement, and do not interfere with, efforts to achieve air quality standards and reduce toxic contaminants;[6]
- design any market-based compliance mechanism to prevent any increase in the emission of toxic air contaminants or criteria air pollutants;[7]
- minimize leakage;[8]
- maximize additional environmental and economic benefits for California;[9]
- direct public and private investment toward the most disadvantaged communities in California;[10] and
- provide an opportunity for small businesses, schools, affordable housing associations, and other community institutions to participate in and benefit from statewide efforts to reduce greenhouse gases.[11]

Though these goals were enumerated by the Legislature, they cannot be considered to be of the same order of priority as reducing greenhouse gases. AB 32 urges CARB to consider achieving

these ancillary goals, if feasible, *in its design of a program to reduce GHGs*. In other words, these goals were to be prioritized within programs aimed at achieving GHG reductions, but were never mandated as ends in themselves.

In light of these legislative directives, using AB 32 revenue to help reach these ancillary goals would be least risky when done in a way that reduces GHGs. The safest revenue expenditure plan would mirror the bill's priorities, using GHG reductions as a threshold directive and prioritizing revenue uses based on their ability to accomplish other AB 32 goals.

A revenue decision that advances one of these secondary goals untethered to GHG reductions may be justified if one considers the entirety of the cap-and-trade program as unitary, with some elements of the program (the cap) achieving GHG reductions and others (certain auction revenue decisions) achieving ancillary benefits. It is difficult to predict whether a court would choose to view the program in this light, or, rather, would see money spent on projects unrelated to GHG reductions as a tax because they fail to further AB 32's central regulatory purpose.

(c) Reduction of climate change impacts on California

The third set of goals is even farther removed from AB 32's central mandate: to lessen the harm from global warming in California, generally. But AB 32 does not state a goal or a mandate focused on mitigating the harms of climate change, separate from its calls for reducing greenhouse gases or for creating the other environmental and economic co-benefits specifically named as secondary goals of the statute. We therefore conclude that it would be risky to use auction revenue for projects that help the state adapt to climate change, but in ways that do not reduce emissions or serve one of the other explicit goals of the statute. To advance adaptation, a less risky approach would be to fund projects that result in both GHG reductions and adaptation (resiliency) benefits.

Needless to say, the most risky decisions for allocation revenue are those that support programs that are unrelated to any of these three sets of AB 32 goals. Such initiatives might include general fund relief; state educational programs; and countless others.

In summary, we conclude that the Legislature should consider these main questions as it determines how risky any given use of auction revenue might be, under a *Sinclair Paint* analysis:

- Will the use permanently, verifiably, quantifiably reduce greenhouse gas emissions?
- Will the use advance other explicit AB 32 goals, such as directing investment to disadvantaged communities, maximizing economic and environmental benefits, or allowing opportunities for community institutions to participate in and benefit from emissions reductions?
- Has the state built a strong record showing how the revenue use will achieve the purposes of AB 32?
- Is the use a direct allocation of money for revenue purposes unrelated to AB 32?

I will note that none of these criteria relates to questions about the relationship between fee payors (*i.e.*, those who pay money at auction) and beneficiaries of revenue allocation decisions. Though some in industry have reportedly argued that *Sinclair* and its progeny require a "nexus" or "proportional relationship" between the amount of regulatory fees paid by an entity and the benefits received by that entity from the regulatory program at issue, courts have squarely rejected this notion. "[R]egulatory fees in amounts necessary to carry out the regulation's purpose are valid despite the absence of any perceived 'benefit' accruing to the fee payers."[12] Thus, the state need not allocate auction revenue with an eye toward "repaying" or benefiting the regulated entities that have paid into auctions.

Finally, I want to emphasize the limits of this analysis. The answers to these questions won't dictate whether any given use of revenue is correct or incorrect. To say that a particular proposal may be risky under *Sinclair* is not to say that it shouldn't be considered; instead, decisionmakers should understand and consider the risk of its being held invalid by the courts when weighing options.

With this summary, I thank you again for your time and attention, and I look forward to answering any questions you might have.

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[1] *Sinclair Paint Co. v. State Bd. of Equalization*, 15 Cal.4th 866, 878 (1997).

[2] *Cal. Farm Bureau Fed'n v. State Water Resources Control Bd.*, 51 Cal. 4th 421, 438 (2001) (emphasis added).

[3] AB 32 § 38551(b).

[4] *Id.* § 38562(b)(1).

[5] *Id.* § 38562(b)(2).

[6] *Id.* § 38562(b)(4).

[7] *Id.* § 38570(b)(2).

[8] *Id.* § 38562(b)(8).

[9] *Id.* § 38570(b)(3).

[10] *Id.* § 38565.

[11] *Id.* § 38565.

[12] *Sinclair Paint*, 15 Cal.4th at 876; see also *Cal. Farm Bureau Fed'n v. SWRCB*, 51 Cal. 4th 421, 438 (2001) ("Regulatory fees are valid despite the absence of any perceived 'benefit' accruing to the fee payers").