Folks are talking again about whether California's climate cap-and-trade auction is an unlawful tax, rather than a valid exercise of the state's regulatory power to control pollution. The news hook for the revival of this conversation is a recent order, discussed below, from the California Court of Appeal to the parties in the court case where this claim is being pressed. In that case, some industry plaintiffs argue that because the auction raises so much money for the state but doesn't look very much like a traditional regulatory fee, it's really a tax in disguise. A lower court rejected this argument and held the auction valid, calling the decision a close call; that decision is on appeal. (Full disclosure: I filed an *amicus* brief in the appeal, representing a client and supporting the views of the state on this issue.)

After a period of seeming dormancy, the Court of Appeal issued an order about two weeks ago asking for further briefing on the tax question. It posed the following questions:

> 1) What is the rationale for and purpose of regulations stating the auction credits confer no property right? (See Cal. Code Regs., tit. 17, §§ 95802(a)(299); 95820(c).)
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> 2) Describe the relationship, if any, between the probable environmental impacts caused by covered entities and the revenue generated from the auctions, and whether the record shows the Board established a reasonable relationship between the two.
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> 3) Can the auction system be defended against the Proposition 13 challenge on the ground it is akin to a development fee? Address what standards apply when assessing the legality of such fees and how the auction system does or does not meet them.
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> 4) Can the auction system be defended against the Proposition 13 challenge on the ground it essentially sells to covered entities the privilege to pollute?
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> 5) Although the current petitions do not seek to invalidate any particular expenditures of the auction revenue, the record shows the revenue is used for a wide variety of programs. The plaintiffs suggest that the auction proceeds–at least in part– are being used to replace what otherwise would be general fund expenditures.
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> (a) How directly must a particular expenditure of auction revenue be related to

> the goal of reducing greenhouse gases?
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> (b) What standards should the judiciary apply in reviewing expenditures that are alleged to be replacements for general revenue expenditures?
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> (c) What, as a practical matter, would be the remedy, if, under the applicable standards a court finds a particular program is not sufficiently tethered to the goals of Assembly Bill No. 32?
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> 6) Address the proper test for voluntariness in the context of determining whether a payment is or is not voluntary for purposes of deciding whether it is a compulsory exaction or freely-entered transaction. Apply the test to explain whether or not the auction payments are voluntary. As part of the discussion, assume for purposes of argument only that the trial court credited the Rabo declaration, and that Morning Star (purely as a hypothetical case) will be forced out of business due to the lack of feasible, affordable, technology to reduce its greenhouse gas emissions, if it must continue to obtain emissions credits in order to operate its tomato processing facilities.
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> 7) If this court finds the auction is deemed to be an invalid tax, what is the remedy regarding the regulations, other than a declaration invalidating the auction component?

What should one make of the court's request?

My takeaway is that the court is thinking seriously and creatively about ways to characterize the auction, and it hasn't yet settled on an answer–or even on an analytical framework. Some of the court's questions, such as #2 especially, suggest that the court may be considering applying a framework for judging the validity of the auction that the state has argued against using. That framework, named for and first articulated in a California Supreme Court case known as *Sinclair Paint*, is used to assess the constitutionality of traditional regulatory fees. Such regulatory fees are levied on industry in order to fund efforts to reduce or mitigate the impacts of pollutants for which that industry is responsible. Under the strictures of *Sinclair Paint*, traditional regulatory fees must be (among other things) limited in scale to an amount necessary to pay for the regulatory program and reasonably related to the environmental impacts of the pollution at issue.

One could apply the *Sinclair Paint* test here and still uphold the auction–in fact, that's just what the lower court did in this case–but it's a somewhat awkward fit because the auction is quite different in form and purpose from traditional regulatory fees. The state and others, including a group of economist *amici* in this case represented by Legal Planeteer Eric Biber, believe that the auction is neither a tax nor a traditional regulatory fee. The auction might, for example, be thought of as charging for a governmental privilege, like a development fee, or as selling a limited right to use a public resource, like a fishing license.

Some questions posed by the court in its recent order suggest that it may be taking up the state's invitation to classify the auction as neither a tax nor a regulatory fee, but as something else entirely. Questions 3 and 4, in particular, lean in this direction. These classifications would skirt both tax limits and the requirements for regulatory fees.

The final two questions on the court's list are tough ones. Ones asks whether, in light of the overall regulatory program, the auction can really be considered voluntary, as the state has argued. The other asks what remedy is appropriate should the court hold that the auction is invalid.

Overall, it's hard to conclude very much from the order other than that the court is digging into the tax question from several angles, without having committed to one approach yet. Parties have until May 23 to answer the court's questions.

My own view remains that the auction is a novel regulatory tool that deserves to be assessed on its own merits, not by the standards developed for traditional regulatory fees. Unlike a regulatory fee, the auction was not created in order to raise money to fund a cleanup program; rather, its purpose is to provide market price-signaling and other benefits, not revenue. Cap and trade wouldn't work as well without a public auction because the act of publicly auctioning allowances makes the program more transparent and efficient, regardless of what one does with the proceeds (though spending the proceeds in smart ways can certainly improve outcomes even more). If the *Sinclair Paint* requirements are an odd fit here, that's because this is an entirely different regulatory tool, not because it's a tax.

And to me, the tax label doesn't fit well either. The auction wasn't adopted in order to raise revenue. It's also not compulsory, since entities can purchase allowances from private parties, reduce their emissions, or both in lieu of participating in the auction. Moreover, buyers at auction receive a commodity at its fair market value, which they may resell at will. We'll hear the court's answer soon enough. Whatever happens in the appellate court, it's a fair bet the case heads to the California Supreme Court next.