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California's Cap-and-Trade Auction Proceeds: Taxes, Fees, or Something Else?

May 2012

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I. Introduction and Summary

In 2006, California enacted the Global Warming Solutions Act, known as AB 32 (Pavley).¹ Under that legislation, the state must reduce greenhouse gas emissions to their 1990 level by the year 2020.² AB 32 provided the California Air Resources Board (CARB) with the authority to use a market-based compliance mechanism as part of its efforts to reduce greenhouse gas emissions.³ As a result, CARB developed a cap-and-trade program, under which allowances to emit greenhouse gases will be sold at auction.⁴ This paper examines the legal viability of a range of potential uses of the auction proceeds generated by AB 32's market-based mechanism. The paper first considers the different legal frameworks under which courts may consider whether the auction proceeds are a regulatory fee, some other fee, an unlawful tax or something else. Then, the paper looks at 18 different spending proposals, and considers potential legal risks associated with the spending proposals under the different legal frameworks.

Legal Framework. California's Legislative Analyst recently concluded, based on a Legislative Counsel opinion, that for the auction proceeds to be considered a "regulatory fee" (and not an invalid "tax") the proceeds would likely need to be spent on programs that reduce or mitigate greenhouse gas emissions.⁵ UCLA recently released a report agreeing that this would be the least risky approach to revenue expenditures.⁶ In general, we agree with other observers about the rankings of key activities in terms of their level of risk. However, in terms of the absolute level of risk, we identify some significant arguments for upholding even the options with a higher level of risk, such as use of the proceeds in the general fund. We view Proposition 13⁷ (as approved in 1978, not as amended by Proposition 26 in 2010) as the

most critical limit on the state. In our view, there are three credible arguments that auctions are not a "tax" under Proposition 13: (1) the primary purpose of CARB and AB 32 is not fiscal thus Proposition 13 does not apply, (2) the allowances constitute a governmental privilege like a development fee rather than a "tax," and (3) the proceeds are spent in such a fashion so as to render them a valid "regulatory fee" under the *Sinclair Paint* regime.⁸ If AB 32's cap-and-trade program is challenged in court as imposing an illegal tax, the legal questions will be ones of first impression, and a court's behavior is difficult if not impossible to predict. As a result, the most conservative approach would be to use the auction proceeds consistent with the *Sinclair Paint* regime because that would maximize the number of different arguments in support of the proposition that the auction proceeds are not a "tax" under Proposition 13.

Spending Proposals. Under *Sinclair Paint*, the least risky spending proposals are those that would advance AB 32's goals, and in particular, AB 32's primary goal: the reduction and mitigation of greenhouse gas (GHG) emissions. Somewhat more risky (but still relatively low risk) are costly spending proposals for projects that advance the goals of AB 32, but also advance other, unrelated goals. Although courts generally do not require that the most cost-effective mitigation measures be adopted, if the cost-effectiveness of a mitigation measure is very low, there is a possibility that a court may conclude that the auction proceeds are being used in lieu of general funds. The timing of the emissions reductions is likely to be treated similarly. The emissions cap remains in place after 2020, so spending proposals that reduce emissions after that date would further the purpose of AB 32. At some point, however, if the emission reductions are projected to occur far into the future, a court may conclude that the auction proceeds are being used in lieu of general funds. Spending proposals that fund

projects that could reduce General Fund expenditures would be somewhat more risky, particularly if the record suggests that the primary purpose of the expenditures was to reduce such expenditures rather than to reduce GHG emissions. Under *Sinclair Paint*, spending proposals that provide a rebate to taxpayers would not advance the purpose of AB 32, and thus would entail substantial risk. Use of the auction proceeds for rebates would support an argument that AB 32 was not enacted “for the purpose of raising revenues,” however, which would support a claim that Proposition 13 does not apply to the auction revenues. Since this is a novel argument, we conclude that rebates would be associated with a high level of risk.

II. Background: Legal Authorities and Recent Reports

There are a number of different legal authorities that may prove important to a court's review of the AB 32 auction proceeds: the statute itself, Proposition 13, approved by the voters in 1978, and Proposition 26, approved by the voters in 2010.⁹ There are also two recent reports on this subject, one prepared by UCLA, the second by the Legislative Analyst. Each of these is briefly described below.

A. AB 32: California's Global Warming Solutions Act

The language of AB 32 itself imposes constraints on spending auction revenues, both directly, by requiring certain spending, and indirectly, by directing CARB to achieve certain aims

Direct Constraints. AB 32 includes a section that allows CARB to adopt "a schedule of fees," and requires that the "revenues collected pursuant to this section" be spent "for the purposes of carrying out this division." The relevant section, California Health & Safety Code §38597 (unless otherwise indicated, all references are to the California Health and Safety Code) states in full:

The state board may adopt by regulation, after a public workshop, a schedule of fees to be paid by the sources of greenhouse gas emissions regulated pursuant to this division, consistent with Section 57001. The revenues collected pursuant to this section, shall be deposited into the Air Pollution Control Fund and are available upon appropriation, by the Legislature, for the purposes of carrying out this division.¹⁰

The UCLA report concludes that this section is unlikely to be found to apply to the auction

proceeds for several reasons, including the fact that this section is explicitly limited to only those revenues "collected pursuant to this Section." Thus, this section of the Health & Safety Code is unlikely to be found to apply to the auction proceeds, which are authorized by a different section.¹¹

Other Constraints Other sections of AB 32 describe the goals and aims of the program, and direct CARB to structure the program to achieve those goals. In describing the overall legislative intent, AB 32 directs CARB to design emissions reductions measures, "in a manner that minimizes costs and maximizes benefits for California's economy, improves and modernizes California's energy infrastructure and maintains electric system reliability, maximizes additional environmental and economic co-benefits for California, and complements the state's efforts to improve air quality."¹² Another section requires CARB to ensure that programs under its jurisdiction, "where applicable and to the extent feasible, direct public and private investment toward the most disadvantaged communities in California 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 gas emissions."¹³

Other sections specifically address the market-based compliance mechanism. CARB is directed to, "[d]esign the [market-based] regulations . . . in a manner that is equitable, seeks to minimize costs and maximize the total benefits to California, and encourages early action to reduce greenhouse gas emissions. . . . [to] [c]onsider overall societal benefits, including reductions in other air pollutants, diversification of energy sources, and other benefits to the economy, environment, and public health. . . . [and to] [m]inimize leakage."¹⁴ CARB is also directed to "[c]onsider. . . localized impacts in communities that are already adversely

impacted by air pollution,” to “[d]esign any market-based compliance mechanism to prevent any increase in the emissions of toxic air contaminants or criteria air pollutants,” and to “[m]aximize additional environmental and economic benefits for California, as appropriate.”¹⁵

B. Proposition 13 (California Constitution Article XIII A)

In 1978, California voters approved Proposition 13, an initiative constitutional amendment that limited taxes. The California Supreme Court described the four major elements of Proposition 13 as:

[A] real property *tax rate* limitation (§1), a real property *assessment* limitation (§2), a restriction on *state* taxes (§3), and a restriction on local taxes (§4). . . . Since the total real property tax is a function of both rate and assessment, section 1 and 2 unite to assure that *both* variables in the property tax equation are subject to control. Moreover, since any tax savings resulting from the operation of sections 1 and 2 could be withdrawn or depleted by additional or increased state or local levies of other than property taxes, sections 3 and 4 combine to place restrictions upon the imposition of such taxes.”¹⁶

More specifically, Section 1 limited the property tax rate to one percent of the value of the property. Section 2 limited the rate at which the value of the property could be increased or decreased to no more than two percent per year. Section 3 required a two-thirds vote of the legislature for “...any changes in State taxes enacted for the purpose of increasing revenues. . . .” Section 4 authorized local governments to impose “special taxes” provided they were approved “. . .by a two-thirds vote of the qualified electors,” but does not include language about the “purpose” of the “special

taxes.” Finally, Sections 5 and 6 concerned the Proposition’s effective date and severability, respectively.¹⁷

The full text of Section 3 of Proposition 13, the provision relevant to the AB 32 auction proceeds, states:

From and after the effective date of this article, any changes in State taxes enacted for the purpose of increasing revenues collected pursuant thereto whether by increased rates or changes in methods of computation 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.¹⁸

Section 4, which courts look to in interpreting Section 3, states in part:

Cities, Counties and special districts, by a two-thirds vote of the qualified electors of such district, may impose special taxes on such district¹⁹

Courts follow certain rule when interpreting ballot measures. When the language included in a ballot measure is “uncertain,” “the ballot summary and arguments and analysis presented to the electorate . . . may be helpful in determining the probable meaning”²⁰ In the California Voters Pamphlet for the 1978 election, project proponents, project opponents, and the Legislative Analyst all focus primarily on the property tax limitations rather than on the state and local government tax limitations. The Legislative Analyst, however, noted “[t]his initiative would require a two-thirds vote by the Legislature to increase state taxes. . . .”²¹ All contributors to the California Voters Pamphlet were silent on the issue of what constitutes a “tax” for purposes of Section

3, although the Legislative Analyst described the “special taxes” authorized by Section 4 as “unspecified.”²²

C. Proposition 26

Proposition 26, approved by the voters in 2010, modified Proposition 13 in several important ways. The modifications are shown below, with deletions shown using strikeout, and additions shown in italics:

~~(a) From and after the effective date of this article, any changes in state taxes enacted for the purpose of increasing revenues collected pursuant thereto~~ Any change in state statute which results in any taxpayer paying a higher tax ~~whether by increased rates or changes in methods of computation~~ must be imposed by an ~~Act~~ *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, for the purchase, rental, or lease of*

state property, except charges governed by Section 1655 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.*

(c) Any tax adopted after January 1, 2010, but prior to the effective date of this act, that was not adopted in compliance with the requirements of this section is void 12 months after the effective date of this act unless the tax is reenacted by the Legislature and signed into law by the Governor in compliance with the requirements of this section.

(d) The State bears the burden of proving by a preponderance of the evidence that a levy, charge, or other exaction is not a tax, that the amount is no more than necessary to cover the reasonable costs of the governmental activity, and that the manner in which those costs are allocated to a payor base bear a fair or reasonable relationship to the payor’s burdens on, or benefits received from, the governmental activity.

Proposition 26 modified Proposition 13 in at least two important ways. First, Proposition 26 expanded the two-thirds vote requirement from “changes in state taxes enacted for the purpose of increasing revenues” to “[a]ny change in state statute which result in any taxpayer paying a higher tax.” Thus, under Proposition 26, the purpose of the statute is not relevant, just the impact. The analysis by the Legislative Analyst in the Voter Guide for this provision stated:

Current Requirement. The State Constitution currently specifies that laws enacted ‘for the purpose of increasing revenues’ must be approved by two-thirds of each house of the Legislature. Under current practice, a law that increases the amount of taxes charged to some taxpayers but offers an equal (or larger) reduction in taxes for other taxpayers has been viewed as not increasing revenue. As such, it can

be approved by a majority vote of the Legislature.

New Approval Requirement. The measure specifies that state laws that result in *any* taxpayer paying a higher tax must be approved by two-thirds of each house of the Legislature.²³

This analysis acknowledges that Proposition 13 was aimed at statutes enacted “for the purpose of increasing revenues,” and not some other purpose. Proposition 26 removed the purpose requirement.

Second, Proposition 26 expanded what is considered to be a “tax.” The term “tax” was not defined in Proposition 13. In cases addressing the question of whether a particular levy was a tax, courts developed certain categories of charges that were not considered “taxes,” namely regulatory fees, special assessments, and development fees, each of which is described in more detail below. There was nothing in the language of Proposition 13 that would have prevented a court from further expanding those categories or from recognizing new categories of charges not considered “taxes.” By contrast, Proposition 26 calls any “levy, charge, or exaction of any kind” a tax unless it falls within one of the five specified exceptions quoted above.

The findings and declarations of Proposition 26 suggest that it was aimed at the “regulatory fee” exception to Proposition 13. The relevant provision states,

[T]he Legislature and local governments have disguised new taxes as ‘fees’ in order to extract even more revenue from California taxpayers Fees couched as ‘regulatory’ but which exceed the reasonable costs of actual regulations or are simply imposed to raise revenue for a new program and are not part of any licensing of

permitting program are actually taxes and should be subject to the limitations applicable to the imposition of taxes.²⁴

The proponents’ ballot arguments in the Voter’s Guide, however, do not appear to unambiguously support this interpretation. It states:

Proposition 26 . . . PROTECTS LEGITIMATE FEES SUCH AS THOSE TO CLEAN UP ENVIRONMENTAL OR OCEAN DAMAGE. . . .Prop. 26 protects legitimate fees and WON’T ELIMINATE OR PHASE OUT ANY OF CALIFORNIA’S ENVIRONMENTAL OR CONSUMER PROTECTION LAWS ‘Proposition 26 doesn’t change or undermine a single law protecting our air, ocean, waterways or forests – it simply stops the runaway fees politicians pass to fund ineffective programs.’ – Ryan Brodrick, former Director, Department of Fish and Game.²⁵

The Legislative Analyst’s summary in the Voter’s Guide states,

Generally, the types of fees and charges that would become taxes under the measure are ones that government imposes to address health, environmental, or other societal or economic concerns.²⁶

Taken together, the text of the proposition appears to be in conflict with the supporters’ ballot argument, resulting in some ambiguity about the application of Proposition 26 to environmental laws that existed at the time, such as AB 32.

D. Sinclair Paint in Brief

Of the three types of charges not considered to be taxes, one – regulatory fees – is most often viewed as applicable to AB 32’s auction proceeds. The leading case interpreting what

charges are “regulatory fees” under Proposition 13 is *Sinclair Paint*. That case concerned the Childhood Lead Poisoning Prevention Act, which provided evaluation, screening and medical follow-up services to children at risk of lead poisoning. The program was entirely supported by fees imposed on former and current manufacturers of lead or products containing lead, based on the manufacturers “market-share” responsibility for the contamination. The court found the program to constitute a “regulatory fee” and not a tax because, (1) there was a causal connection between the product regulated and its adverse effects, (2) the money raised was limited to the reasonable cost of mitigating the adverse effects, and (3) there was a reasonable relationship between the allocation of costs among payors and the burdens imposed by the payor.

E. Recent Reports on Spending the Auction Proceeds

Two recent reports have looked at potential uses of the cap-and-trade auction revenues. The first report, prepared by California’s Legislative Analyst’s Office (LAO), cites to an opinion of the Legislative Counsel when summarizing the applicable law. The LAO report describes the law addressing the use of auction proceeds as follows:

Based on an opinion that we received from Legislative Counsel, the revenues generated from ARB’s cap-and-trade auctions would constitute “mitigation fee” revenues. Because AB 32 was enacted by a majority vote of the Legislature prior to the voter approval of Proposition 26 – and well before its specified retroactive date of January 1, 2010 – we are told that the provisions of Proposition 26 would not apply. Also, because the proceeds from the auctions are fee revenues and not the proceeds of taxes, we are also advised that the state’s receipt of these monies would

not affect the state’s Proposition 98 funding obligation for K-12 school and community college.

As the auction revenues are deemed to be mitigation fee revenues, we are further advised that their use would be subject to the so-called Sinclair nexus test, a concept which is derived from the *Sinclair Paint* court case referenced above. This test requires that a clear nexus must exist between an activity for which a mitigation fee is used and the adverse effects related to the activity on which that fee is levied. Therefore, in order for their use to be valid as mitigation fees, revenues from the cap-and-trade auctions must be used only to mitigate GHG emissions or the harms caused by GHG emissions.²⁷

The UCLA report describes the cap-and-trade program and auctions as “novel” and as having “characteristics that make them unlike either a traditional tax or a traditional regulatory-fee mechanism.” The report nonetheless concludes that in order to minimize the legal vulnerabilities of the cap-and-trade program, “. . . the state should consider allocation decisions as if it may be required to justify those decisions under the *Sinclair* regime.”²⁸ The *Sinclair* “test” is described as having the following four components, the first three of which are not affected by decisions about allocation:

- The *nexus requirement*: there is a causal connection or nexus between the product regulated and its adverse effects.
- The *reasonable cost requirement*: the amount of money raised is limited to the “amounts necessary to carry out the regulation’s purpose.”
- The *fair allocation requirement*: there is a “fair or reasonable” relationship between the allocation of costs among

payors and the benefits received or the burdens imposed by the payor.

- The *no unrelated spending requirement*: the fees may not be used for “unrelated revenue purposes.”²⁹

The second and fourth components are mirror images of each other, as noted by UCLA. In looking at the *Sinclair* test, combined with AB 32’s stated goals, the report sets forth four criteria to judge “the relative risks of expenditure proposals, with ‘yes’ answers yielding less risk.” The four criteria are:

- Will the project permanently, verifiably reduce greenhouse gas emissions?
- Will the project advance other explicit AB 32 goals?
- Has the state built a strong record showing how the revenue will achieve the purposes of AB 32?
- Does the project avoid direct allocation of money for revenue purposes unrelated to AB 32?³⁰

UCLA then applies its test to seven sample spending proposals.

III. Legal Analysis

A. AB 32 Will Likely Be Subject to Prop 13, not Prop 26

Both the LAO and the UCLA reports concluded that Proposition 26 is unlikely to apply to revenues generated by AB 32's market-based compliance mechanism. This is because AB 32, including the provision authorizing a market-based compliance mechanism, was enacted prior to voter approval of Proposition 26, and prior to Proposition 26's specified effective date of January 1, 2010. In addition, as discussed above, the description of Proposition 26 drafted by supporters and contained in the ballot package states that Proposition 26 will not apply to any existing environmental statutes. Opponents of AB 32 may argue that the cap-and-trade regulations were adopted after the effective date of Proposition 26, thereby making the cap-and-trade program subject to Proposition 26. The requirements of Proposition 26, however, are expressly limited to changes in "state statute," not changes in state regulations.

B. Prop 13 and the Auction Proceeds

Proposition 13 requires all taxes to be passed by a two-thirds majority of each of the two houses of the Legislative. Since AB 32 was not passed by a two-thirds vote of the Legislature, the cap-and-trade program may be at risk if the auction proceeds are found to constitute a "tax."³¹ We believe there are at least three plausible arguments that the auction revenues are not "taxes" subject to Proposition 13, each of which is described in more detail below. First, unlike other fees, the cap-and-trade program was not "enacted for the purpose of increasing revenues," and is thus not subject to Proposition 13. Second, the compliance

instruments or allowances could be found to be development fees or special assessments, since they are akin to those types of fees. Third, the proceeds may be considered "regulatory fees" if the auction proceeds are used to mitigate GHG emissions or the harms caused by GHG emission consistent with the criteria set forth in *Sinclair Paint*, the leading California Supreme Court case in this area.

1. The "Purpose of Increasing Revenue" Requirement

The provision of Proposition 13 relevant here, Section 3, applies only to fees "enacted for the purpose of increasing revenues." Consequently, if the cap-and-trade auction program was enacted for some other purpose (and there is evidence that it was) then the auction proceeds should not be viewed as a tax. There are a number of reasons to believe that the AB 32 market-based mechanism was not adopted for the purpose of raising revenues. These reasons are discussed below, and include the language of the statute itself, CARB's purview and the AB 32 planning process, the fact that emitters can take steps to avoid participating in the auctions, evidence that market-based mechanisms have other benefits, and the many benefits to auctioning allowances rather than giving them away. Despite this evidence, this is a novel argument and as a result it is difficult to predict how it would fare in court.

This section first briefly describes some of the many aspects that lead policy makers to prefer market-based approaches to conventional command-and-control approaches. Then, the purpose of the AB 32's cap-and-trade program is reviewed in light of the statutory language. The purpose of CARB in approving the auctions is then discussed, followed by a discussion of how covered entities can take steps minimize or eliminate their participation in the auctions. Finally, this section discusses why courts, in

considering whether an exaction is a fee or a tax, have not typically focused on the “purpose of increasing revenues” language. Consistent with this view, the *Sinclair Paint* Court stated, “. . . if regulation is the primary purpose, the mere fact that revenue is also obtained does not make the imposition a tax.”³²

Cap-and-Trade Compared to Conventional Command-and-Control Measures

Market-based mechanisms such as AB 32’s cap-and-trade program are used principally because they achieve the desired emissions reduction goal at the lowest possible cost, not because they may raise revenue. Under a cap-and-trade program, the producers and consumers of energy choose for themselves the most cost-effective mix of emissions reductions and allowance purchases.³³ Since emitters have the best information about their business processes and practices, they are much better placed to make these decisions than are government regulators. If it is cheaper for a regulated entity to reduce emissions than it is to purchase allowances, the regulated entity will likely reduce emissions. Indeed, regulated entities could choose to switch fuels, increase energy efficiency, or implement other means of GHG reductions instead of participating in the cap-and-trade program. If the regulated entities choose not to do this, it is because it is cheaper for them to meet the pollution control requirements using the allowances. The ability to trade under AB 32’s cap-and-trade program further enhances the ability of emitters to take advantage of the least costly means of meeting their compliance requirements.³⁴ Thus the cost of compliance is less for a market-based approach than with a command-and-control approach, which is the reason market-based approaches are used.

The Reasons Allowances are Auctioned

Even if market-based mechanisms are the most efficient way to allocate allowances, if the statute is not for the purpose of generating revenues, why not just give the auction allowances away? There are a number of reasons why an auction is preferable to the free distribution of allowances. An auction is the most socially and economically efficient way to allocate allowances to the entities that value them most highly because auctions are administratively transparent and efficient, and result in allowances being allocated to those that value them most (the highest bidders).³⁵ These and more reasons for preferring auctions are discussed very briefly below, and include price discovery, transparency, the treatment of new entrants, efficiency, and the avoidance of windfall profits.

Price Discovery. Auctions create a clear price signal – one that does not exist if the compliance instruments are the subject of private exchanges. For that reason, the price signal sent by an auction provides information that facilitates the smooth functioning of the market.³⁶

Transparency. Auctions are transparent, and there are two ways in which transparency is important. First, with an auction, the assignment of allowance value is transparent. By contrast, giving away allocations can obscure the true recipients of the value, and the magnitude of the value being distributed.³⁷ Second, this transparency helps expose hoarding behavior. Hoarding occurs when an entity obtains compliance instruments that it does not need for its own emissions. There are a number of reasons why entities may hoard allowance, among them speculation, market manipulation (the purchasing of allowances to raise their price, and then selling them), and raising rivals’ costs.³⁸ Exposure through the use of an auction helps minimize this behavior.

Simple and Fair Treatment of New Entrants. Market mechanisms that rely in free allowances need to include in the allocation scheme a process to address sources entering and exiting the market.³⁹ Allocation formulas involve controversial issues relating to equity between emitters and to grandfathering. The use of an auction avoids these issues, and allows new emitters to face the same cost as existing competitors.

Most Efficient Method of Allocation. An auction is the method that best allocates allowances to those who value them most. There are several reasons for this. First, by relying on businesses to determine for themselves the worth of the allowances, auctions “. . . extract and use information unavailable to the government.”⁴⁰ Second, if allowances are distributed freely, there is no guarantee a market will efficiently reallocate them because of friction, and resale does not resolve all inefficiencies.⁴¹ Auctions reduce transaction costs because rather than buyers and sellers trying to find one other, they can buy and sell allowances on a centralized market, which reduces transaction costs.⁴²

Avoidance of Windfall Profits. The free allocation of compliance instruments would result in windfall profits for existing regulated entities, at the expense of consumers and new entrants.⁴³ Auctions treat new entrants fairly since they compete on the same playing field as older firms, which is not the case if allowances are given away. When allowances are given away, existing companies, and inefficient companies (those who have not taken action to reduce emissions) are rewarded, while new companies, and companies that took early action to reduce emissions are penalized.⁴⁴

Statutory Language and the Design of the Program. Both the statutory language and the design of the cap-and-trade program suggest that the AB 32 was not enacted for the purpose of increasing revenues. The portion of AB 32

that pertains to the market-based mechanism is silent on the issue of revenues. Except for the provision of AB 32 that imposes fees to fund implementation of the program, revenues are not discussed nor mandated by the statute. The statute does not require the State Board to include a market-based approach, stating that the state board “*may* include. . . the use of market-based compliance mechanisms. . . .”⁴⁵ If Legislators intended to use an auction to raise revenues, AB 32 would likely have required market-based mechanisms, and would have included a requirement that emission allowances be sold or auctioned. Instead, the market-based mechanism is optional, and there is no requirement that the allowances be sold or used to generate revenues. Indeed, the plan adopted by CARB initially allocates a majority of the allowances free of cost to emitters (e.g., investor-owned utilities are initially provided allowances at no charge).⁴⁶ Throughout AB 32 there is language about the purpose of the statute, but there is no language suggesting the purpose of a market-based compliance mechanism is to raise revenues. As the California Supreme Court has stated, “if regulation is the primary purpose, the mere fact that revenue is also obtained does not make the imposition a tax.”⁴⁷

The only language in the section authorizing market-based compliance mechanisms that could be said to touch on anything even remotely related to this topic requires the State Board, in designing a market-based program, to “[m]aximize additional environmental and economic benefits for California, as appropriate.”⁴⁸ In order to read this provision as a requirement that revenues be generated, the term “maximize economic benefits for California” would need to be equated with “raising revenues.” It would strain the plain language of the statute to read this provision as calling for revenues instead of calling for the State Board to consider economic concerns, such as leakage or the impact of regulations on

jobs, in the event a market-based mechanism is used. The fact that such considerations need only be made, “as appropriate” further supports this point.

CARB and the AB 32 Planning Process. The identity of the decision maker and the decision-making process are also relevant in considering the purpose of the statute. CARB is not part of the state’s fiscal apparatus, and its mission does not include raising revenue for the state. Moreover, the lengthy planning process and attendant documentation confirm that CARB’s concerns were environmental and economic impacts, not state revenue. In the Scoping Plan, CARB acknowledges that “emission allowances represent a significant economic value whether they are freely allocated or sold through auction,” but goes on to note,

[A] broad set of factors must be considered in evaluating the potential timing of a transition to a full auction including competitiveness, potential for emissions leakage, the effect on the regulated vs. unregulated industrial sectors, the overall impact on consumers, and the strategic use of auction revenues.⁴⁹

We were unable to locate any language in the planning documents that would support a claim that CARB included a market-based approach “for the purpose of increasing revenues.”

Emitters Can Avoid Participating in the Auctions. “Most taxes are compulsory rather than imposed in response to a voluntary decision . . . to seek . . . governmental . . . privileges.”⁵⁰ In contrast, the AB 32 auction is not mandatory. Entities could choose to reduce or eliminate their greenhouse gas emissions instead of participating in the auction. Alternatively, subject to CARB restrictions, emitters could obtain offsets or could purchase allowances from other emitters rather than purchasing allowances by auction. By contrast,

the fee at issue in *Sinclair Paint* was imposed on manufacturers “formerly and/or presently engaged in the stream of commerce of lead or products containing lead” and was based on the manufacturer’s “past and present responsibility for environmental lead contaminations, or its ‘market share’ responsibility for this contamination.”⁵¹ Ceasing production might reduce a manufacturer’s payment, but it would not eliminate the payment. Moreover, manufacturers could not purchase offsets or allowances from others. Thus, there was no way the manufacturers in *Sinclair Paint* could avoid paying the fee, the primary purpose of which was to fund a mitigation program.

Why Courts Have Not Focused on the “Purpose” Requirement in Proposition 13. The statute at issue in *Sinclair Paint* was enacted for the purpose of raising revenue to fund a mitigation program. In *Sinclair Paint*, the California Supreme Court asked whether the “fees” at issue were, “in legal effect ‘taxes enacted for the purpose of increasing revenues’ . . . and therefore subject to a two-thirds majority vote. . . .”⁵² Since the *Sinclair Paint* court “. . . found no cases that interpret the language of section 3 [of Proposition 13],” the Court looked at California cases that considered whether various fees were “special taxes” governed by Section 4. In those cases, courts analyzed certain statutes enacted for the purpose of raising revenue, but nonetheless found them to be fees because they fell into one of three categories of exactions that were not considered taxes, namely regulatory fees, development fees, and special assessments. The *Sinclair Paint* Court described the “special tax” cases as “. . . helpful, though not conclusive” because “[t]he reasons why particular fees are, or are not, ‘special taxes’ under article XIII A, section 4, may apply equally to section 3 cases.”⁵³ Section 4, unlike Section 3, however, does not limit the two-thirds vote requirement to taxes “enacted for the purpose of increasing revenues,” thus the “special tax”

cases do not weigh in on that precise language. The Section 4 cases do look at the purpose of the exaction by considering whether it is aimed at generating general revenue but use that as a proxy for the purpose of the statute.

In sum, there are many reasons to believe that AB 32's market-based compliance mechanism was not enacted for the purpose of increasing revenues. Provided “. . . regulation is the primary purpose of the fee measure, the mere fact that the measure also generates revenue does not make the imposition a tax.”⁵⁴ Relying solely on this approach, however, is potentially risky as no courts have looked at this precise question.

2. Assessments, Development Fees, and Regulatory Fees

Courts have held that under certain circumstances statutes enacted in part for the purpose of increasing revenues are fees, not taxes. As described by the *Sinclair Paint* Court, there are three general categories of fees or assessments: (1) special assessments, based on the value of benefits conferred on property; (2) development fees, exacted in return for permits or other government privileges; and (3) regulatory fees, imposed under the police power.⁵⁵ The Court went on to note that the three categories may overlap in a particular case, which may be the case here.⁵⁶ Spending the auction proceeds in such a way so as to allow them to be characterized as falling into one of these exceptions would be the safest way to move forward since then there would be multiple argument that the super-majority requirement does not apply – the cap-and-trade program was not enacted for the purpose of increasing revenue, and even if it was enacted for the purpose of raising revenue, the auction proceeds constitute a fee not a tax. Following is a discussion of each of the three exceptions.

Special Assessments. Special assessments “...on property or similar business charges, in amounts reasonably reflecting the value of the benefits conferred by improvements, are not ‘special taxes’ under Article XIII A, section 4.”⁵⁷ Examples include “assessments on businesses for downtown promotion,” “facilities benefit assessments,” “special assessment on real property,” and “special assessments for construction of streets.”⁵⁸ These examples share a common trait, which is that the assessments are used to fund some type of improvement – be it infrastructure or downtown beautification. Since GHG emissions are not tied to a particular property, and since emissions reduction more closely resemble a mitigation fee than an improvement, the auction proceeds are unlikely to be found to fall within this category.

Development Fees. Development fees “. . . exacted in return for building permits or other governmental privileges are not special taxes if the amount of the fees bears a reasonable relation to the development’s probable costs to the community and benefits to the developer.”⁵⁹ Examples include “school facilities fees,” “fire hydrant fees,” “transit impact fees,” “new facilities water hookup fees,” “fees as preconditions for building permits,” “fees for processing subdivision, zoning and land use applications.”⁶⁰ Put differently, development fees “compensate the state for governmental privileges granted to those manufacturers.”⁶¹ Traditionally, such fees are “imposed on development projects in order to finance public improvements or programs that bear a ‘reasonable relationship’ to the development at issue.”⁶²

The auction proceeds are similar in some ways to development fees. An emitter that purchases an allowance will have obtained a governmental privilege that benefits the emitter – the right to emit a certain quantity of greenhouse gas emissions. And, the fee will

bear a reasonable relation to the benefit provided to the purchaser since an auction will be used to determine the price. If the purchaser did not think the value of the allowance was greater than the bid, the purchase would not have been made. Put differently, if it was less costly for an emitter to reduce emissions than it was to purchase the allowances at auction, the emitter would reduce emissions. Moreover, the price for the allowances will be the lowest price bid by a successful bidder, so all purchasers except for those bidding at that exact price will be paying less than they bid. This suggests that for most bidders the value of the allowances is more than what they ultimately pay. The fact that the allowances can be sold and the profit retained by the seller also supports a claim that the auction allowances are tantamount to “development fees” in that the emitter will have obtained a governmental privilege. If the auction proceeds were used to finance adaptation measures only, that would be even closer to the traditional development fee than if also used to fund GHG emission reduction programs. Since no court has looked at this issue, such an approach would entail some risk.

Regulatory Fees. The type of fee that is most likely to be found to be applicable here is a regulatory fee. Regulatory fees are imposed under the police power, rather than the taxing power, and are not taxes provided the fees “. . . do not exceed the reasonable cost of providing the services necessary to the activity for which the fee is charged and which are not levied for unrelated revenue purposes.”⁶³ In order to avoid being called a “tax,” a fee or assessment must not be “primarily aimed at producing revenue.”⁶⁴ Nonetheless, “if regulation is the primary purpose of the fee measure, the mere fact that the measure also generates revenue does not make the imposition a tax.”⁶⁵

The *Sinclair Paint* court stated, however, that distinguishing between a tax and a fee can be difficult.

The cases recognize that ‘tax’ has not fixed meaning, and that the distinction between taxes and fees is frequently ‘blurred,’ taking on different meanings in different contexts. In general, taxes are imposed for revenue purposes, rather than in return for a specific benefit conferred or privilege granted. Most taxes are compulsory rather than imposed in response to a voluntary decision to develop or to seek other government benefits or privileges. But compulsory fees may be deemed legitimate fees rather than taxes.⁶⁶

The *Sinclair Paint* Court found statutes that shifted the costs of controlling pollution from the public to the polluters to be consistent with the intent of Proposition 13. The “...police power is broad enough to include mandatory remedial measures to mitigate the *past, present or future* adverse impact of the fee payer’s operations, at least where, as here, the measure requires a causal connection or nexus between the product and its adverse effects.”⁶⁷ The Court continued, “[i]n our view, the shifting of costs of providing evaluation, screening, and medically necessary follow-up services for potential child victims of lead poisoning from the public to those persons deemed responsible for that poisoning is likewise a reasonable police power decision.”⁶⁸ *Sinclair Paint* applied the test set forth in an earlier case, *San Diego Gas & Electric Co. v. San Diego County Air Pollution Control District*, which described the test for a “regulatory fee” as follows:

- (1) the fee cannot exceed the cost of the service or regulatory activity (i.e., cannot be primarily aimed at producing revenue), and
- (2) the fee must be fairly or reasonably related to the payor’s burdens on or benefit from the service provided.⁶⁹

Provided the auction proceeds are spent within the regulatory fee framework, the cost of the allowances may be viewed as a regulatory fee. Part one of the test states, “the fee cannot exceed the cost of the service or regulatory activity.” As previously discussed, in addition to the section allowing a market-based compliance mechanism, AB 32 also contains a section that authorizes the imposition of fees on regulated entities for the purpose of funding AB 32’s implementation. Auction proceeds will not be needed to fund such implementation, so in order to satisfy the first part of the test, the auction proceeds would need to equal the cost of the service provided, in this case GHG emissions reductions and/or mitigation. This is somewhat different from a traditional regulatory fee where the fee is imposed in order to fund a specific program, but spending the cap-and-trade proceeds on mitigation and adaptation would seem fit within the regulatory fee framework. Part two of the test states, “the fee must be fairly or reasonably related to the payor’s burdens on or benefit from the service provided.” Since the allowances will be auctioned off, the cost of the allowances would seem to be reasonably related to the payor’s benefit from the service provided since otherwise the payor would not have bid what it did.

Last year, the California Supreme Court issued another opinion on regulatory fees that may have narrowed the definition of regulatory fees.⁷⁰ That case, *California Farm Bureau Federation v. State Water Resources Control Board* (CFBF), was focused largely on whether the way the fee was imposed was fair, however, the Court described regulatory fees as follows:

A regulatory fee may be imposed under the police power when the fee constitutes an amount necessary to carry out the purposes and provisions of the regulation. . . . [P]ermissible fees must be related to the

overall cost of the governmental regulation. They need not be finely calibrated to the precise benefits each individual fee payor might derive. What a fee cannot do is 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.⁷¹

This language is somewhat more restrictive than the *Sinclair Paint* language, since it suggests that revenue generation, even if not the primary purpose of the fee measure, would turn a fee into a tax. Provided the auction proceeds are not used for general revenue purposes, however, they may be consistent with this language. The Court also considered whether the statutory language “reveals a specific intention to avoid imposition of a tax.”⁷² Since “there is a safeguard in the statute authorizing the SWRCB to ‘further adjust the annual fees’ if it ‘determines that the revenue collected during the preceding year was greater than, or less than, the revenue levels set forth in the annual Budget Act...’” the Court concluded that the charges were regulatory fees, not taxes.⁷³ There is no similar provision in AB 32.

In both cases, the fees were enacted for the purpose of raising revenues to fund particular regulatory programs. For the auction allowances, however, the primary purpose of the auction is to reduce the overall cost of compliance, not to fund a regulatory program, so the auctions do not fit neatly in this category. The benefit of the program should be clear, though, since covered entities purchase allowances because it is less costly than installing pollution control equipment.

3. A New Exception?

Since the auction proceeds do not fall neatly into any of the existing exceptions from Proposition 13, a court might establish a new

category rather than shoehorning them into one of the existing categories. There are a number of examples of revenue-generating activities that are not considered taxes, and the auction allowances may be found to be similar to them. For example, proceeds from the sale of state property are not considered taxes, nor are fees to attend the University of California, nor expenditures to acquire state bonds. They are not considered taxes because the purchasers are getting something for their money. The purchase of auction allowances that give the holder permission to emit greenhouse gasses bears some resemblance to these programs. The auction is also similar in many ways to the federal government's sale of rights to use the broadcast spectrum. Auction allowances share many of the indices of property – they can be bought, sold, traded, and banked for future use, and are capable of private ownership. The cap-and-trade program is less likely to be viewed by a court as the sale of state property, however, because the regulations implementing AB 32 state that the compliance instruments are not property.⁷⁴ As a result, it is possible that some new category may be created for the auction proceeds. Such an approach is untested, and would thus be risky, but it has a logical foundation.

IV. The Proposition 26 Regime

Proposition 26, which was aimed at limiting the scope of the *Sinclair Paint* decision, removed the requirement that for something to be considered a tax it was required to be “enacted for the purpose of increasing revenues.”⁷⁵ Proposition 26 also narrowed the definition of what courts had found to be regulatory fees, special assessments, and development fees. Last, Proposition 26 shifted the burden of proof from the person challenging the fee to the State. The fact that Proposition 26 made these changes lends credence to the argument that for Proposition 13 to apply to a fee, the fee had to be “enacted for the purpose of increasing revenues.”

We agree with UCLA and the Legislative Analyst that Proposition 26 is unlikely to be found to apply because the enactment of AB 32 preceded January 2010.⁷⁶ Even if Proposition 26 was found to apply, however, it is not a foregone conclusion that the cap-and-trade program would be found to be invalid. There are several reasons for this.

First, in the context of an auction of a transferable allowance, it could be argued that no “levy, charge, or exaction” has taken place because the buyer has exchanged cash for a legally recognized, transferable interest at the market price. This is similar to buying a state bond at its market value – the balance sheet of the buyer has not changed because cash has been exchanged for another asset of equal value. This distinguishes the sale of marketable allowances from other transactions with the state, where no marketable asset is acquired and where the state may charge a price unrelated to market value.

Second, the auction proceeds may fall within the ambit of Proposition 26 Section 3 (b)(2) – the “government service or product provided”

exemption – because the auction is the equivalent of a fee, and the fees are consistent with Proposition 26 “because emitters are allowed to voluntarily change their behavior in order to reduce the amount of the fee – indeed that is the whole point.”⁷⁷

Third, the compliance instruments or the ability to emit greenhouse gas emissions may be viewed as “benefit conferred or privilege granted directly to the payor,” and thus exempt under Section 3 (b) (1). In this case, the privilege is that of emitting a ton of carbon dioxide.

For both of the exemptions just described, the benefit must not be provided to those not charged, and the cost may not exceed the reasonable costs to the State of providing the benefits or product. In order to minimize leakage and economic impacts, initially some compliance instruments will be made “available to those not charged.” Providing some allowances without charge does not violate this requirement. Such provision is similar to the school lunch program. It’s not a tax for public schools to charge some students for school lunches even though some low-income children receive free lunches. It is not a tax to give vulnerable industries allowances to achieve certain policy goals. Last, because the market sets the price of the compliance instruments, and because all successful bidders will pay the lowest clearing price, the cost will by implication be “reasonable.”

Proposition 26 and Spending Proposals.

If Proposition 26 is found to apply, the most defensible spending proposal may be revenue rebates to all taxpayers rather than spending on GHG reductions since that would help support the claim that the cap-and-trade program was not enacted to raise revenues. Proposition 26’s “Findings and Declarations of Purpose”

describes the difference between taxes and fees as follows:

Fees couched as “regulatory” but which exceed the reasonable costs of actual regulation or are simply imposed to raise revenue for a new program and are not part of any licensing or permitting program are actually taxes and should be subject to the limitations applicable to the imposition of taxes.⁷⁸

If the auction proceeds are distributed as rebates to taxpayers or residents, it would be difficult to argue that they “are simply imposed to raise revenue for a new program.” Opponents of this could argue that the revenue rebates themselves constitute a “new program,” but that argument seems unlikely to prevail since AB 32 was not enacted for the purpose of providing revenue rebates.

V. General Restrictions on State Spending

Even if the auction proceeds are not “taxes,” the proceeds could be subject to other restrictions on state spending. For example, Proposition 98 “generally requires that a minimum share of General Fund tax revenues be provided to public schools and community colleges.”⁷⁹ If the auction proceeds are placed in the general fund rather than in an account aimed at funding GHG emission reductions, then Proposition 98 would likely apply. In addition, other constraints on state spending would apply. On the other hand, if the auction proceeds are found to be fees rather than taxes, “. . . the state’s receipt of these monies would not affect the state’s Proposition 98 funding obligation for K-12 schools and community colleges.”⁸⁰ In addition to Proposition 98, there may be other requirements that constrain the uses to which the auction proceeds can be put, but an analysis of such requirements are beyond the scope of this paper.⁸¹

VI. Analysis of Spending Options Under Different Legal Schemes

We were asked to evaluate the legal risk associated with 18 different spending proposals. Since there are several different legal regimes that may be found to apply, this section considers the spending proposals under the different regimes. A number of spending proposals are very similar – they either reduce GHG emissions, or mitigate the effects of GHG emissions. For ease of reference, a chart summarizing the risk levels follows the text.

The most conservative approach would be to treat the auction proceeds as regulatory fees. Under *Sinclair Paint*, programs that mitigate the harm caused by GHG emissions and that are funded by a special pollution control fund present the lowest level of risk. Such programs could either reduce GHG emissions, or aid in adaptation to the harms caused by GHG emissions. The UCLA report lists four criteria for evaluating the legal risk of different spending proposals – whether the project will reduce GHG emissions; whether the proposal will advance other AB 32 goals; whether the State has built a strong record that demonstrates how the revenue will achieve the purposes of AB 32; and whether the project avoids the allocation of auction proceeds for purposes unrelated to AB 32.⁸² Many of the 18 spending proposals meet these criteria.

1. Revenue rebates to taxpayers. Example: Dividend checks to all Californians.

Proposition 13 Analysis: High risk.

Since this proposal would not advance the primary goal of AB 32, reducing or mitigating GHG emissions, using the auction proceeds in this way would not be consistent with the definition of a “regulatory fee” set forth in

Sinclair Paint, even though it would advance other goals of AB32. This proposal is more likely to succeed if a court finds that auction proceeds are akin to development fees, but the auction proceeds do not fall neatly within the development fee category. Use of the auction proceeds to provide a rebate to all Californians would support the argument that the statute was not enacted for the purpose of raising revenues, in which case the statute might be found to fall outside the ambit of Proposition 13.

2. Implement energy efficiency improvements on state owned buildings, which could reduce General Fund expenditures. Example: Solar on school roofs, energy efficiency projects at the UCs to lower energy costs.

Proposition 13 Analysis: Low to Medium risk.

This program advances the primary aims of AB 32, and thus would be consistent with a regulatory fee. However, if the record suggests that the primary purpose of this proposal is to supplement the General Fund, then the level of risk would be higher since courts have repeatedly considered General Fund revenues as indicative of a tax.

3. Offset General Fund expenditures through creative financing approaches. Example: Establish a revolving load fund from the Air Pollution Control Fund into the General Fund, or use for debt service. (Revenue is spent on non-environmental investments with zero greenhouse gas reductions.).

Proposition 13 Analysis: High risk.

If offsetting General Fund expenditures was found to be the primary purpose of this spending proposal, this proposal would not advance the main goals of AB 32 and thus would not be consistent with a regulatory fee.

That said, it may be possible for the general fund to “borrow” funds from a GHG emissions reduction fund, provided certain conditions are satisfied. *Tomra Pacific* recently held that under Proposition 13, a budget bill that authorized the Director of Finance to order the Controller to transfer recycling funds to the general fund did not change a regulatory fee into a tax.⁸³ As that case notes, California Government Code Section 16310 gives the Governor the authority to order the Controller to transfer unused funds from a special fund to the general fund provided certain conditions are satisfied (among them, the transfer may not “interfere with the object for which such fund was created”).⁸⁴ Thus, loans from a GHG reduction fund to the general fund may be possible if the statutory requirements of Govt. Code §16310 are satisfied. *Tomra Pacific*, however, can be distinguished from this spending proposal because the fee at issue in *Tomra Pacific* was not originally assessed for the purpose of offsetting general fund expenditures.⁸⁵

Proposition 26 does not appear to include any language that would affect a court’s analysis of Govt. Code §16310, and Proposition 26 was approved after the loans in the *Tomra Pacific* case were made, so presumably the Prop 26 drafters chose not to change that statute. Thus even under Proposition 26, loans may be possible provided the statutory requirements are satisfied. The Legislature also has the authority to transfer funds by means of the budget bill, however, if the budget bill is considered a “change in state statute,” then Proposition 26 may be found to apply. Even then, however, it’s not clear that a transfer would “result in any taxpayer paying a higher tax,” which is the language used in Proposition 26.

4. Energy efficiency actions to upgrade residential lighting. Example: Free or

reduced cost for energy efficient light bulbs.

Proposition 13 Analysis: Low risk.

Under a *Sinclair Paint* analysis, this program would be consistent with a regulatory fee. This spending proposal has similar characteristics to the following ten spending proposals, thus this analysis also applies to them. According to the UCLA report, there are four risk criteria: whether the spending proposal reduces GHG emissions permanently, whether the proposal advances other explicit AB 32 goals, whether there is a strong record demonstrating the proposal will achieve the purposes of AB 32, and whether the spending proposals avoids direct allocation of money for purposes unrelated to AB 32. These spending proposals would reduce GHG emissions, and some would also aid in adaptation to climate change (e.g., the proposal to fund energy efficiency upgrades on low-income dwellings). Many also advance other AB 32 goals, such as helping disadvantaged communities, and providing an opportunity for small businesses, schools, and other community institutions to benefit from the efforts to reduce greenhouse gasses. If the state developed a strong record demonstrating that these uses will achieve the purposes of AB 32, the risk is likely to be low provided the auction proceeds are placed in a special GHG emission reduction/adaptation account and not the general fund. That would be required to avoid the direct allocation of money for revenue purposes unrelated to AB 32.

5. Energy efficiency actions including appliance efficiency upgrades and replacements. Example: Rebates.

Proposition 13 Analysis: Low risk, see analysis for 4, above.

6. Energy efficiency actions to upgrade residential building efficiency. Example:

Rebates for upgrading windows, insulation, and other building efficiency measures.

Proposition 13 Analysis: Low risk, see analysis for 4, above.

7. Financing program for renewable energy installations at residential properties. Example: PACE.

Proposition 13 Analysis: Low risk, see analysis for 4, above.

8. Industrial energy efficiency. Example: retrofits and compliance investments for utilities and large industrial activities (energy, cement, etc.).

Proposition 13 Analysis: Low risk, see analysis for 4, above.

9. Commercial energy efficiency and distributed generation programs. Example: Funding for energy efficiency measures in commercial buildings.

Proposition 13 Analysis: Low risk, see analysis for 4, above.

10. Small business energy efficiency. Example: Financial and other supporting services to overcome technology adoption and compliance hurdles.

Proposition 13 Analysis: Low risk, see analysis for 4, above.

11. Programs that provide financing for, or directly fund conservation and energy efficiency upgrades in low-income and middle-income dwellings.

Proposition 13 Analysis: Low risk, see analysis for 4, above.

12. Financing programs for commercial, industrial and manufacturing facilities to reduce greenhouse gas emissions by investment in energy efficiency, energy storage, and clean and renewable energy projects. Example: Commercial PACE.

Proposition 13 Analysis: Low risk, see analysis for 4, above.

13. Accelerated deployment of advanced technology vehicles. Example: Adoption of fuel cell and electric vehicles, charging infrastructure.

Proposition 13 Analysis: Low risk, see analysis for 4, above.

14. Low-carbon goods movement, freight vehicle technologies, public transportation, and infrastructure development. Examples: Public transit, measures to reduce pollution in ports, rail yards, high traffic corridors, freeways.

Proposition 13 Analysis: Low risk, see analysis for 4, above.

15. High Speed Rail Project - specific to the bookend projects.

Proposition 13 Analysis: Low to medium-low risk

This spending proposal would advance the primary aim of AB 32 because it would reduce GHG emissions. There are many other purposes of high-speed rail, however, so the record would need to make clear that a primary purpose of the project is the reduction of GHG emissions. This will be especially important if other spending proposals are much more cost-effective in reducing GHG emissions. Although courts generally do not require that the most cost-effective mitigation measures be adopted, if the cost-effectiveness

of the mitigation is very poor, a court may conclude that auction proceeds are being used in lieu of general funds.

16. Improve water supply through more efficient storage, conveyance, and management infrastructure. Example: Efficient pump technologies.

Proposition 13 Analysis: Low to medium-low risk.

As is the case with high-speed rail, this spending proposal would advance the primary aim of AB 32 because it would reduce GHG emissions. There are other purposes for such a program, however, so the record would need to demonstrate that a primary purpose of the project is the reduction of GHG emissions. Here again, although courts generally do not require that the most cost-effective mitigation measures be adopted, if the cost-effectiveness of the mitigation is very poor, a court may conclude that auction proceeds are being used in lieu of general funds.

17. Financial assistance for local governments to implement their Sustainable Community Strategies developed to meet the goals of SB 375. Example: Revenues directed in regions to reduce VMT.

Proposition 13 Analysis: Low risk, see analysis for 4, above.

18. Green Bank. Example: DOE loan guaranteed program, similar programs in CT, HI, and Britain.

Proposition 13 Analysis: Low risk, provided the bank only provides funding for projects that reduce GHG emissions. See analysis for 4, above.

If courts find that the AB 32 auction revenues fall outside of the ambit of Proposition 13 because the statute was “not enacted for the purpose of increasing revenue,” then the proceeds could be spent as the state sees fit. Of course, distributing the proceeds as a rebate to taxpayers would support such an argument.

VII. Conclusion

As we have seen, there are some intriguing arguments that auction proceeds do not constitute a tax under California law, regardless of how the proceeds are used. If the court did

not accept these arguments, we believe that the validity of the revenue use would then be determined by their congruence with benefit received or the harm incurred by the public from carbon emissions (the *Sinclair Paint* regime). As a result, we conclude that the least risky way to spend the auction proceeds is consistent with the goals of AB 32.

Appendix A: Spending Proposals Risk Chart

| SPENDING PROPOSALS | LEGAL RISK UNDER A <i>SINCLAIR PAINT</i> ANALYSIS |
|---|---|
| Revenue rebates to taxpayers. Example: Dividend checks to all Californians. | High Risk: does not reduce GHG emissions. But, would suggest that the auction was not “enacted for the purpose of raising revenue,” and thus Prop. 13 may be found not to apply. |
| Implement energy efficiency improvements on state owned buildings, which could reduce General Fund expenditures. Example: Solar on school roofs, energy efficiency projects at the UCs to lower energy costs . | Low to Medium Risk: reduces GHG emissions, but could be seen as aimed at supplementing the General Fund. A strong record would be critical. |
| Offset General Fund expenditures through creative financing approaches. Example: Establish a revolving loan fund from the Air Pollution Control Fund into the General Fund, or use for debt service. (Revenue is spent on non-environmental investments with zero greenhouse gas reductions.) | High Risk: does not reduce GHG emissions. Under certain circumstances, however, loans from a special fund to the general fund have been upheld. <i>See, e.g., Tomra Pacific</i> , which held that loans from the Recycling Fund to General Fund did not change a regulatory fee into a tax, provided certain conditions were met. 199 Cal. App. 4 th at 488. |
| Energy efficiency actions to upgrade residential lighting. Example: Free or reduced cost for energy efficient light bulbs. | Low Risk: reduces GHG emissions. |
| Energy efficiency actions including appliance efficiency upgrades and replacements. Example: Rebates. | Low Risk: reduces GHG emissions. |
| Energy efficiency actions to upgrade residential building efficiency. Example: Rebates for upgrading windows, insulation, and other building efficiency measures. | Low Risk: reduces GHG emissions. |

| | |
|--|--|
| | |
| Financing program for renewable energy installations at residential properties. Example: PACE . | Low Risk: reduces GHG emissions. |
| Industrial energy efficiency: retrofits and compliance investments for utilities and large industrial activities (energy, cement, etc.). | Low Risk: reduces GHG emissions, may reduce other air pollutants, esp. in low-income communities. |
| Commercial energy efficiency and distributed generation programs. Example: Funding for energy efficiency measures in commercial buildings. | Low Risk: reduces GHG emissions. |
| Small business energy efficiency - financial and other supporting services to overcome technology adoption and compliance hurdles. | Low Risk: reduces GHG emissions, helps small businesses. May depend on how the program is designed. |
| Programs that provide financing for, or directly fund conservation and energy efficiency upgrades in low-income and middle-income dwellings. | Low Risk: reduces GHG emissions, helps disadvantaged communities. |
| Financing programs for commercial, industrial and manufacturing facilities to reduce greenhouse gas emissions by investment in energy efficiency, energy storage, and clean and renewable energy projects. Example: Commercial PACE. | Low Risk: reduces GHG emissions, may help small businesses. |
| Accelerated deployment of advanced technology vehicles. Example: Adoption of fuel cell and electric vehicles, charging infrastructure. | Low Risk: reduces GHG emissions, reduces other air pollutants, and may help disadvantaged communities located near heavily used roads. |
| Low-carbon goods movement, freight vehicle technologies, public transportation, and infrastructure development. Examples: Public transit, measures to reduce pollution in ports, rail yards, high traffic corridors, freeways. | Low Risk: reduces GHG emissions, reduces other air pollutants, may help disadvantaged communities located near heavily used roads. |

| | |
|---|---|
| <p>High Speed Rail project - specific to the bookend projects.</p> | <p>Low to Medium-Low Risk: reduces GHG emissions, but has many other purposes. A strong record would be critical.</p> |
| <p>Improve water supply through more efficient storage, conveyance, and management infrastructure. Example: Efficient pump technologies.</p> | <p>Low to Medium-Low Risk: reduces GHG emissions, but has other purposes. A strong record would be critical.</p> |
| <p>Financial assistance for local governments to implement their Sustainable Community Strategies developed to meet the goals of SB 375. Example: Revenues directed in regions to reduce VMT.</p> | <p>Low Risk: reduces GHG emissions, reduces other air pollutants.</p> |
| <p>Green Bank. Example: DOE loan guaranteed program, similar programs in CT, HI, and Britain</p> | <p>Low Risk: reduces GHG emissions, may reduce other air pollutants (assumes bank funds just GHG programs, not other “green” programs).</p> |

Appendix B: Excerpts from AB 32

§38501(h) It is the intent of the Legislature that the State Air Resources Board design emissions reduction measures to meet the statewide emission limits for greenhouse gases established pursuant to this division in a manner that minimizes costs and maximizes benefits for California’s economy, improves and modernizes California’s energy infrastructure and maintains electric system reliability, maximizes additional environmental and economic co-benefits for California, and complements the state’s efforts to improve air quality.

§38562(b) In adopting regulations pursuant to this section and Part 5 (commencing with Section 38570 [titled “Market-Based Compliance Mechanisms] to the extent feasible and in furtherance of achieving the statewide greenhouse gas emissions limit, the state board shall do all of the following:

- (1) Design the regulations, including distribution of emissions allowances where appropriate, in a manner that is equitable, seeks to minimize costs and maximize the total benefits to California, and encourages early action to reduce greenhouse gas emissions. . . .
- (6) Consider overall societal benefits, including reductions in other air pollutants, diversification of energy sources, and other benefits to the economy, environment, and public health. . . .

§38565 The state board shall ensure that the greenhouse gas emission reduction rules, regulations, programs, mechanisms, and incentives under its jurisdiction, where applicable and to the extent feasible, direct public and private investment toward the most disadvantaged communities in California 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 gas emissions.

§38570(a) The state board may include in the regulations adopted pursuant to Section 38562 the use of market-based compliance mechanisms to comply with the regulations.

(b) Prior to the inclusion of any market-based compliance mechanism in the regulations, to the extent feasible and in furtherance of achieving the statewide greenhouse gas emissions limit, the state board shall do all of the following:

- (1) Consider the potential for direct, indirect, and cumulative emission impacts from these mechanisms, including localized impacts in communities that are already adversely impacted by air pollution.
- (2) Design any market-based compliance mechanism to prevent any increase in the emissions of toxic air contaminants or criteria air pollutants.
- (3) Maximize additional environmental and economic benefits for California, as appropriate.

(c) The state board shall adopt regulations governing how market-based compliance mechanisms may be used by regulated entities subject to greenhouse gas emission limits and mandatory emission reporting requirements to achieve compliance with their greenhouse gas emission limits.

Endnotes

- ¹ Chpt. 488, Statutes of 2006 (codified as Cal. Health & Saf. Code § 38500 *et seq.*). Unless otherwise indicated, all references are to the Health & Safety Code.
- ² § 38550.
- ³ § 38570.
- ⁴ 17 Cal. Code Regs. §§ 95800 – 96023.
- ⁵ Mac Taylor, Legislative Analyst’s Office, “The 2012-13 Budget: Cap-and-Trade Auction Revenues” (February 16, 2012).
- ⁶ Cara Horowitz, M. Rhead Enion, Sean B. Hecht, and Ann Carlson, “Spending California’s Cap-and-Trade Auction Revenue: Understanding the *Sinclair Paint* Risk Spectrum” (March, 2012).
- ⁷ Cal. Const. art. XIII A (prior to 2010).
- ⁸ *Sinclair Paint Co. v. State Bd. of Equalization*, 15 Cal 4th 866 (1997).
- ⁹ Cal. Const. art XII A.
- ¹⁰ §38597.
- ¹¹ Horowitz, *supra* note 6, at 10.
- ¹² §38501(h).
- ¹³ §38565.
- ¹⁴ §38562(b)(1),(6),(8).
- ¹⁵ §38570(a).
- ¹⁶ *Amador Valley Joint Union High Sch. Dist. V. State Bd. of Equalization*, 22 Cal. 3d 208, 231 (1978) (italics in original).
- ¹⁷ Cal. Const. art. XIII A §3 (prior to 2010).
- ¹⁸ *Id.*
- ¹⁹ Cal. Const. art. XIII A §4 (prior to 2010).
- ²⁰ *Amador*, 22 Cal. 3d at 245-46.
- ²¹ March Fong Eu (complier) and William G. Hamm (legislative analyst), “California Voters Pamphlet: Primary Election,” Jun 6, 1978 at 56 - 60.
- ²² *Id.* at 57.
- ²³ *Id.* at 58-59.
- ²⁴ Bowen, Deborah, “Official Voter Information Guide: General Election, November 2, 2010,” Proposition 26 § 1(e) at 114.
- ²⁵ *Id.* at 60-61 (emphasis in original).
- ²⁶ *Id.* at 58.
- ²⁷ Mac Taylor, LAO, “The 2012-13 Budget: Cap-and-Trade Auction Revenues” (Feb. 16, 2012) at 4.
- ²⁸ Horowitz, *supra* note 6 at 11.
- ²⁹ *Id.* at 12.
- ³⁰ *Id.* at 15.
- ³¹ For a discussion of potential consequences if revenue allocation decision are challenged and invalidated, see Horowitz, *supra* note 6 at 16.
- ³² *Sinclair Paint* 15 Cal. 4th at 880.
- ³³ Cal. Air Res. Bd., Climate Change Scoping Plan, at 30 (December 2008).
- ³⁴ *Id.*

- ³⁵ Cal. Air Res. Bd., Proposed Regulation to Implement the California Cap-and-Trade Program: Initial Statement of Reasons, J-63 (October 28, 2010) [hereinafter “ISOR”].
- ³⁶ Economic and Allocation Advisory Committee, Allocating Emissions Allowances Under a California Cap-and-Trade Program at 14 (March 2010) [hereinafter “EAAC”].
- ³⁷ *Id.* at 14-15.
- ³⁸ For a discussion of these issues in the context of the Regional Greenhouse Gas Initiative, *see*, Charles Holt, William Shobe, Dallas Burtraw, Karen Palmer, and Jacob Goeree, Selling CO₂ Emission Allowances Under the Regional Greenhouse Gas Initiative, pp. 67-72 (October 2007), *at* http://www.rggi.org/docs/rggi_auction_final.pdf.
- ³⁹ EAAC, *supra* note 5, at 15.
- ⁴⁰ Ken Binmore and Paul Klemperer, The Biggest Auction Ever: The Sale of the British 3G Telecom Licenses, *The Economic Journal* 112: C74, C76 (March 2002).
- ⁴¹ *Id.* at C75.
- ⁴² ISOR, *supra* note 35, at J-62.
- ⁴³ Daniel Farber, Emissions Trading and Social Justice, at 19 (August 2011), *at* available at http://www.law.berkeley.edu/files/Emissions_Trading_and_Social_Justice.pdf.
- ⁴⁴ ISOR, *supra* note 35, at J-63.
- ⁴⁵ §38570(a) (emphasis added).
- ⁴⁶ Mac Taylor, Legislative Analyst’s Office, “Evaluating the Policy Trade-Offs in ARB’s Cap-and-Trade Program” at 9 (February 9, 2012).
- ⁴⁷ *Sinclair Paint* at 880 (citations omitted).
- ⁴⁸ §38570.
- ⁴⁹ Scoping Plan, *supra* note 33, at 36.
- ⁵⁰ *Sinclair Paint*, 15 Cal. 4th at 874.
- ⁵¹ *Id.* at 872.
- ⁵² *Sinclair Paint*, 15 Cal. 4th at 873.
- ⁵³ *Id.*
- ⁵⁴ *Id.* at 880.
- ⁵⁵ *Id.* at 874.
- ⁵⁶ *Id.*
- ⁵⁷ *Id.*
- ⁵⁸ *Id.* at 874-75.
- ⁵⁹ *Id.* at 875.
- ⁶⁰ *Id.*
- ⁶¹ *Id.*
- ⁶² *Barratt American, Inc. v. City of Rancho Cucamonga*, 37 Cal 4th 685, 696 (2005).
- ⁶³ *Id.* at 876.
- ⁶⁴ *Id.* at 877.
- ⁶⁵ *Id.* at 880.
- ⁶⁶ *Id.* at 874 (citations omitted).
- ⁶⁷ *Id.* at 877-878 (citations omitted).
- ⁶⁸ *Id.* at 879.
- ⁶⁹ *San Diego Gas & Electric Co. v. San Diego County Air Pollution Control Dist.*, 203 Cal. App. 3d 1132, 1146 (1988).
- ⁷⁰ *California Farm Bureau Federation v. State Water Resources Control Board*, 51 Cal. 4th 421 (2011), upheld a statute that authorized the imposition of annual fees on entities who hold a permit or license to appropriate water or who lease water. The purpose of the fees was to

cover the total cost of operating the Division of Water Rights, but the Court remanded on the question of “...whether the fees, as imposed, were reasonably proportional to the costs of the regulatory program.” *Id.* at 442.

⁷¹ *Id.* at 438 (citations, quotation marks omitted).

⁷² *Id.*

⁷³ *Id.* at 440.

⁷⁴ 17 Cal. Code Regs. Section 95820(c).

⁷⁵ Darien Shanske, *Going Forward by Going Backward to Benefit Taxes*, 3 Cal. J. of Politics & Policy 1, 5-6 (2011).

⁷⁶ The fact that the regulations were adopted after the effective date of the statute is unlikely to cause Proposition 26 to apply. Since “the requirements of this section” apply only to “changes in statutes” (sub. a), that supports the argument that “adopted” here refers to the enactment of the statute authorizing the “tax,” not to the administrative implementation. It would be unworkable if you needed a two-thirds vote in the Legislature every time that the Department of Revenue adopted a regulation or interpretation of law that raised the tax paid by a single taxpayer (even if it lowered the tax paid by everyone else).

⁷⁷ *Id.* at 10.

⁷⁸ Proposition 26, Section 1(e).

⁷⁹ Taylor, *supra* note 5, at 4.

⁸⁰ *Id.*

⁸¹ There are a number of other limitations on the state’s spending power, which are generally described as limitations on the taxing power. *See, e.g., 9 Witkin Sum Cal. Law Tax § 2* (2010).

⁸² Horowitz, *supra* note 6 at 15.

⁸³ *Tomra Pacific v. Chiang*, 199 Cal. App 4th 463 (2011).

⁸⁴ Cal. Govt. Code §16310(a).

⁸⁵ *Tomra Pacific*, 199 Cal. App. 4th at 488.