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Spending California's Cap-and-Trade Auction Revenue:

Understanding the *Sinclair Paint* Risk Spectrum

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I. INTRODUCTION AND SUMMARY

California's landmark cap-and-trade program for controlling greenhouse gases (GHGs) gets underway this year, with the state's first public auction slated for November 2012. The state faces crucial questions about how to spend proceeds from its cap-and-trade auctions. Although the auctions are not primarily aimed at generating revenue, the amount of money at stake is significant, with projections on the order of a billion dollars in the program's first year and anywhere from $2 billion to $10 billion annually or more as the program expands.

As legislators, stakeholders, and advocates develop their positions about how these monies should be spent, they may face legal constraints in determining how to allocate the proceeds generated from the auctions.

This paper assesses legal limitations on using AB 32 state auction revenue that derive from the statute itself or from California's constitutional restrictions on the use of regulatory fees (embodied in Proposition 13). Based on our findings, we make recommendations about the relative risks of approaches to allocating AB 32 state auction proceeds. The aim of our paper is to inform decisionmaking on revenue allocation; as such, we do not address broader questions about the legality of the cap-and-trade program as a whole, but focus on questions that are affected by allocation decisions. We also take no position about the policy wisdom of various revenue spending choices but instead limit our analysis to the legality of those choices.

We conclude that the safest proposals, from a litigation risk perspective, are:

1) proposals primarily aimed at funding greenhouse gas reductions;

2) proposals that achieve other goals explicitly endorsed by AB 32;

3) proposals supported by a factual record developed by the Legislature or by CARB concerning the achievement of reductions or other goals; and

4) proposals that avoid direct allocation of money for revenue purposes unrelated to AB 32.

The further the state strays from these principles in spending auction money, the more it risks a litigation loss that could set back its cap-and-trade program. If a court ultimately concludes that portions of its revenue allocations are illegitimate, the likely potential consequences include invalidation of that revenue choice or of the overall legislative allocation of revenue, though it is possible that a court-ordered remedy would create more significant disruptions of cap-and-trade.

We recognize that decisions about how to spend auction revenue will reflect policy judgments and goals that are beyond our scope here. Instead, we hope to inform the dialogue on allocation by shedding light on the relative litigation risks of various approaches.

We begin our analysis with background about California's Global Warming Solutions Act and then describe the cap-and-trade program, including the auction process. We also provide estimates for how much revenue the auction of cap-and-trade allowances will raise annually. We then outline current proposals for allocating the revenue. We next turn to our legal analysis, focusing primarily on potential legal constraints imposed by Proposition 13's taxing provisions. We conclude by estimating the relative legal risk, under a *Sinclair* analysis, of some example allocation proposals.

II. BACKGROUND

A. AB 32 and California's cap-and-trade program

In 2006, California passed the Global Warming Solutions Act,[1] commonly referred to by its bill number, AB 32 (Pavley). AB 32 requires the state to return to 1990 levels of GHG emissions by the year 2020. The legislature largely delegated to the California Air Resources Board (CARB) the job of establishing programs to achieve this goal.

In response, CARB identified and began implementing a suite of programs to reduce GHG emissions from a variety of sources with the goal of achieving the AB 32 emissions limit. Among the measures CARB has adopted is a cap-and-trade program that imposes a declining cap on 85% of statewide GHG emissions, beginning this year.

A cap-and-trade program for pollutant emissions seeks to cap overall emissions while allowing emitters flexibility in whether and how to decrease their individual emissions. Emissions trading, very generally, works as follows. The regulating body caps overall emissions and allocates allowances to emitters that permit an allowance holder to emit a set amount per allowance (typically a ton of the regulated pollutant). Allowance holders can satisfy their regulatory obligations either by emitting up to the amount they hold in allowances, trading for additional allowances if they need to emit more, or emitting less than their allocated amount and selling/trading the difference. In theory, market forces drive emitters to find the cheapest means to reduce emissions while reducing overall pollution levels. In searching for the cheapest emissions reductions, cap-and-trade should also spur technological innovation.

As described by CARB in its Initial Statement of Reasons for the cap-and-trade regulation,

> The cap-and-trade program . . . establishes an overall limit on the emissions from sources responsible for 85 percent of California's GHG emissions, establishes the price signal needed to drive long-term investment in cleaner and more efficient types of fuels and energy sources, and affords covered entities flexibility to seek out and implement the most cost-effective options to reduce emissions.[2]

The cap also operates as a backstop, ensuring that even if the other planned reductions fall short of their estimates, California will still meet its 2020 emissions reduction target.[3]

CARB approved the final regulation for its cap-and-trade program last year. The regulation sets a declining, statewide cap on the emission of CO_2 and other greenhouse gases.[4] Businesses and other entities included in the program must obtain and surrender to CARB sufficient allowances to cover their GHG emissions, with one allowance equaling an authorization to emit up to the potential warming equivalent of 1 metric ton of carbon dioxide (CO_2e).[5] The cap-and-trade program covers about 350 businesses, representing 600 mostly large industrial facilities.[6]

CARB's program defines three compliance periods between now and 2020. During the first compliance period (2013–2014), the capped sectors cover the electricity industry, including imported electricity, and large industrial facilities. The program expands in the second and third compliance periods (2015–2017, 2018–2020) to cover fuel distributors, too.

CARB set the initial cap to match emissions forecasts for 2012. It plans to ratchet down the cap by about 2% each year in the first period. In 2015, the cap increases to account for the additional covered emissions from fuel distributors, and decreases approximately 3% thereafter. By 2020, the cap will have declined to about 15% below 2012 emission levels.

One advantage of market-based regulatory mechanisms such as cap-and-trade programs is their flexibility. Under CARB's program, allowances can be traded among regulated entities and others. Each allowance has a vintage year and can be used to cover emissions emitted on or after that vintage year. That is, a covered entity can purchase current vintage year allowances and "bank" those allowances for use in a subsequent year.[7] Allowances are also trackable. Each allowance has a corresponding unique serial number.[8] This serial number allows the allowance to be tracked throughout its trading life. Once an allowance is surrendered to CARB to cover reported emissions, it is permanently retired.

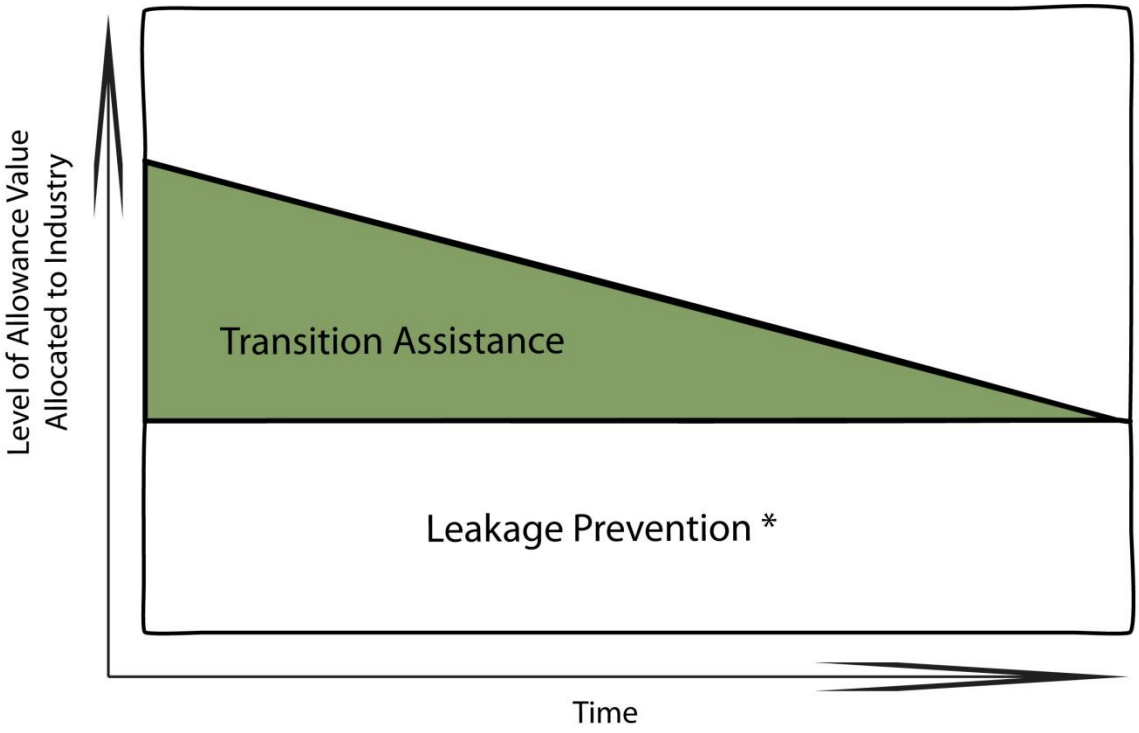

Figure 1: Free allowance distribution for industry assistance over time

Adapted from ISOR, supra note 2, at II-27, fig. II-1.

B. The cap-and-trade auction

A key design feature in any cap-and-trade program is the decision about how, initially, to distribute allowances into the market. Regulators can choose to give away allowances at the start of the program, according to various formulas; to auction off allowances to the highest bidders; or to undertake some mix of these two strategies.

Auctioning allowances serves several regulatory ends. Theoretically, the advantages of initially distributing allowances through a public auction are price discovery, market liquidity, revenue generation, and abatement efficiency.

- Auctions allow firms to see how others value allowances and signal to emitters how much a ton of emissions will cost them, a process known as price discovery.[9]
- Auctions improve market liquidity by limiting market power of any one participant, making it more difficult to corner the allowance markets or exclude new entrants.[10]
- Auctions generate revenue, which can be used to advance program goals or for other purposes entirely, such as "financ[ing] reductions in pre-existing distortionary taxes."[11]
- Auctions affect the total cost of abatement, as compared with programs in which permits are freely allocated. Free allocation schemes often increase the cost of the trading program compared to ones with auctions.[12]

Importantly, although the method of initial allocation of allowances affects the distributional consequences of the program (in other words,

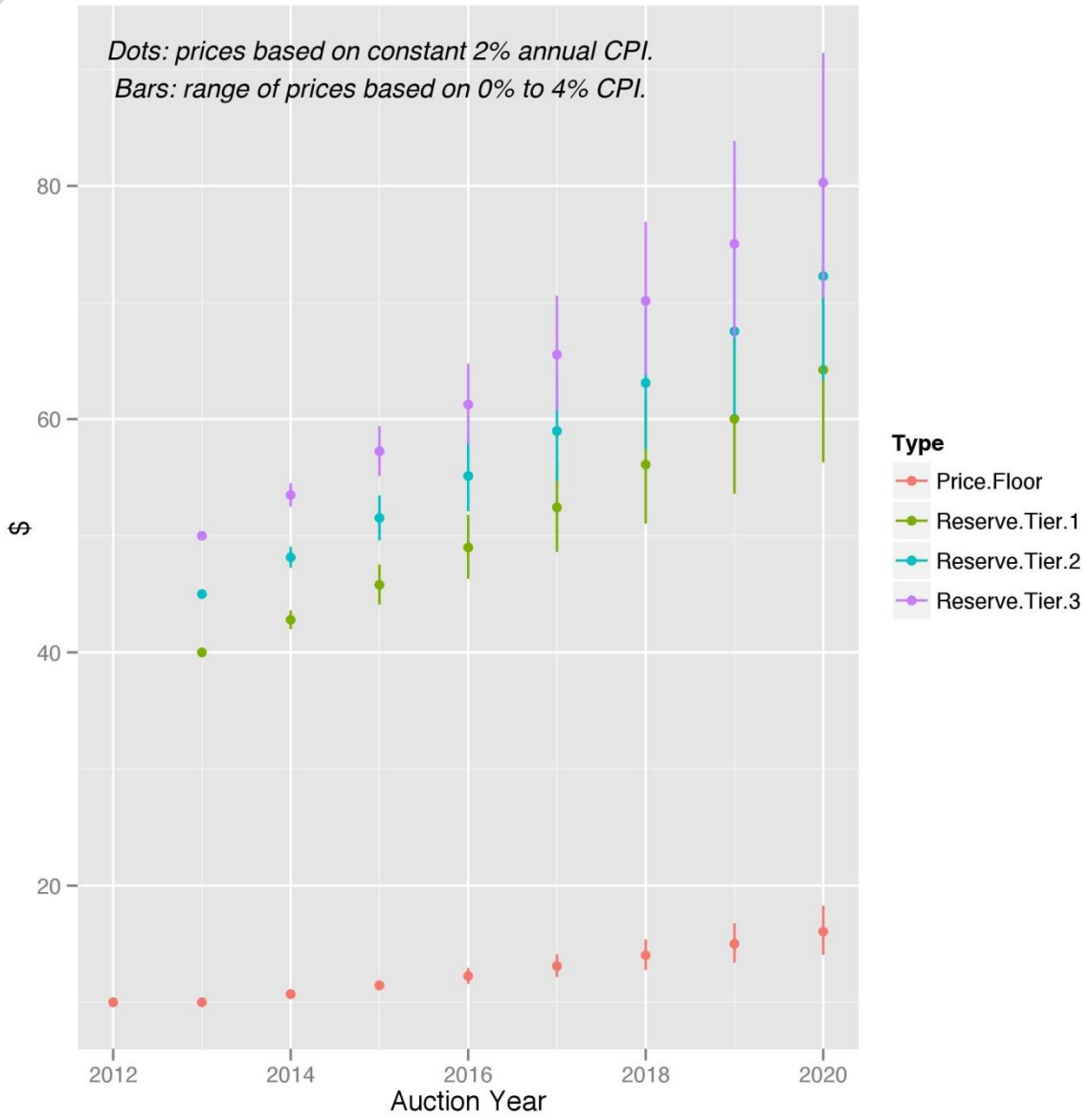

Figure 2: Estimated Auction Price Floor and Reserve Price Tiers, by Year

Auction settlement prices are expected to fall between the price floor and the reserve tiers.

who bears the costs of compliance), it does not affect the emissions reductions achieved.[13]

Here, CARB adopted a blended approach. CARB will distribute free allowances to certain industrial sources and utilities, taking account of historical emissions and in a manner designed to shield particularly vulnerable industries from leakage (the shifting of emissions from the regulated jurisdiction to jurisdictions outside of it). About 4% of allowances will be placed into a strategic reserve account that CARB will make available to avoid allowance price spikes. CARB will put the remainder of allowances up for public auction.

The purpose of the auction, in part, is to help "reveal[] the market valuation of allowances."[14] State revenue from these public auctions is the subject of this report.

Over the life of the program, CARB plans to increase the proportion of allowances that are auctioned. This is largely because CARB's free allocations are motivated by two goals: leakage prevention, the need for which remains relatively constant over time, and transition assistance, the need for which decreases as industry adapts to allowance trading.[15] (See Figure 1.)

C. Auction mechanics

California's allowances can be grouped into four basic categories: current, advance, consignment, and reserve.[16]

1) **Current allowances** are released for sale by CARB in the same year as their vintage. In other words, current allowances can be used immediately for compliance.

2) **Advance allowances** are released for sale by CARB three years in advance of their vintage. Advance allowances cannot be used immediately for compliance, but instead must be held at least until their vintage year.

3) **Consignment allowances** are freely allocated to certain utilities, then put up for sale on consignment in auction. CARB requires Investor Owned Utilities (IOUs) to offer their freely allocated allowances for auction, via consignment, each year. Publicly owned utilities (POUs) are permitted, but not required, to offer their allowances for consignment auction. Revenue from the sale of consigned allowances is returned to and controlled by the consigning utilities, to be used for the benefit of their ratepayers.

4) **Reserve allowances** have no vintage and can be used immediately. Reserve allowances, however, are not offered at auction; instead they are offered at Reserve sales at predetermined price tiers.

Each quarter, CARB will run one auction for current and consigned allowances and a separate auction for advance allowances (the "advance auction"). Allowances from different vintage years are sold separately. Auctions for current, advance, and consignment allowances will be held on November 14, 2012, and then quarterly thereafter.[17] Each quarterly auction will offer ¼ of the available current year allowances and ¼ of allowances set aside from the vintage year three years in advance.[18] Consigned allowances[19] and confiscated allowances[20] will also be offered for sale. Reserve sales occur six weeks after the quarterly allowance auctions, beginning on March 8, 2013.

Anyone who submits a valid registration can bid for allowances at the current, advance, and consignment auctions. In other words, auction participants are *not* limited to entities regulated by the cap-and-trade program. By contrast, only covered entities may participate in the Reserve sales.

Auctions are single-price, sealed bid in multiples of 1000 allowances.[21] This means that each bid consists of a price and quantity of allowances to purchase at that price. Multiple bids are allowed. The cost of allowances is determined by accepting all bids starting with the highest price and moving downwards, until all allowances have been sold. The price paid by all winning bidders is the price of the lowest winning bid (the "settlement price").

CARB has attempted to constrain the range of potential auction settlement prices via a firm floor and a soft ceiling. The Auction Reserve Price, initially set at $10, creates a firm lower floor of potential auction settlement prices.[22] Bidders cannot submit a bid for less than the reserve price. Unsold allowances will be offered again for sale at a future auction.[23]

The Allowance Reserve Tier prices, initially set at $40, $45 and $50, create a soft ceiling on potential auction settlement prices. By releasing additional allowances into the auction market, the Allowance Reserve should temper allowance price spikes. If the Allowance Reserve is depleted, however, the price ceiling for potential auction settlement prices is theoretically unlimited.

Both the Auction Reserve Price and the Allowance Reserve Tier prices will increase each year by 5% plus the annual rate of inflation.[24] Figure 2 estimates the Auction Reserve Price and Reserve Tier prices based on inflation ranges of 0% to 4%.[25] Given these price ranges, a reasonable range for auction settlement prices might begin at $10–$40 in 2012, moving up to $18–$60 by 2020.

D. How many allowances will be sold by CARB at auction?

For vintage years 2013 through 2020, CARB has allocated a total of 2.5 billion allowances, representing 2.5 billion metric tons of CO2e emissions. Only some of these, however, will be auctioned. Formulas and tables in the cap-and-trade regulation define how allowances are to be allocated. CARB has dedicated allowances to the following:[26]

- Allowance Price Containment Reserve (121.8 million)
- Advance Auction (218.6 million)
- Voluntary Renewable Electricity Reserve Account (7.078 million)
- Electrical Distribution Utility Sector (716.0 million)
- Industrial Covered Entities ("Industry Assistance")[27]
- Remainder

Of these categories, CARB will sell only Advance

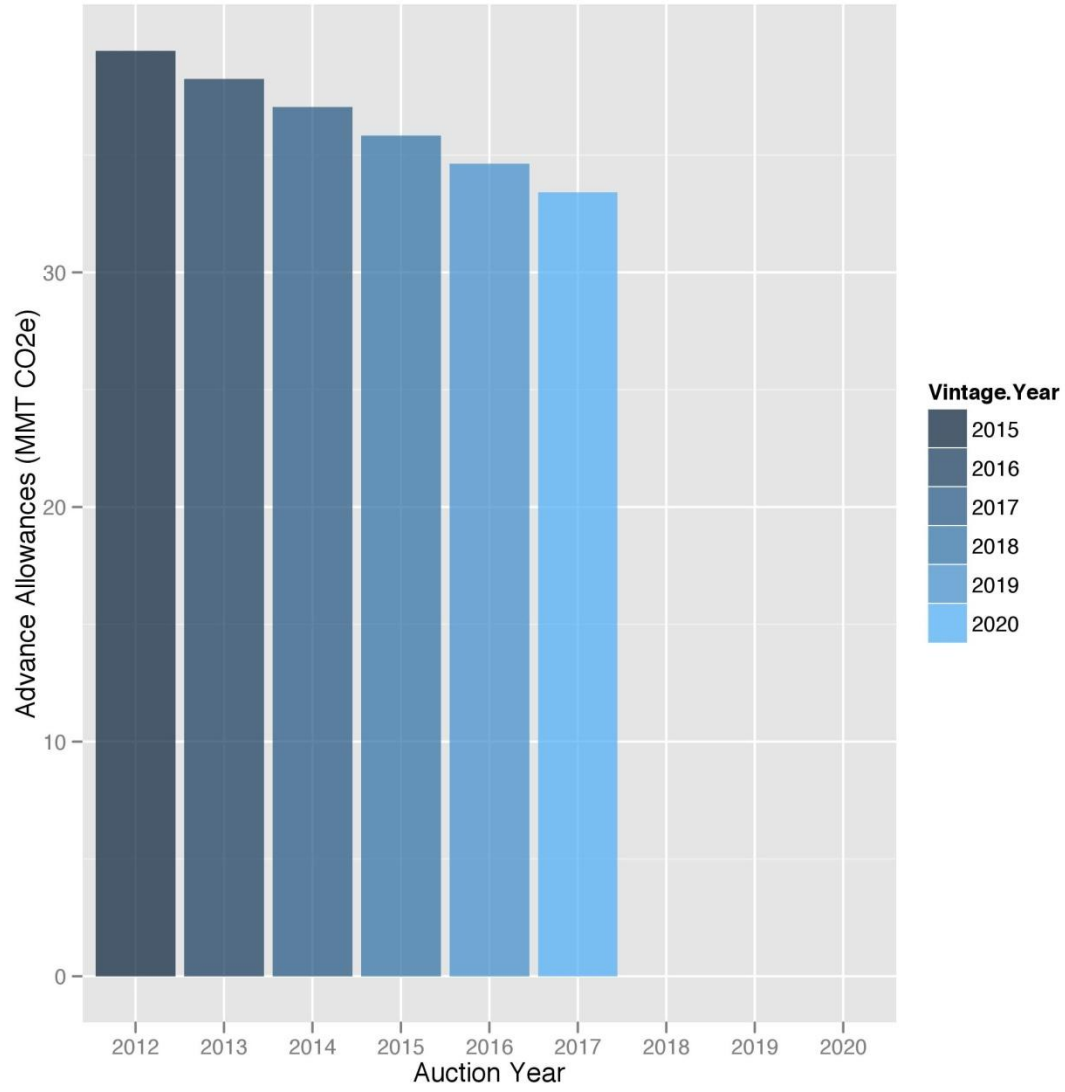

Figure 3: Advance Allowance Allocation, based on auction year.

Auction allowances and Remainder allowances at auction, and the revenue generated will be placed in CARB's Air Pollution Control Fund. Portions of the Electrical Distribution Utility Sector allowances will be sold on consignment in auction, but revenue from those sales will go directly to utilities, not to the state, as discussed further below. Figure 3 displays the number of Advance Auction allowances to be offered at auctions in 2012 through 2020.[28]

The number of Remainder allowances to be sold, however, is not so easily determined. This is because the 'Remainder' category is the number of allowances remaining after all other allocations. Crucially, the number of Remainder allowances depends on the number dedicated each year to industry assistance. More allowances dedicated to industry will result in a lower number of Remainder allowances. Allocations to industry, however, will not be precisely known until the relevant industrial sectors submit their annual

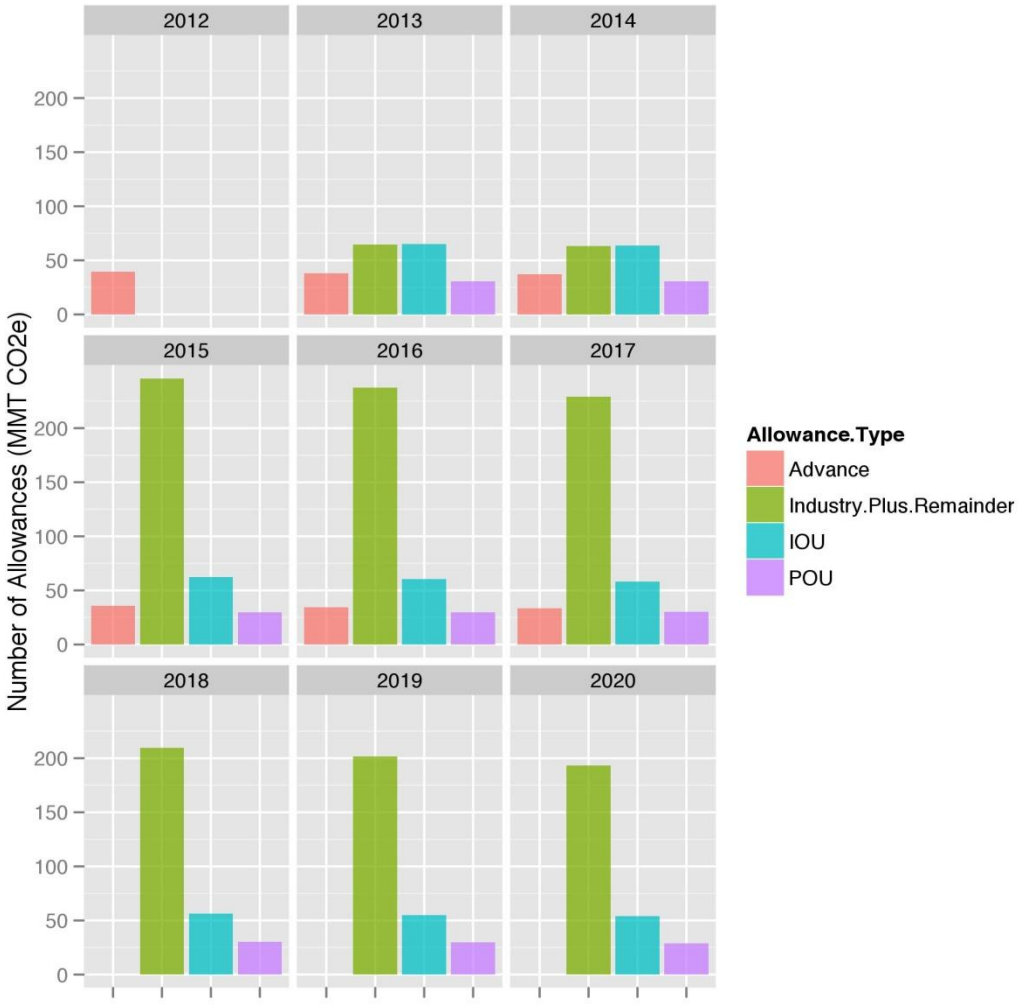

Figure 4: Allowances that may be auctioned, by type and auction year

Remainder but not industry allowances will be auctioned. IOU allowances are consigned to auction; POUs can choose to consign their allowances to auction.

reports on emissions and production output, as required under the Mandatory GHG Reporting Regulation (MRR). Thus, the exact number of Remainder allowances is unknown.

One early estimate of Industry Assistance allowances puts the number at about equal to the number of allowances available after other allocations.[29] This would mean that for 2013 and 2014, few allowances, if any, would be auctioned in the Remainder category. From 2015 onwards, the total number of allowances more than doubles while industry assistance stays relatively flat. CARB will likely have a significant number of allowances to auction in the Remainder category starting in 2015, approximately 200 million each year.

E. How much state auction revenue is likely?

Auction proceeds are a function of two numbers: the amount of allowances sold at auction times the auction settlement price for those allowances. Neither number is known with precision at this time, so auction revenue can only be estimated.

The Governor's office and the Legislative Analyst's Office have both recently estimated auction proceeds. The Governor's budget estimates that the revenue generated in 2012–2013 from cap-and-trade auctions will be approximately $1 billion.[30] LAO put the range of revenue at between $1 and $3 billion for fiscal year 2012–2013.[31] For fiscal year 2015–2016, its range is much broader, between $2 and $14 billion.[32] Neither set of figures clearly distinguishes between consignment revenue and other allowance auction revenue.

Assuming a $15 auction settlement price, CARB would raise $590 million in the advance allowance auction in 2012, and $570 million in 2013. As noted above, auctioning remainder allowances not allocated to industry in 2013 could raise an additional unknown amount, likely not very large. Remainder allowance revenue may be close to zero for 2013 and 2014. Because remainder allowances are projected to increase by approximately 200 million in 2015, revenue from remainder allowances could easily exceed $3 billion in 2015, again assuming a $15 auction settlement price.

Throughout this paper, we treat consignment auction proceeds separately from CARB's own auction proceeds, because consignment auction revenue is returned directly to the utility sellers for the benefit of ratepayers, not to the state. Assuming only IOU allowances are consigned to auction, and a $15 auction settlement price, the consignment auction would raise another $980 million in 2013.

F. What proposals for spending state auction proceeds are being considered?

No commitments have yet been made about how to spend auction proceeds. AB 32 does not address how auction proceeds should be used. Instead, it authorizes CARB to consider the use of market-based mechanisms to achieve the statewide emissions limit.[33] As discussed further below, a cap-and-trade program with auction is an example of such market-based mechanisms. CARB's cap-and-trade regulations provide for state auction proceeds (other than utility consignment revenues, which are treated separately as noted above) to be placed into its Air Pollution Control Fund, but does not otherwise direct their use.[34]

Decisions about how to spend state auction proceeds may be made by the Legislature in coordination with the Governor's office and CARB. The Legislature passes an annual Budget Act that appropriates money to agencies, such as CARB, and directs their use of funds. Other legislative acts may direct an agency to spend funds in certain ways. Thus, the Legislature may direct CARB to use the auction revenue in a specific way, and may take some or all of the auction revenue and redirect it for other uses.

Negotiations over the Budget Act formally begin when the Governor submits his budget to the Legislature by January 10 each year. This legislative season, Governor Brown's 2012–13 budget assumes CARB will raise $1 billion from the auctions. The budget would create a new Greenhouse Gas Reduction Account within the existing Air Pollution Control Fund. Five hundred million dollars would be used to pay for GHG mitigation activities previously funded by the General Fund (an "offset" of General Fund costs). The remaining $500 million would be devoted to investments in "(1) clean and efficient energy, (2) low-carbon transportation, (3) natural resource protection, and (4) sustainable infrastructure

development."[35] After the first auction, the Governor would submit an expenditure plan to the Legislature that "could include funding for such areas as low-carbon vehicle technologies, residential energy efficiency programs, local and regional sustainable development efforts, and certain projects undertaken by public universities and schools."[36] Governor Brown has also suggested using auction proceeds to fund part of California's high-speed rail project.[37]

Governor Brown's approach is echoed in a bill recently introduced by Assemblymember Pérez, AB 1532. Like the Governor's budget proposal, AB 1532 would create a dedicated fund, the Greenhouse Gas Reduction Account, for auction revenue controlled by CARB. It would limit use of that revenue to the same four categories as outlined by Governor Brown and listed above.

Senator de León has introduced another legislative proposal, SB 535, to establish the California Communities Healthy Air Revitalization Trust. This bill would commit 10% of auction revenues to a trust. Moneys in the trust could be appropriated by the Legislature only to fund programs or projects that reduce GHG emissions or mitigate health impacts of climate change in the "most impacted and disadvantaged communities."

Generally speaking, advocates, industry and others are pressing for uses of the revenue as varied as general fund relief; jobs training; investment in technology research and development; public health programs; traditional air pollution mitigation; infrastructure planning and construction; energy efficiency programs; direct consumer rebates; and many others.

III. LEGAL ANALYSIS

As legislators, stakeholders, and advocates develop their positions about how these AB 32 auction monies should be spent, it is critical to understand what legal constraints the state is under in its decisions about allocation. Here we consider two main potential sources of constraint on auction allocation decisions: AB 32 itself, and California constitutional requirements for regulatory fees.[38]

A. Does AB 32 itself constrain use of auction proceeds?

While AB 32 does authorize market-based mechanisms for achieving GHG reductions, it does not dictate how to spend auction revenue. The heart of the statute is its statewide greenhouse gas emissions cap for 2020. The legislature largely delegated the work of achieving that goal to CARB. In doing so, it set forth some mandates, goals, and guidelines for greenhouse gas regulation, none of which directs CARB on auction revenue expenditures, but some of which inform revenue decisionmaking in ways we address in more detail in later sections of this paper.

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

We conclude that this fee schedule provision, however, likely does not constrain or relate to the use of auction revenue proceeds, for the following reasons. The authority to enact these fees is set forth separately from the authority to enact a "market-based compliance mechanism" to achieve the statewide greenhouse gas limit.[39] A cap-and-trade program with auction is a well-known example of a market-based compliance mechanism. Nothing in the statute suggests that the Legislature meant to constrain CARB's separately-granted authority to enact a market-based program when the Legislature granted CARB additional authority to enact fees to implement AB 32. Indeed, Section 38597 is explicitly limited to directing the use of only those revenues "collected pursuant to this Section"—i.e., not to any other proceeds that might be generated by other sections of AB 32, such as under a market-based program.

This conclusion is supported by a letter within the legislative history of AB 32, from Assembly Speaker Fabian Nunez to the Chief Clerk of the Assembly. In that letter, Speaker Nunez states that "AB 32 authorizes the California Air Resources Board to adopt a schedule of fees to pay for the direct costs of administering the reporting and emissions reduction and compliance programs" established by AB 32, and that it is his intent that any funds "provided by Health and Safety Code Section 38597 are to be used solely for" direct administrative costs. The letter says nothing about funds generated pursuant to other AB 32 authorities or programs, and, in fact, emphasizes that Section 38597 is contained in an entirely separate part of the bill from AB 32 authorities that relate more directly to greenhouse gas control.[40]

Elsewhere, the legislature did give some guidance to CARB about how to design its greenhouse gas reduction programs, including guidance that is relevant to the use of any revenue generated directly from those programs:

> The state board [CARB] 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 gases.[41]

Again, the fact that this language is tempered by the phrases "where applicable and to the extent feasible" suggests that the Legislature intended to give CARB wide berth in making these choices.

B. Does Article XIII of California's constitution constrain use of auction proceeds?

California's constitution could limit AB 32 auction revenue allocation in significant ways, although the question of the constitutionality of the revenue is a novel one. The auction may be viewed as generating a type of revenue known as "regulatory fees," which may be spent only for limited purposes under Article XIII of the state constitution without a two-thirds vote of the legislature or the people.

1. Legal background: Proposition 13, taxes, and regulatory fees

With the passage in 1978 of Proposition 13, California law held that a majority vote is insufficient to enact a tax increase. Instead, no tax proposed for the purpose of increasing revenue could be adopted without the approval of two-thirds of the Legislature or of the people. [42] The law, however, distinguished between taxes and regulatory fees, allowing the government to impose charges on some businesses and products in order to help to offset the public health or environmental impact of those businesses' activities. Those fees could be passed with a simple majority vote.[43]

AB 32 passed the California legislature by a majority, but not with a two-thirds supermajority. Therefore AB 32 cannot have authorized the collection of tax revenue. Some opponents of California's cap-and-trade program have argued that the program imposes an unlawful tax on regulated businesses. They point, in particular, to the proceeds to be generated by CARB's allowance auctions as evidence that the program amounts to an unlawful tax.[44] The state must anticipate having to defend against these claims in court.

The California Supreme Court set forth the framework for distinguishing between state regulatory fees and taxes in a landmark case known as *Sinclair Paint*, in which the Court assessed the validity of a fee charged by the state to manufacturers of products that caused environmental lead contamination. To address the very serious problem of childhood lead poisoning in California, in 1991 the state enacted a fee imposed on manufacturers of products sold in California, such as lead paint, that contribute to lead poisoning in children. It used the fee to pay for community health programs, like lead screenings, which detect and treat children suffering from lead poisoning. The fee was challenged in court as an unlawful tax, but the Supreme Court held that the fee could be a valid regulatory fee, not a tax, if it met certain criteria—and would therefore be lawful even though it was not passed by a 2/3 supermajority.[45] The Court held that fees may legitimately "require[] manufacturers and other persons whose products have exposed children to lead contamination to bear a fair share of the cost of mitigating the adverse health effects their products created in the community."[46]

If AB 32's cap-and-trade program is challenged in court as an illegal tax, questions about the reach of *Sinclair Paint* will be ones of first impression. The AB 32 cap-and-trade program and auctions are novel, and California courts have not been called on before to try to classify such a program under the *Sinclair Paint* regime. Moreover, the cap-and-trade program and its auctions have characteristics that make them unlike either a traditional tax or a traditional regulatory-fee mechanism, such that a court may conclude that they are neither. For example, the program may be thought of as more akin to a traditional pollution regulation, one that may impose costs on industry but that does not exact fees or taxes as traditionally understood.

Nevertheless, the program does raise state money as part of a program to regulate and reduce pollution. Thus, it is arguable that the cap-and-trade program imposes something akin to a regulatory fee. To minimize its legal vulnerability and any appearance of market uncertainty, then, the state should consider allocation decisions as if it may be required to justify those decisions under the *Sinclair* regime.

With this in mind, the remainder of this analysis assesses how a range of auction revenue choices would fare under *Sinclair*. We first explain, however, why we apply the *Sinclair* regime and not Proposition 26.

2. Applying the *Sinclair* regime or Proposition 26?

Proposition 26, which passed as a voter initiative in 2010, changed the distinction between taxes and fees previously outlined in *Sinclair* by modifying the definition of tax in Article XIII of the California constitution. After Proposition 26,

certain exemptions still exist for regulatory fees, but these exemptions are likely narrower than those approved in *Sinclair*. Thus, many fees that would have been considered "regulatory" under *Sinclair* may now be considered a "tax" requiring a supermajority vote in the Legislature.

Proposition 26 applies, however, only to state exactions that result from "change[s] in state statute" adopted after January 1, 2010.[47] Nothing in Proposition 26 suggests that it should be applied retroactively to constrain auction proceeds generated under AB 32, which passed in 2006. In the absence of clear contrary intent, there is a presumption against such retroactivity.[48] So long as the Legislature does not amend AB 32, we conclude that it is unlikely that revenues generated under AB 32 will be subject to Proposition 26's new limits.

The cap-and-trade program, its auction, and any resulting revenues result from changes in state statute made well before Proposition 26's effective date. This remains the case even if the Legislature now weighs in on the use of those revenues. It is therefore most prudent to apply the law as it existed before Proposition 26.

3. Analyzing auction revenue in light of *Sinclair's* regulatory fee requirements

Proposition 13 prohibited new "[s]tate taxes enacted for the purpose of increasing revenues," unless passed by a two-thirds supermajority vote of the Legislature.[49] Only a handful of cases have examined state exactions to determine whether they are taxes that violate this provision, or, rather, are better classified as regulatory fees.[50]

In general, because both taxes and regulatory fees serve to raise revenue, courts have acknowledged that "the distinction between taxes and fees is frequently 'blurred.'"[51] Indeed, "'tax' has no fixed meaning," but instead takes on different meanings in different contexts.[52] A key factor is the purpose for which the exaction is imposed. "[I]f 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."[53] In *Sinclair*, the Supreme Court was focused not on revenue generation, but on the primary purpose of the regulation.

In determining whether CARB's allowance auction is a "state tax[] enacted for the purpose of increasing revenue,"[54] a court will look to the state's regulatory purposes in approving the auction. Those purposes, as outlined above in section II.B, relate to improving the function and efficiency of the state's cap-and-trade program for reducing greenhouse gases. The more the state emphasizes the regulatory function of the auction to help reduce greenhouse gases or serve other AB 32 purposes, the better it will fare.

But these principles bring the analysis only so far. Cases examining the validity of regulatory fees are very fact-intensive, which makes it difficult to predict the outcome of any future case. Some clear lessons, however, have emerged. There is no precise test or formulation, but to successfully defend an exaction as a regulatory fee, rather than a tax, the Supreme Court has held that the state should be able to show:

(1) "a causal connection or nexus between the product [regulated] and its adverse effects;"[55]

(2) that the total amount of money raised by the program is "limited to the reasonable costs of . . . [the] program,"[56] as defined by "amounts necessary to carry out the regulation's purpose;"[57]

(3) that the allocation of burdens among payors reflects "a fair or reasonable relationship" between the charges allocated to a payor and "the payor's burdens on or benefits from the regulatory activity;"[58] and

(4) that the fees are not used "for unrelated revenue purposes."[59]

In *Sinclair*, for example, the Supreme Court allowed that the plaintiff might still prevail at trial by showing that "no clear nexus exists between its products and childhood lead poisoning," that the fees assessed exceeded the reasonable cost of the screening and medical services they supported, that the fees "bore no reasonable relationship to" the social or economic burdens of the plaintiff's product, or that "the fees were levied for unrelated revenue purposes."[60]

Of the numbered requirements, the fourth is most relevant to California's allocation decisions. Though the first three factors may be critical to the state's defense of the cap-and-trade program, they not affected by decisions about allocation—rather, they relate to the design of the cap-and-trade program approved by CARB last year. The

businesses to be regulated, the total value of the regulatory fees to be collected, and the apportionment of those fees among payors are contingent on decisions that have largely already been made.

Looking to the fourth requirement, California's imminent decisions about spending auction funds will be relevant to whether auction monies have been used "for unrelated revenue purposes." What are related revenue purposes, exactly? One way to understand the "unrelated revenue purposes" requirement is as the flip side of the requirement that the total amount of money collected is no more than necessary to fund the regulatory program giving rise to the fee. To help ensure that this is so, regulatory-fee revenue must be used to further the purposes of the regulatory program authorizing that revenue.[61] As recently summarized by the Supreme Court,

> "Permissible fees must be related to the overall cost of the government regulation. . . . 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."[62]

Here, what are AB 32's goals, and how directly must a program funded with auction revenue advance them? We discern three potential sets of legislative goals.

1. Reduction of greenhouse gas emissions

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

Potential difficulties arise if the GHG reductions are unlikely to occur until after 2020, because of AB 32's specific 2020 mandate. However, the statute calls for the greenhouse gas limit to remain in effect past 2020 and to "be used to maintain and continue reductions in emissions of greenhouse gases beyond 2020."[63] Because California's economy and population will presumably grow beyond 2020, but the statewide GHG limit will remain static, the limit effectively becomes more stringent over time—justifying the funding of GHG reduction efforts even beyond 2020.

2. Advancement of other goals set by the Legislature

The second set of goals consists of those enumerated by the Legislature itself in its statutory directions to CARB for designing a regulatory program. The Legislature gave CARB significant discretion to figure out how to reduce the state's climate emissions, but also urged the agency to consider and prioritize a set of secondary goals along the way.

The most relevant of these goals direct CARB, to the extent feasible and "in furtherance of achieving the statewide greenhouse gas emissions limit," to:

- design the regulations in a manner that is equitable;[64]
- ensure that activities undertaken to comply with the regulations do not disproportionately impact low-income communities;[65]
- ensure that activities undertaken pursuant to the regulations complement, and do not interfere with, efforts to achieve air quality standards and reduce toxic contaminants;[66]
- design any market-based compliance mechanism to prevent any increase in the emission of toxic air contaminants or criteria air pollutants;[67]
- minimize leakage;[68]
- maximize additional environmental and economic benefits for California;[69]
- direct public and private investment toward the most disadvantaged communities in California;[70] and
- provide an opportunity for small businesses, schools, affordable housing associations, and other community institutions to participate in and benefit from statewide efforts to reduce greenhouse gases.[71]

Though these goals were enumerated by the Legislature, they cannot be considered to be of the same order of priority as reducing greenhouse gases. AB 32 urges CARB to consider achieving these ancillary goals, if feasible, *in its design of a program to reduce GHGs*. In other words, these goals were to be prioritized within programs aimed at achieving GHG reductions, but were never mandated as ends in themselves. Fairly stated, and taking the goal of directing public investment toward disadvantaged communities as an example, the aim of the legislature was to reduce GHGs in a way that directed public investment toward those communities, if feasible and in furtherance of efforts to achieve the statewide limit.

In light of these legislative directives, using AB 32 revenue to help reach these ancillary goals would be least risky when done in a way that reduces GHGs. The safest revenue expenditure plan would mirror the bill's priorities, using GHG reductions as a threshold directive and prioritizing revenue uses based on their ability to accomplish other AB 32 goals. It becomes more risky to spend auction revenue on programs aimed at these ancillary goals in isolation—for example, spending money to reduce traditional air pollutants without also reducing GHGs.

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

3. Reduction of climate change impacts on California through adaptation projects

The third set of goals is even farther removed from AB 32's central mandate. In deciding to reduce statewide greenhouse gas emissions, the Legislature presumably was motivated by a desire to reduce the adverse effects of global warming on California.[72] An implicit goal of AB 32 was, therefore, to lessen the harm from global warming in California. Given this, people have asked whether auction revenue may be used to fund adaptation projects—that is, those that help California address the effects of climate change, rather than help California decrease the emissions of climate change pollution. An example of such a project might be the creation of cooling centers, where people could take shelter during heat waves.

In its Findings and Declarations, the Legislature recognized that climate change will seriously and detrimentally impact the state, such as through the "exacerbation of air quality problems," "damage to marine ecosystems" and "detrimental effects on . . . agriculture, wine, tourism, skiing, recreational and commercial fishing, and forestry."[73] But AB 32 does not state a goal or a mandate focused on reducing these harms, separate from its calls for reducing GHGs or for creating the other environmental and economic benefits specifically named as aims of the statute.

Advocates for using auction revenue to lessen harm from climate change may point to *Sinclair* itself, in which the Supreme Court approved of using regulatory fees to fund "measures to mitigate the *past, present, or future* adverse impact of a fee payer's operations."[74] They may also point out that *Sinclair* involved a regulatory fee that funded efforts to reduce the effects of lead pollution on communities and children—not just to decrease the amount of that pollution in the environment. The difference between the two cases turns on differences in the statutes authorizing and designing the respective regulatory programs.

The statute authorizing the lead paint fee in *Sinclair* was explicitly aimed at mitigating the harms from lead poisoning. It called not just for programs to reduce lead in the environment, but also for programs to lessen the harmful effects of lead pollution that had already occurred and to which children and communities were already exposed.[75] Thus, spending money on such programs in *Sinclair* was directly related to the regulatory program that gave rise to the challenged fee.

We cannot say that the same would be true here. To spend proceeds in a way that furthers AB 32's goals, the safest approach is to stick to the goals named by the Legislature in the statute. Therefore, it would be risky to use auction revenue for projects that help the state adapt to climate change, if those projects do not reduce emissions or serve one of the other explicit goals of the statute. To advance adaptation, a less risky

Proposal Risk Criteria

Reviewing the caselaw on regulatory fees, we believe that the following criteria are useful in judging the relative risks of expenditure proposals, with "yes" answers yielding less risk:

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

approach would be to fund projects that result in both GHG reductions and adaptation (resiliency) benefits.

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

Given these conclusions, CARB or the Legislature will reduce risk by creating a good record showing how chosen projects will further the goals of AB 32. We do not, however, conclude that the state has an obligation to create a precise, or even consistent, formula for funding projects based on their relative costs and GHG-reduction benefits. Courts will likely defer to the priorities and inevitable tradeoffs made by CARB and the Legislature, so long as there is a reasonable record, at the time of the state's choice of revenue allocation, showing that those choices are aimed at advancing the goals of AB 32.

Moreover, none of these criteria relates to questions about the relationship between fee payors (*i.e.*, those who pay money at auction) and beneficiaries of revenue allocation decisions. Courts have squarely rejected the notion that *Sinclair* and its progeny require a "nexus" or "proportional relationship" between the amounts of regulatory fees paid by an entity and the benefits received by that entity from the regulatory program at issue. "[R]egulatory fees in amounts necessary to carry out the regulation's purpose are valid despite the absence of any perceived 'benefit' accruing to the fee payers."[76] Thus, though the state may choose to fund programs that benefit regulated entities, it is not required to allocate auction proceeds with an eye toward "repaying" the regulated entities that have paid into auctions.

Finally, we emphasize again the limits of our analysis. To say that a particular proposal may be risky under *Sinclair* is not to say that it shouldn't be considered; instead, decisionmakers should understand and consider the risk of its being held invalid by the courts when weighing options. And if, of course, the Legislature musters a two-thirds vote in favor of a particular use of revenue, its options expand. It can overcome these *Sinclair* constraints at any time with a two-thirds vote reauthorizing the auction exaction, perhaps packaged with a revenue expenditure plan. We caution that doing so, however, may have implications for the application of Proposition 26 to AB 32 more generally, for other revenue uses and in other years.

C. Consequences if revenue allocation decisions are challenged and invalidated

In weighing litigation risks, it is also critical for decision-makers to understand the potential *consequences* of a revenue choice being struck down by a court. If the state were to lose a challenge because certain revenue allocation decisions are held to suggest that the auction is collecting a tax, not a regulatory fee, what would happen?

Any challenge to the choice of how to allocate auction proceeds would be a case of first impression, with many unknowns about the form or content of such a challenge. Consequently, it is difficult to evaluate the likely remedy. Nonetheless, courts are likely to follow some basic principles. California courts presume the constitutionality of legislative enactments, and avoid finding laws unconstitutional if there is a reasonable interpretation that renders them constitutional.[77] Thus, a court is likely to invalidate only the actions that it believes necessary in order to remedy any possible constitutional infirmity. Relatedly, a court should not uphold a facial challenge to a law's constitutionality, or a similarly broad challenge to the constitutionality of a body of regulations, if the statute or regulations can be implemented constitutionally.[78] In such a situation, a court typically would hold that the statute or regulations are invalid in the particular application that makes them function unconstitutionally, but valid in applications in which they do not violate the State constitution.

Here, AB 32 and CARB's existing cap-and-trade regulations authorize the development of an auction system that in no way requires any particular allocation of auction proceeds. Consequently, a court upholding a challenge to a future allocation choice would likely fashion a narrow remedy, focusing on the specific actions that result in the finding that the allocation choice is an impermissible tax—not a broader remedy that would invalidate the statute or regulations that initially authorized the auction, or enjoin a future auction.

If, as this analysis assumes, the allocation choice is made through a new legislative appropriation enactment, any court decision declaring that choice to effect an unlawful tax would likely base that decision on a finding that the enactment dedicates auction proceeds "for unrelated revenue purposes" and thus fails the fourth prong of the *Sinclair Paint* test enumerated above. But the existing regulations, and the auctions authorized by them, do not depend on any particular allocation of revenue, and certainly can be implemented in a way that avoids using revenue for unrelated revenue purposes, thus avoiding constitutional problems. A declaration or injunction invalidating either AB 32 or any of those regulations, or an injunction preventing or invalidating an auction under those regulations, would therefore inappropriately hamper the implementation of lawful elements of the program.

In this circumstance, a court is likely to declare the legislative action allocating the auction proceeds invalid, and enjoin its implementation, but only to the extent that it finds the new enactment to create an unlawful tax through its allocation of auction proceeds. Courts typically will leave other legislative provisions intact that are independent and not unconstitutional.[79] Nonetheless, it is possible that a court would declare the entire legislative action authorizing the allocation to be invalid, if the court finds that the unconstitutional part is inextricably intertwined with the other parts and if the legislative purpose would not be served simply by excising one section. If the Legislature's allocation includes language demonstrating its intent that invalidation of any portion of the allocation would not affect the remainder of the allocation, a court should limit its relief to defer to the Legislature's intent.[80]

D. Do these constraints apply to the consigned utility allowances and the related PUC proceedings?

In this analysis, we have focused on decisions to allocate money from the auction of state allowances. We have not discussed whether these constraints should similarly affect proceeds from the auction of consigned utility allowances.

In our view, there is a strong argument that the consignment auction proceeds should not be held to the same *Sinclair* strictures as other auction funds arguably may be. Simply put, this is because consignment auction proceeds are not state revenue. Under the cap-and-trade program, investor-owned utilities (or IOUs) are given free allowances by the state, and are then required by regulation to sell those allowances, on consignment, through auctions. Revenues from

the sale of those allowances go immediately back to the IOU sellers, not to the state. The IOU auctions thus serve as a means for the utilities themselves to exchange allowance value for cash, and to "thicken" the market for allowances in ways that will help make that market more resilient.[81]

Though the PUC plays a role in determining the use of that revenue, its oversight role, without more, should not convert utility revenue to state revenue. Because the sale of consigned utility allowances does not provide any additional revenue to the state, the *Sinclair* regime seems not to apply to the consignment auction.

IV. CONSIDERATION OF SAMPLE SPENDING PROPOSALS

To illustrate the spectrum of risk of various allocation proposals, we consider a handful of exemplar proposals and ask how they might fare under a *Sinclair Paint* analysis, and why. (For reasons addressed in section III.D above, these assessments apply only to the use of state auction proceeds, not to the use of consigned auction revenue returned to utilities and subject to PUC oversight.)

Under a *Sinclair Paint* analysis, how risky would it be for the state to use auction revenue to:

Augment the General Fund, with no further restriction?

Analysis: Likely to fail.

Using revenue to augment the General Fund has repeatedly been cited by courts as a flag that a fee is being used for unrelated revenue purposes and is, in fact, a tax.

Augment the General Fund, but restrict the use of those new General Fund revenues to preexisting projects that reduce greenhouse gas emissions?

Analysis: High risk.

This approach is still high risk because courts have repeatedly flagged funneling revenue into the General Fund as indicative of a tax, not a fee, because the monies are being used for unrelated revenue purposes. It may be hard to overcome the sense that General Fund monies are fungible.

A better approach would be to place the auction funds into the Air Pollution Control Fund (or, if it's created, the Greenhouse Gas Reduction Account) and to shift payment for those preexisting projects over to the specialized fund.

Fund greenhouse gas reduction projects, out of the specialized fund, favoring projects within disadvantaged communities that also achieve ancillary benefits such as the reduction of traditional air pollution?

Analysis: Low risk.

Projects that reduce greenhouse gases, paid for from the specialized auction revenue fund, will be low risk even if they aim to achieve multiple purposes. This is especially true when all purposes reflect AB 32 goals, as with this project.

Fund greenhouse gas reduction projects, out of the specialized fund, that also achieve adaptation goals?

Analysis: Low risk.

Projects that reduce greenhouse gases, paid for from the specialized auction revenue fund, will be low risk even if they aim to achieve multiple purposes. For example, the state might use money for urban water-use efficiency projects that both reduce the energy required to provide water to urban areas, and increase the state's resiliency to drought.

Provide direct, per capita, equal-share rebates to all taxpayers as a dividend on auction revenue?

Analysis: High risk.

A court may see money spent on projects unrelated to GHG reductions as failing to further AB 32's central regulatory purpose. It is hard to see how an equal-share, lump-sum dividend to all taxpayers furthers AB 32's stated goals.

A better, though still not risk-free, approach would tie targeted rebates to one of AB 32's explicit goals, such as the avoidance of disproportionate impacts on low-income communities.

Reduce sources of traditional air pollution in low-income communities and disadvantaged communities, without also reducing GHGs?

Analysis: Medium risk.

A court may see money spent on projects unrelated to GHG reductions as failing to further AB 32's central regulatory purpose. If such programs concurrently reduce GHGs, then they are much lower risk.

Fund the construction of portions of California's proposed high-speed rail line?

Analysis: Low to medium risk.

The high-speed rail is a major infrastructure project with many purposes that go beyond GHG reductions. If there is a record showing that the line will reduce GHGs, this project should be low to medium risk. Potentially more (but not much more) risk if the GHG reductions are unlikely to occur until after 2020.

This analysis also applies to planning activities or other non-construction activities necessary to support the project.

V. CONCLUSION

The decisions that California makes about how to spend revenue from its cap-and-trade program to reduce greenhouse gas emissions may affect the integrity of that program in significant ways. In creating a revenue expenditure plan, the state should consider the risks that derive from California's limits on the use of regulatory fees as an important factor, among others. In sum, the safest expenditure proposals – from a litigation risk perspective considering Proposition 13's tax limitations – are those that are used to reduce greenhouse gas emissions and to further AB 32's goals.

ENDNOTES

[1] Chpt. 488, Statutes of 2006 (codified in Cal. Health & Saf. Code § 38500 et seq.) [hereinafter "AB 32"].

[2] CAL. AIR RES. BD., PROPOSED REGULATION TO IMPLEMENT THE CALIFORNIA CAP-AND-TRADE PROGRAM: INITIAL STATEMENT OF REASONS I-4 (Oct. 28, 2010) [hereinafter "ISOR"].

[3] Cal. Air Res. Bd., Status of Scoping Plan Measures 5, http://www.arb.ca.gov/cc/scopingplan/status_of_scoping_plan_measures.pdf.

[4] *See generally* Cal. Air Res. Bd., ARB Emissions Trading Program Overview, *at* http://www.arb.ca.gov/newsrel/2010/capandtrade.pdf.

[5] California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms, CAL. CODE REGS. § 95802(a)(8) [hereinafter "Cal. Cap-and-Trade Reg."].

[6] Overview of ARB Emissions Trading Program, http://www.arb.ca.gov/newsrel/2011/cap_trade_overview.pdf.

[7] Entities cannot borrow allowances: they cannot use future vintage year allowances to cover present emissions.

[8] Cal. Cap-and-Trade Reg. § 95802(a)(259).

[9] Bowman Cutter, M. Rhead Enion, Ann Carlson, and Cara Horowitz, RULES OF THE GAME: EXAMINING MARKET MANIPULATION, GAMING AND ENFORCEMENT IN CALIFORNIA'S CAP-AND-TRADE PROGRAM, at Part I.D (Aug. 2011).

[10] *Id*. at Part II.B.

[11] Robert N. Stavins, Experience with Market-Based Environmental Policy Instruments 42, *in* THE HANDBOOK OF ENVIRONMENTAL ECONOMICS (Karl-Göran Mäler & Jeffrey Vincent, eds., 2001), *available at* http://www.hks.harvard.edu/fs/rstavins/Papers/Handbook_Chapter_on_MBI.pdf (citing Lawrence H. Goulder, Ian W.H. Parry, and Dallas Burtraw, *Revenue-Raising vs. Other Approaches to Environmental Protection: The Critical Significance of Pre-Existing Tax Distortions*, 28 RAND J. ECON. 708 (1997)).

[12] *Id.* at 42 (citing Robert N. Stavins, *Policy Instrumetns for Climate Change: How Can National Governments Address a Global Problem?*, U. CHI. LEGAL F. 293 (1995)).

[13] W. David Montgomery, *Markets in Licenses and Efficient Pollution Control Programs*, 5 J. ECON. THEORY 395, 410 (1972).

[14] ISOR, *supra* note 2, at II-35 to II-36.

[15] *Id.* at II-27, fig. II-1.

[16] A small number of allowances are also dedicated to the Voluntary Renewable Electricity Reserve Account. Cal. Cap-and-Trade Reg. § 95870(c).

[17] *Id.* § 95910(a).

[18] *Id.* § 95910(c). Ten percent of allowances from vintage years 2015–2020 are designated as advance sales. Cal. Cap-and-Trade Reg. *Id.* § 95870(b).

[19] *Id.* § 95910(d).

[20] *Id.* § 95910(d)(2) (withdrawal of allowances from suspended or revoked holding accounts).

[21] *Id.* § 95911(a).

[22] *Id.* § 95911(b)(6).

[23] *Id.* § 95911(b)(4). Specifically, unsold allowances are offered at the next auction after the auction settlement price exceeds the Auction Reserve Price for two consecutive auctions. *Id.* § 95911(b)(4)(B). Only 25% of allowances at any given auction can be previously unsold allowances. *Id.* § 95911(b)(4)(C).

[24] Rate of inflation as measured by the Consumer Price Index (CPI) for All Urban Consumers. *Id.* § 95911(b)(6)(B).

[25] 2% is the current Federal Reserve Bank target for inflation. *See, e.g.*, Jonathan Spicer, *In historic shift, Fed sets inflation target*, REUTERS, Jan. 25, 2012, http://www.reuters.com/article/2012/01/25/us-usa-fed-inflation-target-idUSTRE80O25C20120125.

[26] Cal. Cap-and-Trade Reg. § 95870.

[27] Industry plus remainder total 1.445 billion allowances.

[28] Note that advance allowances have vintages three years in the future, such that advance allowances offered at auction in 2012 will be 2015 vintage. Advance allowances in the 2017 auction will be 2020 vintage. Because no allowance submissions are currently required after 2020, no advance allowances are planned for auction in 2018 through 2020.

[29] *See* ISOR, *supra* note 2, at appx. J-25, fig. J-7.

[30] GOVERNOR'S BUDGET SUMMARY 2012–13, at 98, *available at* http://www.ebudget.ca.gov/pdf/BudgetSummary/FullBudgetSummary.pdf.

[31] MAC TAYLOR, LEG. ANALYST'S OFFICE, EVALUATING THE POLICY TRADE-OFFS IN ARB'S CAP-AND-TRADE PROGRAM 13 fig. 4 (Feb. 9, 2012), *available at* http://www.lao.ca.gov/reports/2012/rsrc/cap-and-trade/cap-and-trade-020912.pdf.

[32] *Id.*

[33] AB 32 § 38562(c).

[34] Cal. Cap-and-Trade Reg. § 95870.

[35] MAC TAYLOR, LAO, THE 2012–13 BUDGET: CAP-AND-TRADE AUCTION REVENUES 4 (Feb. 16, 2012), *available at* http://www.lao.ca.gov/analysis/2012/resources/cap-and-trade-auction-revenues-021612.pdf.

[36] *Id.* at 5.

[37] *See, e.g.*, David Siders, *Capitol Alert: Jerry Brown says cap-and-trade fees will fund high-speed rail*, SAC. BEE, Jan. 29, 2012, *at* http://blogs.sacbee.com/capitolalertlatest/2012/01/jerry-brown-says-cap-and-trade-fees-will-fund-high-speed-rail.html.

[38] We recognize that uses of state revenue may be constrained by other general limitations as well. Addressing limits that apply equally to all uses of state revenue is beyond the scope of this paper.

[39] *Compare* AB 32 §§ 38562(c) and 38570 to § 38597.

[40] We also note that CARB's regulations do place certain limitations on the use of consignment auction revenues by the utilities. The revenue must benefit retail ratepayers "consistent with the goals of AB 32" and are further subject to any restrictions imposed on them by CPUC. CARB resolution 10-42, adopted on December 16, 2010, advises that consignment revenues be used to further environmental justice. These agency regulations obviously do not constrain Legislative decisionmaking and also relate only to utility consignment revenue, not to state auction revenue.

[41] AB 32 § 38565.

[42] CAL. CONST. art. XVIII A, § 3 (prior to Nov. 2010). This summary of the law is as it existed prior to the passage of Proposition 26, which revised the definition of a tax and reworked the distinction between taxes and regulatory fees. We apply pre-Proposition 26 law in this analysis for reasons discussed *infra*, in the next subsection.

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

[44] *See* letter from the California Chamber of Commerce *et al.* to members of the Assembly Budget Subcommittee #3 (Feb. 12, 2012) (on file with authors).

[45] *Sinclair Paint*, 15 Cal. 4th at 878.

[46] *Id.* at 877.

[47] Proposition 26 applies to "[a]ny change in state statute which results in any taxpayer paying a higher tax." CAL. CONST. art. XIII A, § 3(a); *see also* CAL. CONST. art. XIII A, § 3(c).

[48] *See Evangelatos v. Superior Ct.,* 44 Cal.3d 1188, 1208 (Cal. Sup. Ct. 1988)*; Rosasco v. Comm'n on Judicial Performance,* 82 Cal.App.4th 315, 320 (Cal. Ct. App. 2000). *See generally* Lois A. Weithorn, *Can a Subsequent Change in Law Void a Marriage that Was Valid at Its Inception? Considering the Legal Effect of Proposition 8 on California's Existing Same-Sex Marriages*, 60 HASTINGS L.J. 1062, at Part II (2009) (discussing the presumption against retroactivity in California law).

[49] CAL. CONST. art. XIII A, § 3 (prior to Nov. 2010).

[50] *See Sinclair Paint*, 15 Cal. 4th; *Cal. Farm Bureau Fed'n v. State Water Resources Control Bd.*, 51 Cal. 4th 421 (Cal. Sup. Ct. 2001); *Cal. Ass'n of Prof'l Scientists v. Dept. of Fish and Game*, 79 Cal.App.4th 935 (Cal. Ct. App. 2000); *Equilon Enter. v. State Bd. of Equalization,*189 Cal.App.4th 865 (Cal. Ct. App. 2010); *Morning Star Co. v. Bd. of Equalization,* 201 Cal.App.4th 737 (Cal. Ct. App. 2011). The Supreme Court has noted that a larger group of cases analyzing Section 4 of Proposition 13, which imposes "similar restrictions on local entities," "may be helpful, though not conclusive, in" assessing Section 3 cases. *Sinclair Paint*, 15 Cal. 4th at 873. Our analysis relies largely on Section 3 cases, drawing occasionally from Section 4 cases as useful.

[51] *Cal. Farm Bureau Fed'n*, 51 Cal. 4th at 437.

[52] *Id.*

[53] *Sinclair Paint,* 15 Cal. 4th at 880.

[54] CAL. CONST. art. XIII A, § 3.

[55] *Sinclair Paint,* 15 Cal. 4th at 878.

[56] *Id.*

[57] *Id.* at 876.

[58] *Id.* at 878 (quoting *San Diego Gas & Elec. Co. v. San Diego County Air Pollution Control Dist*., 203 Cal. App. 3d 1132, 1146 (1988)).

[59] *Id.*

[60] *Id.* at 881.

[61] *See, e.g.*, *id.*

[62] *Cal. Farm Bureau Fed'n*, 51 Cal. 4th at 438 (2001) (emphasis added).

[63] AB 32 § 38551(b).

[64] *Id.* § 38562(b)(1).

[65] *Id.* § 38562(b)(2).

[66] *Id.* § 38562(b)(4).

[67] *Id.* § 38570(b)(2).

[68] *Id.* § 38562(b)(8).

[69] *Id.* § 38570(b)(3).

[70] *Id.* § 38565.

[71] *Id.*

[72] It did not state such a goal explicitly. Stated goals included continuing the tradition of California environmental leadership; encouraging other states, the federal government, and other countries to act; and positioning its economy and businesses to benefit from national and international efforts to reduce GHGs. *Id.* § 38501(c)-(d).

[73] *Id.* § 38501.

[74] *Sinclair Paint,* 15 Cal. 4th at 878 (emphasis in original).

[75] *Id.* at 871.

[76] *Id.* at 876; *see also Cal. Farm Bureau Fed'n*, 51 Cal. 4th at 438 ("Regulatory fees are valid despite the absence of any perceived 'benefit' accruing to the fee payers").

[77] *See*, *e.g.*, *Lockyer v. City and County of San Francisco*, 17 Cal.4th 1055, 1086 (2004) ("The unconstitutionality of a statute must be clearly shown, and doubts as to its constitutionality will be resolved in favor of its validity" [citations omitted]); *Copley Press, Inc. v. Superior Court*, 39 Cal.4th 1272, 1302 (2006) (same).

[78] *See*, *e.g.*, *California State Personnel Bd. v. California State Employees Ass'n*, 36 Cal.4th 758, 769 (2005) ("Challenges to the facial constitutionality of legislative acts require a demonstration that the acts inevitably pose a present total and fatal conflict with applicable constitutional prohibitions" [citations omitted]); *Ventas Finance I, LLC v. California Franchise Tax Bd.*, 165 Cal. App. 4th 1207 (1st Dist. 2008) ("A statute should be found facially unconstitutional only if there are no circumstances under which it can be validly applied")

[79] *See*, *e.g.*, *In re Kapperman*, 11 Cal. 3d 542, 550 (1974).

[80] *See*, *e.g.*, *Lewis v. City of Hayward*, 177 Cal. App. 3d 103, 115-116 (1st Dist. 1986).

[81] CUTTER, *supra* note 9, at 27.