

September 19, 2016

Clerk of the Board
California Air Resources Board
1001 I Street
Sacramento, CA 95814

Re: Proposed Amendments to the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms (Legal comment letter)

Dear ARB Board Members and Staff,

Thank you for the opportunity to comment on ARB's proposed extension of the cap-and-trade program.¹ We are longtime academic observers of California's energy and climate policies. Each of us has each spent over a decade conducting research on state, federal, and international climate policy with a particular focus on the design and implementation of emissions trading systems.

We strongly support California's goal of reducing greenhouse gas emissions in line with applicable statutory targets and executive orders, and believe that market-based climate policies, such as cap-and-trade, will be critical to achieving the deeper emission reductions required after 2020. Nevertheless, we write here to raise concerns with respect to ARB's legal authority to extend the cap-and-trade program after its current expiration at the end of 2020. In a separate comment letter we also address substantive policy and market design considerations in ARB's proposal.

We believe that the risk of proceeding with the proposed rule is significant. The lack of clear legal authority to continue cap-and-trade after 2020 will

¹ California Air Resources Board, Public Hearing to Consider the Proposed Amendments to the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms, Staff Report: Initial Statement of Reasons (Aug. 2, 2016) (hereinafter "ISOR"), *available at* <https://www.arb.ca.gov/regact/2016/capandtrade16/capandtrade16.htm>.

bring a high profile legal challenge from industry opponents. And in contrast to the current challenge to allowance auctions in the cap-and-trade program, we believe that the risks of a defeat for ARB are much greater. Any such litigation, if successful, would do serious damage to California's leadership on climate policy.

We also believe—based upon discussions with market participants and our observation of recent market activity in secondary spot, futures, and options markets—that the passage of SB 32 has not convinced market participants that ARB has legal authority to implement cap-and-trade after 2020. Market sentiment is an important objective because this proceeding is designed in part to increase interest, and hence demand, at ARB-administered allowance auctions from now until 2020.² Proceeding with this rulemaking is unlikely to restore market confidence; losing a lawsuit concerning ARB's authority to proceed with cap-and-trade in the post-2020 period could do much to damage it.

We are also concerned that the timing of this rulemaking appears to have been driven by a need to finalize rules in order to schedule and hold auctions of post-2020 future vintage allowances according to currently established timelines and procedures. While the stable and predictable administration of the market is a valid concern, we urge the board to weigh a minor procedural deviation against the risk of a potentially successful challenge of authority to implement the post-2020 program at all.

Meanwhile, the Legislature and Governor's office have publicly indicated their intention to revisit the question of post-2020 climate policy and carbon pricing in the upcoming 2017 legislative session. Given these commitments, we urge the Board to weigh the serious risks of proceeding with its proposed regulation against the relatively modest costs of waiting for the Legislature to act next year.

² *Id.* at 16-17 (discussing ARB's proposal to transfer unsold allowances into the Allowance Price Containment Reserve, where the allowances would be made available at \$60 per tCO₂e above the price floor in the post-2020 program). We discuss this issue in detail in Section 3 of our policy comment letter in this docket.

In our judgment, the risks are so significant that the Board should withdraw or delay finalizing the proposed regulation until such time as the Legislature provides clear and specific authority to extend the cap-and-trade or utilize another carbon pricing mechanism in the post-2020 period. If the Board opts instead to proceed with the present rulemaking, it should state clearly and forthrightly why it has legal authority to extend the cap-and-trade program beyond 2020 given Cal. Health and Safety Code Section 38652(c) and Proposition 26. To be clear, we want very much to be convinced by the arguments ARB presents on these issues. But we also believe that the interests of the Board and of the State of California are not well served by failure to address them in the ISOR. We respectfully detail our concerns in greater detail below.

1. CARB should explain its statutory authority under AB 32, as amended, to extend the cap-and-trade program beyond 2020.

Under currently applicable regulations, the cap-and-trade program is authorized only through the end of 2020.³ We note that the market's enabling statute, AB 32, authorizes ARB to develop market-based measures (including cap-and-trade) in order to reduce statewide emissions to their 1990 levels by 2020. However, Section 38562(c)—the provision of AB 32 under which ARB developed and maintains California's cap-and-trade market—is time-limited:

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

³ Cal. Code Regs. tit. 17, §§ 95840-41.

reductions in greenhouse gas emissions, in the aggregate, from those sources or categories of sources.⁴ [Emphasis added.]

The relationship between ARB’s authority to maintain a post-2020 cap-and-trade program and this statutory provision is particularly important for ARB to clarify because the standard judicial interpretation of a time-limited grant of authority is to foreclose the use of that authority after the stated period of time. Thus, a reviewing court would likely presume that the Legislature meant to grant ARB authority to employ a cap-and-trade program through the end of 2020, but not after 2020.

Such an interpretation is all the more likely because other provisions in AB 32 grant authority to ARB in perpetuity. For example, AB 32 provides the authority to maintain statewide emissions at no more than the 2020 statewide target level after 2020.⁵ When a time-limited grant of authority is found alongside a perpetual grant of authority, a reviewing court is even more likely to conclude that the time-limited grant of authority forecloses use of that authority beyond the stated period of time because other provisions in the same statute illustrate that the Legislature intended to distinguish between applicable time horizons. As a result, the broader context of AB 32 makes it even more likely that a reviewing court would interpret Section 38562(c) as foreclosing the authority to continue cap-and-trade after 2020.

If ARB believes Section 38562(c) is ambiguous and should not be interpreted to foreclose the use of cap-and-trade after 2020, the Board has an obligation to explain its reasoning in the proposal. Yet nowhere in its proposed regulation does ARB clearly state that it believes it has the necessary statutory authority to continue cap-and-trade beyond the program’s current expiration at the end of 2020; indeed, the proposal does not mention the time-limited authority issue or refer to Section 38562(c) as even a potential barrier to the legal authority it claims.

⁴ Cal. Health & Safety Code § 38562(c).

⁵ *Id.* at 38551(a) (“The statewide greenhouse gas emissions limit shall remain in effect unless otherwise amended or repealed.”)

Instead, the proposal makes two references to authority to “maintain and continue” emission reductions beyond 2020⁶ and to comply with the Governor’s executive order targets for 2030 and 2050, consistent with existing (but unspecified) statutory authority.⁷ We presume this “maintain and continue” phrase refers to Section 38551 of AB 32:

- (a) The [2020] statewide greenhouse gas emissions limit shall remain in effect unless otherwise amended or repealed.
- (b) It is the intent of the Legislature that the statewide greenhouse gas emissions limit continue in existence and be used to **maintain and continue** reductions in emissions of greenhouse gases beyond 2020. [Emphasis added.]
- (c) The state board shall make recommendations to the Governor and the Legislature on how to continue reductions of greenhouse gas emissions beyond 2020.⁸

As an initial matter, we note that the “maintain and continue” phrasing occurs in an aspirational clause—in subsection (b), the Legislature is declaring its intent, not requiring or explicitly authorizing ARB to achieve deeper targets. Similarly, subsection (c) declares that ARB “shall make recommendations” on how to achieve deeper post-2020 greenhouse gas reductions. Thus, in our view, the plain text of subsections (b) and (c) does not provide a firm basis for ARB to develop post-2020 policies. At a minimum, ARB needs to explain how it interprets these provisions.

In addition, subsection (a) clearly requires that the legally binding 2020 statewide greenhouse gas emissions limit⁹ will continue to apply after

⁶ ISOR at ES-1; *id.* at 1.

⁷ *Id.* at 3.

⁸ Cal. Health & Safety Code § 38551.

⁹ *Id.* at § 38550 (requiring that “the state board shall ... determine what the statewide greenhouse gas emissions level was in 1990, and approve ... a statewide greenhouse gas emissions limit that is equivalent to that level, to be achieved by 2020.”).

2020; thus, the aspirational language of subsection (b) and the advisory nature of subsection (c) indicate that the Legislature intended to differentiate between the requirements of each subsection.

Even if Section 38551(b)'s "maintain and continue" language is strictly binding, and not merely aspirational, it has at best unclear relevance to addressing the apparent time-limited grant of authority to employ cap-and-trade after 2020. It would be entirely logical for a court to interpret AB 32 such that (1) authority to use cap-and-trade would expire in 2020 (per Section 38562(c)), even as (2) the 2020 statewide target continues to apply in 2021 and thereafter (per Section 38551(a)) and (3) ARB has the authority to maintain and continue deeper post-2020 statewide emission reductions (per a robust interpretation of Section 38551(b)). Thus, not even a generous interpretation of Section 38551(b) resolves the time-limited grant of authority in Section 38562(c).

Section 38551 is even less relevant in light of positive developments in the state climate policy that have transpired since ARB issued this regulatory proposal. At the very end of the 2016 session, the Legislature passed SB 32, which the Governor then signed into law.¹⁰ SB 32 is a remarkable accomplishment for climate policy because it codifies the Governor's ambitious objective for 2030—reducing statewide greenhouse gas emissions 40% below their 1990 levels.¹¹

We applaud this outcome but note that SB 32's success frustrates any legal argument that Section 38551 can be used to justify post-2020 authority to employ cap-and-trade. Any argument that Section 38551 authorizes post-2020 statewide emission reductions is now irrelevant in practical terms because SB 32 provides the necessary authority to reach the 2030 statewide emissions target. In turn, the 2030 target implies a consistent

¹⁰ SB 32 (Pavley), Global Warming Solutions Act of 2006: emissions limit, https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201520160SB32

¹¹ Cal. Health & Safety Code § 38556 (as added by SB 32).

trajectory from the relatively less stringent 2020 target towards the more stringent 2030 target.

Furthermore, the legislature's decision in SB 32 not to amend Section 38562(c)'s time limited grant of authority, despite apparent attempts by the Governor to include such language in the bill, might be viewed as significant by a court reviewing the ISOR.

Finally, we note that the more general language at Section 38562(b) requiring ARB to consider the cost-effectiveness of the regulations it adopts to limit greenhouse gases, to consider the overall societal benefits of the program, and to minimize administrative burdens, do not, without a well developed legal theory, allow for the extension of cap-and-trade either. These general provisions would not usually override a more specific, time-limited grant of authority, such as that in Section 38562(c). If ARB believes that they do, it should explain its reasoning.

As a result of the specific time-limited grant of authority to employ cap-and-trade in Section 38562(c) and the general irrelevance of authority to "maintain and continue" emission reductions in light of SB 32, ARB needs to clearly and forthrightly explain its view of the statutory authority to employ cap-and-trade after 2020.

2. CARB should explain why extension of the cap-and-trade under SB 32 does not trigger the provisions of Proposition 26.

SB 32 is a laudable milestone in climate policy. Nevertheless, it does not create clear authority for ARB to continue auctions of government-owned allowances in a cap-and-trade program after 2020 because of the provisions of Proposition 26, which are codified in the California Constitution. Because we believe that auctions of government-owned allowances are a critical component of the current cap-and-trade market design—and that without them and the Greenhouse Gas Reduction Fund, there might not be sufficient political support for this approach to achieving SB 32's goals—we respectfully request that ARB address the applicability of Proposition 26 to its regulation.

Pursuant to Proposition 26, “any change in statute” that raises any taxpayer’s taxes must pass both houses of the legislature by a 2/3 supermajority vote.¹² In turn, Proposition 26 defines “tax” as “any levy, charge, or exaction of any kind imposed by the State.”¹³ Under this expansive definition, the cap-and-trade program’s auction of government-owned allowances almost certainly constitutes a tax for the purposes of Proposition 26 because covered parties that need to obtain these allowances would characterize them as a “levy, charge, or exaction ... imposed by the State.”

It would seem that SB 32 cannot be used to justify extending ARB’s authority to employ allowance auctions after 2020 because SB 32 passed by a simple legislative majority. The reasoning is simple. If SB 32 creates new authority that was not otherwise present in AB 32, it is a change in statute. Any change in statute that causes any taxpayer to pay a higher tax requires a 2/3 supermajority vote.¹⁴ Because extending the cap-and-trade program while retaining the auction of government-owned allowances appears to constitute a tax for the purposes of Proposition 26,¹⁵ SB 32 would have required a 2/3 supermajority vote in order to extend the cap-and-trade program.

If this argument is wrong, ARB needs to explain why. The Proposition 26 issue is well known in policy and legal circles, and therefore the absence of a comprehensive discussion in the current rulemaking lowers, rather than increases, market confidence in the program.

¹² California Constitution, Art. XIII A § 3(a)

¹³ *Id.* at § 3(b).

¹⁴ *Id.* at § 3(a).

¹⁵ We note that this is a separate question from whether the current cap-and-trade program is a “tax” under Proposition 13, *e.g.* as raised in the ongoing *Morning Star Packing Company / California Chamber of Commerce* litigation. California case law recognizes permissive categories of policies that are not considered taxes for the purposes of Proposition 13, which never defined the key term “tax.” These kinds of judicial exemptions are not available for statutory changes made after 2010, after which point Proposition 26 and its expansive definition of “tax” apply.

Because SB 32 passed by a simple majority vote it most likely cannot be used to justify an extension of ARB’s authority to employ cap-and-trade after 2020. Any such authority must be found in the pre-Proposition 26 statutory authority contained in AB 32, or in subsequent statutory changes that are consistent with Proposition 26. We again respectfully request that ARB either articulate a legal justification that addresses these issues or consider withdrawing or suspending the current proposal until future action on the part of the Legislature and Governor clarifies the situation.

We believe there is time to work these issues out. In contrast, finalizing a regulation before their resolution would be extremely unhelpful to achievement of the cap-and-trade’s ultimate objectives.

3. CARB has not identified a firm basis in state law for pursuing a state measures approach to Clean Power Plan compliance.

Finally, we note that ARB has proposed using a post-2020 extension of the cap-and-trade program as a means of complying with the U.S. Environmental Protection Agency’s Clean Power Plan via a “state measures” approach.¹⁶

Under the federal Clean Power Plan,¹⁷ states may choose to develop compliance plans based on so-called state measures that require comparable or greater emission reductions at affected Electricity Generating Units than the mass-based target calculated by EPA.¹⁸ Among other requirements, states pursuing this compliance option must identify the specific laws and/or regulations (*i.e.*, the state measures) that achieve

¹⁶ ISOR at 22-29; *accord* California Air Resources Board, California’s Proposed Compliance Plan for the Clean Power Plan Under Clean Air Act Section 111(d) (Aug. 5, 2016) at 1-2, *available at* <https://www.arb.ca.gov/cc/powerplants/powerplants.htm>.

¹⁷ U.S. Environmental Protection Agency, Carbon Pollution Emission Guidelines for Existing Stationary Sources: Electric Utility Generating Units, 80 Fed. Reg. 64,662 (Oct. 23, 2015).

¹⁸ *Id.* at 64,668 (describing the state measures option).

the emission reductions EPA requires.¹⁹ In turn, each state measure must be “quantifiable, verifiable, non-duplicative, permanent, and enforceable with respect to each affected entity.”²⁰

Absent a clear explanation of ARB’s authority to extend its cap-and-trade program beyond 2020, we do not see how ARB can satisfy EPA’s requirements for a state measures plan.

California is already doing a great deal to reduce greenhouse gas emissions from the power sector—including its bold 50% renewable portfolio standard, to be achieved by 2030²¹—so we are optimistic that the substantive efforts required for Clean Power Plan compliance are well underway. Nevertheless, presenting EPA with a state measures plan that relies on regulations that face significant litigation risks raises the prospect of damaging both California’s and EPA’s credibility at a time when the Clean Power Plan is very much under attack. Particularly given the lack of any currently applicable requirement that ARB submit a state measures plan to EPA until completion of the pending litigation, there are good reasons to continue planning but to delay formalizing a plan at this time—both for EPA’s sake and for California’s. Again, we would be happy to be proven wrong here, but the absence of any argument in the ISOR concerning either the statutory or constitutional provisions that might limit ARB’s authority to act leaves us concerned.

We urge ARB to proceed with caution and note that several alternatives are available. ARB could, for example, wait to develop a formal compliance strategy until it has clear legislative authority to extend cap-and-trade;²²

¹⁹ *Id.* at 64,945 (to be codified at 40 C.F.R. § 60.5745(a)(6)(i)).

²⁰ *Id.* at 64,948 (to be codified at 40 C.F.R. § 60.5780(a)).

²¹ Cal. Public Utilities Code § 399.11(a).

²² The final Clean Power Plan contains an initial deadline for state plan submissions of September 6, 2016. EPA, 80 Fed. Reg. at 64,946 (to be codified at 40 C.F.R. § 60.5760(a)). In addition, states can petition for up to a two-year extension for state plan submissions. *Id.* at 64,947 (to be codified at 40 C.F.R. § 60.5760(b)). In February 2016, however, the Supreme Court stayed implementation of the Clean Power Plan pending the final outcome of

identify other state measures (such as SB 350) that would be sufficient to meet its Clean Power Plan target; or adopt one of the standard rate- or mass-based targets offered by EPA. Simply put, there is no need to rush—and certainly not on anything less than solid legal footing.

4. Unless ARB can articulate a clear and compelling legal basis for extending cap-and-trade beyond 2020, it should withdraw or suspend the proposed regulation and urge the Legislature to act.

We strongly support California’s climate policy leadership and have great respect for the efforts that the Board, ARB Staff, the Legislature, and two successive Governors have brought to bear on this important issue over the past fifteen years. We also believe that market-based climate policies, such as cap-and-trade, will be critical to achieving the deeper emission reductions required for long-term climate mitigation, including SB 32’s target for 2030 as well as the target for 2050 contained in executive orders from Governors Brown and Schwarzenegger.

Nevertheless, we are concerned that ARB’s proposal does not provide a clear and compelling legal basis for extending the cap-and-trade program beyond 2020. That the proposal does not address apparent limitations in the cap-and-trade program’s original authorizing provision nor the limitations created by recent changes to the California Constitution is especially troubling. We respectfully request that ARB either address these issues in a transparent and rigorous manner, or withdraw or suspend the proposed rule with a clear request that the Legislature and Governor provide the necessary authority to act.

Thank you again for the opportunity to comment on the proposed rule. We would be happy to discuss our comments further with ARB Board Members or Staff if there is any interest in doing so.

litigation, effectively suspending the compliance timeline. *West Virginia v. EPA*, 136 S. Ct. 1000 (2016). We believe it is extremely likely that EPA will extend state plan submission deadlines if it is successful in court. As a result, ARB need feel no pressure to prepare the first state plan.

Sincerely,

A handwritten signature in black ink, appearing to read "D. Cullenward". The signature is stylized and cursive.

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