



Two days ago, I [posed](#) a series of questions about what AB 197 might mean for the future of cap and trade in California but never really answered the question of whether we're likely to see a continuation of the program going forward post-2020. Eric posted [his view](#) this afternoon that he is relatively pessimistic about its future in light of AB 197's passage. My view is more optimistic than his and I thought I'd describe why. First, though, here is some important and lengthy background concerning the legal authority the state's Air Resources Board (ARB) has to adopt a cap-and-trade program and whether that program can include an auction of the allowances issued under it.

### **Effect of SB 32**

The passage of [SB 32](#), which extends California's landmark climate goals to 2030 by requiring reductions of greenhouse gas emissions by 40 percent below 1990 levels, is a huge deal. Prior to the bill's passage, it was unclear whether ARB could continue to reduce greenhouse gases beyond 1990 levels after 2020 (Cara [blogged](#) on the question here). Now it is clear that ARB not only can continue to regulate but indeed is required to do so in order to meet the 40 percent goal. The extension of authority and the adoption of ambitious goals is a major victory for the planet.

Whether cap and trade will be part of the regulatory effort to reduce California's emissions remains an open question. At least three legal questions complicate the answer about the form a post-2020 cap-and-trade program might take.

### **Pending Lawsuit Against the Cap-and-Trade Auction**

The first legal question involves the validity of the state's system of auctioning cap-and-

trade allowances. That system of auctioning is currently under legal attack and pending in a state appellate court. As a result, the future of California's use of cap-and-trade in its current form is unsettled. Cara [has described](#) the basis for the lawsuit and its status here.

The outcome of the case is obviously far from certain and, unlike in some lawsuits, not only is the outcome important but so is the basis on which the court of appeals decides the case.

As I see it, there are three potential bases and outcomes in the case. First, the court could hold that the auction is a tax. If the court were to do so, presumably it would also declare the auction unconstitutional because California's Constitution, as amended by Proposition 13 in 1978, requires a 2/3s vote of the Legislature to impose a new tax. AB 32 did not pass the Legislature by a 2/3s vote. The second possibility is that the court would find the auction to be a regulatory fee. If it does so, the auction is valid because regulatory fees require only a majority vote as long as the fees generated are used to support programs that further the purposes of AB 32. The state has used the revenues thus far for programs that it argues further AB 32's purposes, though the litigants seeking to invalidate the auction argue otherwise. The third possibility is that the court finds that the auction is neither a tax nor a fee but something else not subject to the strictures of tax voting requirements under the state constitution. The last finding would be a complete victory for the state.

Importantly, if the state were to win on the grounds that the auction is neither a tax nor a fee, then the state's Air Resources Board (ARB) could not only continue with its cap-and-trade program to meet the 2020 goals established by AB 32 but could - -without constitutional limitation — extend the program to meet the new 2030 goals that were enacted this week in SB 32 and include an auction as part of the program's design.

If the court of appeals decides instead that the auction is a tax then things get more complicated. If the auction is invalid, then one possibility (and the outcome the parties who are suing the state want) is to remand the case to the lower court to determine how the cap-and-trade program should go forward. Presumably, California could have a cap-and-trade program without auctioning permits. Whether the state would want to do so is a different question. If the auction is declared to be a tax, then there is no question that to reinstate the auction for future years, the legislature would need to authorize cap and trade, or ARB authority to implement cap and trade, with a 2/3s vote.

If the court of appeals decides that the auction is a regulatory fee, then presumably the program can go forward to meet the 2020 goal. But here's where things get really complicated (if they weren't already). After AB 32 passed, the voters changed the definition of regulatory fee in an initiative, Proposition 26. The definition got much narrower and is probably sufficiently narrow that the definition [does not include](#) a cap-and-trade auction. That means that if the court of appeals says that the state's auction is a regulatory fee, it is

only a regulatory fee for the program authorized by AB 32. So presumably, if ARB wanted to extend cap-and-trade beyond 2020 to meet the 2030 goals, if the program included an auction, the new auction would no longer be considered a regulatory fee because of the definitional change in Prop. 26. Instead, any auction adopted to implement the 2030 goal would now be considered a tax. As a result, in order for ARB to extend the cap-and-trade program beyond 2020 with an auction included, it would need authorizing legislation passed by a 2/3s vote of the legislature.

In short, if California wins the lawsuit completely and the auction of cap-and-trade allowances is neither a tax nor a fee, then ARB is on completely safe legal ground adopting cap-and-trade with an auction subject to limitations just imposed by AB 197. More about that in a minute.

If California loses the lawsuit on the grounds that the auction of cap-and-trade allowances is a tax, the current auction system will be invalid and the fate of the overall program will be in the hands of a lower court judge. Presumably, the state could go forward with a cap-and-trade system with no auction. The only way to reinstate the auction would be to have the legislature authorize an auction by a 2/3s vote.

If California's auction is upheld on the grounds that the auction is a regulatory fee, then the state's current program is valid but likely only through 2020. An extension of cap-and-trade to meet the 2030 goals contained in SB 32 would be legal only if the program did not contain an auction of allowances (though even with this possibility, as Cara has written, ARB has an argument that it could keep regulating under AB 32 power). If ARB wanted to extend cap-and-trade to include an auction, the legislature would have to authorize the program with a 2/3s vote. Got all that?

### **Language in AB 32 About Cap and Trade**

[AB 32](#) gives ARB a remarkable amount of latitude to determine how to achieve the 2020 greenhouse gas emissions limit. Included within that latitude is explicit (and general) authority to use market-based mechanisms to reduce emissions provided certain conditions are met. In addition, AB 32 includes the following language:

In furtherance of achieving the statewide greenhouse gas emissions limit, by January 1, 2011, the state board may adopt a regulation that establishes a system of market-based declining annual aggregate emission limits for sources or categories of sources that emit greenhouse gas emissions, applicable from

January 1, 2012, to December 31, 2020, inclusive, that the state board determines will achieve the maximum technologically feasible and cost-effective reductions in greenhouse gas emissions, in the aggregate, from those sources or categories of sources.

One question is whether this language limits ARB's authority to use cap-and-trade (or any market based mechanism with declining annual aggregate emission limits) to the time period specified. I think the better view is that the language contemplates the use of cap-and-trade to "achieve[] the statewide greenhouse gas emissions limit," which is defined as the state's greenhouse gases as of 1990. Now that the state must achieve cuts that are 40 percent below the 1990 limits, ARB should continue to have the power to use whatever means necessary to achieve those limits so long as the means are consistent with the conditions set forth in both AB 32 and AB 197. Because AB 32 specifically authorizes market-based mechanisms more generally in Section 38570, ARB should have authority to use market-based mechanisms, including cap and trade, to achieve the 2030 limit. Cara's [post](#) on the issue is a helpful reference.

### **The Effect of AB 197 on Cap and Trade**

My blog of two days ago sets forth the third — and new — restriction on ARB's ability to use cap and trade as a regulatory tool to meet the 2030 goals. In addition to adopting new climate goals for 2030, the state legislature adopted [AB 197](#), which places some restrictions on ARB's regulatory choices in meeting the goals. Here is the relevant language of the bill:

#### **38562.5.**

When adopting rules and regulations pursuant to this division to achieve emissions reductions beyond the statewide greenhouse gas emissions limit [which is 1990 emissions] and to protect the state's most impacted and disadvantaged communities, the state board shall follow the requirements in subdivision (b) of [Section 38562](#) [requirements contained in the original AB 32], consider the social costs of the emissions of greenhouse gases, and prioritize both of the following:

- (a) Emission reduction rules and regulations that result in direct emission reductions at large stationary sources of greenhouse gas emissions sources and direct emission reductions from mobile sources.
- (b) Emission reduction rules and regulations that result in direct emission reductions from sources other than those specified in subdivision (a).

In my earlier blog I raised a number of questions about what these restrictions mean for cap and trade without answering those questions. Here is my preliminary answer to the overall question: I think ARB can continue to use cap and trade so long as it ensures — in some way — that large stationary sources are actually reducing greenhouse gas emissions. These reductions could be the result of cap and trade itself because of complementary policies like the Renewable Portfolio Standard, because of actual reductions emitters choose to make on site (improving boiler efficiency at a refinery, for example) or potentially even reductions that are occurring because of other air pollution policies that stationary sources are required to meet under state and federal law. ARB could design its cap-and-trade program to, for example, give extra credits to reductions that occur on site (hat tip to former SCAQMD board member and UCLA Law grad David Holtzman for that suggestion). Or ARB could impose some direct emissions reductions requirements on stationary sources while requiring the remaining reductions assigned to large emitters to be met through cap and trade. It is even possible, in my view, that ARB could impose *no* direct emissions reductions on stationary sources if it found that the social costs of the emissions could be mitigated less expensively through cap and trade than through direct reductions. As long as ARB ensures that some direct reductions are occurring - or that direct reductions would be far more expensive than other regulatory means for meeting the goal — I believe the agency would be on solid legal ground in continuing to use cap and trade.

### **The Politics of Cap and Trade**

I am not an expert in California politics and don't pretend to understand the complexities of the coalitions necessary to pass climate legislation. But here is at least one fact to stress again: there is a strong case to be made that the legislature does not need to pass legislation to authorize ARB to continue using cap and trade. ARB already has the power to do so as long as it does so in a manner consistent with AB 197. The legislature *may* need to authorize ARB to utilize an auction as part of a cap-and-trade program or it may not depending on the outcome of the court case I described above. If the legislature does need to do so any authorization would need a 2/3s vote. But without that authorization, ARB could continue to use cap and trade without auctioning off revenues (it could simply give the allowances to emitters as was done — for the most part — in the Acid Rain Trading Program). And if the court of appeals holds that the auction is neither a tax nor a fee, then ARB could use cap and trade with an auction.

Two more points about the politics of cap and trade. First, the November election could alter the make up of the Legislature and make it more likely that a 2/3s majority could authorize a cap and trade auction. Second, I think all bets are off about the politics of the legislature until we know the outcome of the court of appeals case. The dynamics of the issue will change. If the court invalidates the auction then the pressure to reinstate it will increase, especially because the auctions have raised a significant amount of money for many popular programs. So trying to speculate now about what the legislature might do in 2017 or 2018 seems quite difficult with so much up in the air. In the mean time, it seems worth celebrating a truly important accomplishment, the extension and strengthening of California's climate goals.