There's big news for California's cap-and-trade program to control the state's greenhouse gas emissions on two fronts this week. Cara alluded to the first in her post this week about California Democrats gaining a supermajority in both houses of the legislature after Tuesday's election. The legislative development is important because the state legislature can probably take steps — with a two-thirds vote — to reduce legal vulnerability about whether cap-and-trade constitutes a tax, as I'll explain in a moment. The other big news is that next week the state will hold its first public auction of allowances under the cap-and-trade program. The auction will provide the first sense for how robust the market will be and at what price the first allowances will trade. One question looming over the auction is whether potential legal challenges to the program could affect auction prices. More about that too.

First, here's how the news that Democrats have secured a supermajority in both houses of the legislature affects cap-and-trade. California's constitution – as a result of the same Proposition 13 that lowered property taxes — requires that taxes used for general purposes be enacted by a 2/3s vote of the legislature whereas taxes used for specific purposes can be enacted by a simple majority (we explain this all in detail in an Emmett Center report you can download here) . What do tax requirements have to do with cap-and-trade? It is possible — though by no means certain — that the auctioning off of allowances and subsequent allocation of the auction revenue under cap-and-trade could be considered a tax under Prop 13. If a court considers the auction process to constitute a tax, then the way in which the auction revenues are allocated is highly significant to the legality of the program. AB 32 was passed with a majority vote, not with a supermajority. The Emmett Center has concluded that as long as the revenues from the auction are allocated for purposes related to greenhouse gas emissions reductions, a court is likely to find that if the cap-and-trade auction constitutes a tax, it will be considered a special or specific tax needing only a majority vote. But if the legislature allocates auction revenue to general purposes, then the auction could be an invalid general tax since AB 32 did not receive a 2/3s vote. Therefore to withstand legal challenge we have previously recommended that the legislature allocate the revenues for purposes closely tied to reducing greenhouse gases.

But now, the state legislature has a much more available legislative option to avoid constitutional attack. In allocating auction revenue, if the legislature reaffirms AB 32 with a supermajority vote (all the Democratic legislators) it can allocate the revenues for general purposes. Given that auction revenues are expected to bring in more than a billion dollars in the first year and as much as $14 billion annually in later years, the temptation to want to spend auction revenues for more general purposes like education will understandably be very high. The legislature probably now has the votes necessary to meet the 2/3s

requirement for a general tax simply by reaffirming AB 32. That's a big deal. Cap-and-trade could now provide a large source of revenue to help the state resolve its ongoing budgetary woes (helped by the passage of a Proposition 30 on Tuesday, which raises income and sales taxes temporarily, but by no means solved).

Now for the auction next week. California will auction off more than 23 million 2013 vintage allowances and almost 40 million vintage 2015 allowances on Wednesday, November 14. The state has set a floor price of $10 per allowance but the big question will be how much above $10 an allowance will sell for. In addition to the question of price, there are still questions about the degree to which the cap-and-trade program can withstand legal challenge. The program has already successfully withstood a challenge by environmental justice groups. The state has also been sued by groups seeking to invalidate the offset component of the program (for a description of offsets see here) on the grounds that the offset protocols do not achieve real reductions in greenhouse gases. My best guess is that the state will also successfully defend the offset challenge, though some commentators believe the case may have merit..

We're also very likely to see — any day now — a more complicated and potentially more problematic legal challenge to California's cap-and-trade rules for the importation of out-of-state electricity. For a really thorough explanation of the problem, see here. Here's an abbreviated description of the legal issue. The state Air Resources Board has designed rules to prevent two potential problems in regulating emissions from the electricity sector. One problem is the potential for emissions to shift from in-state to out-of-state sources not subject to regulation. If in-state generation is simply shifted to out-of-state sources that aren't regulated and then the electricity is shipped back into California, no real greenhouse gas reductions occur. And the second problem is called resource-shuffling, which is really a form of leakage. Resource shuffling occurs when a carbon-intensive electricity generator (say a coal-fired power plant) that used to import coal-generated electricity to California shifts its California imports to a lower-generating source (natural gas or even a renewable resource) and sends its more carbon-intensive electricity to an unregulated state without actually changing its overall electricity mix. California gets the renewable source of electricity but another jurisdiction gets the carbon-intensive electricity with no net reduction in greenhouse gas emissions.

The state's Air Resources Board has drafted regulations that attempt to eliminate, or at least dramatically reduce, these problems of leakage and resource shuffling. The rules are complex and technical and for the most part are not likely to raise serious legal problems. But one portion of the rules pose at least one potential constitutional problem. For what are known as "unspecified sources" of electricity — that is sources of electricity outside of

California that cannot be specifically traced to a a particular facility — California will subject those sources to its cap-and-trade system whether or not they meet a regulatory threshold of total greenhouse gas emissions. In-state sources and out-of-state specified sources will, by contrast, only be subject to compliance obligations under cap-and-trade if they emit more that a threshhold amount (25,000 metric tons of carbon dioxide or its equivalent). Unspecified emitters will also be subject to a default emissions rate that is based on the average emissions from all unspecified sources. In-state sources and out-of-state specified sources will, by contrast, be subject to compliance obligations based on their actual emissions. The reason for the distinction is that if regulators don't know exactly what the source is of imported electricity they can't know what the actual emissions are. Instead they'll apply a default average rate to any emissions they believe are attributable to the importation of electricity into California. If they know the source they can measure the actual emissions. To put it simply, the reason California is treating unspecified out-of-state sources differently is not to favor in-state over out-of-state sources but instead to try to account for emissions that should rightfully be attributable to California electricity usage when the state lacks sufficient information to know where the electricity is coming from.

From a legal perspective, however, the question is whether — consistent with the U.S. Constitution — the state can treat in-state and out-of-state sources differently. This is the same legal issue facing California's low carbon fuel standard, and here's how I explained the dormant Commerce Clause issue in an earlier post:

> The dormant Commerce Clause — which really isn't a clause at all but an implicit constitutional limitation on states' rights to regulate — prohibits states from discriminating against or improperly burdening interstate commerce. States may not, for example, explicitly favor their own businesses while discriminating against out-of-state ones. This "facial" discrimination, especially when geared at "simple economic protectionism," is virtually always impermissible. Leading Supreme Court cases include *City of Philadelphia v. New Jersey* and *Hunt v. Washington State Apple Advertising Comm*. Even a state statute that doesn't on its face discriminate against out-of-state commerce can still be found unconstitutional if it imposes an excessive burden on out-of-state businesses as compared to the in-state benefits the law produces. But the constitutional test for such "incidental" effects on commerce is much easier for a state to pass than the test imposed on state statutes that discriminate directly.

California will face two separate questions: first, is the state discriminating against out-of-

state sources on the face of the regulations themselves? If so, the state faces a very tough constitutional hurdle. But it is possible that the state could prevail even if the regulation is found to be facially discriminatory since the purpose of the regulation isn't economic protectionism. We simply won't know how a court will treat the question until the state is sued and a court rules. If a court finds the out-of-state rule not to discriminate facially, then the state will have an easier time justifying the "incidental" effects on commerce.

So what does all of this legal uncertainty have to do with next Wednesday's auction? It is possible that the uncertainty could put a damper on auction prices if traders believe that the program could be partially invalidated. This dampening effect is likely to be particularly true for the Commerce Clause challenge because if out-of-state rules are thrown out compliance may be cheaper if the result is that leakage or resource shuffling occurs. If the offset case succeeds, by contrast, compliance would be more expensive because offsets provide an alternative means of complying with emissions reduction requirements. If offsets are eliminated, businesses subject to cap-and-trade will have fewer options to comply.

In short, California remains at the center of much of the country's action on climate change. The state is moving slowly toward fully implementing the most comprehensive system of greenhouse regulation in the world. Tuesday will be a big step forward.