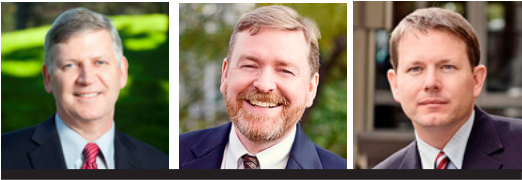


Cap-and-Trade, Legally Challenged



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California's greenhouse gas cap-and-trade program is due to be finalized within a few weeks, over widespread opposition and concern about its effects on California's economy. Looking forward, California business and citizens groups are considering how and when to challenge the regulations in court. Below are some of the likely challenges and their strengths and limitations.

Final regulations in California are subject to judicial review, and may be challenged as being unconstitutional or inconsistent with the statute that authorized their development, or for conflicting with other federal or state statutes. In the case of the Air Resource Board's cap-and-trade program, all of these objections are likely. A successful appeal can invalidate all or part of a new program, and sometimes requires an agency to start a new rulemaking process entirely.

CONSTITUTIONALITY

The most obvious challenge, and one that ARB prepared for, is that the cap-and-trade regulations violate the commerce clause of the federal Constitution. There are at least two ways to frame this argument. The first is that the program discriminates against out-of-state goods or services. The second is that the regulation impermissibly burdens or inhibits interstate commerce.

The cap-and-trade program regulates out-of-state emissions differently than in-state emissions. In the area of electric power, for example, the program is designed to raise the price of generating electricity in-state using fossil fuel, which in turn should reduce electricity consumption. Because ARB cannot directly regulate out-of-state generators,

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electricity importers are subjected to allowance requirements in an indirect path to the same objective.

The program's regulation of natural gas and motor fuel "suppliers," commencing in 2015, is similar. Certain in-state persons (suppliers of petroleum products and natural gas) are covered by the surrender obligation based on volumes of GHG emissions attributable to such fuels. But these obligations vary depending on where in the distribution chain such suppliers or producers are located, with exclusions designed to prevent double counting. Importers, on the other hand, are uniformly regulated by imposing upon them requirements that may not apply to similarly situated in-state suppliers.

On both the electricity and fuels sectors, the express intent of the program's regulation of imports is to prevent "leakage," which is the transfer of emissions (along with economic activity) from in-state to out-of-state sources. But in preventing leakage, it also may prevent out-of-state sources from competing with in-state regulated sources on the basis of price, which may discriminate against the out-of-state sources and inhibit interstate commercial competition.

Burdens on interstate commerce are not necessarily unconstitutional. They can be justified by compelling state interests that fall within the realm of state regulation, such as protection of health and safety, especially if the burden on interstate commerce is minor. But here, California is acting alone in a manner that will not materially influence climate change or the health and well-being of Californians. In its rulemaking process, ARB made no finding that the program would effectively combat climate change or any of the health effects associated with it. The compelling state interest is therefore not identified, and the argument for the constitutionality of the regulations appears relatively weak.

There is also a question of the validity of ARB's program under other constitutional concepts. Federal and state constitutions assign to legislatures the responsibility for enacting substantive legislation and making fundamental policy decisions about health and safety, among other issues. In the case of AB32, the delegation of legislative authority to ARB was very broad and lacked specificity on key issues. Although AB32 authorized market-based regulatory programs, it did not provide any detail about how such a program would be constituted. It is not clear whether ARB's adoption of sweeping regulations governing California and all who do business in the state is an action that can constitutionally be delegated to an administrative agency.

CONSISTENCY WITH AB32

There also are likely to be a large number of objections to ARB's program arising from AB32 itself, based on provisions limiting ARB's authority. Among these requirements, the programs adopted by ARB must be "feasible," "cost-effective" and "equitable." These terms provide ample room for argument as to whether the costs imposed by the program are justified by the benefits, and whether the program could have been designed differently.

A few simple examples illustrate the point. Some entities will receive allowances from ARB for free, and other entities must buy allowances at auction. There is essentially no justification given for the disparities in treatment of those who receive allowances for free and those who do not. Likewise, some parties will be required to purchase allowances, but operate under contracts that may not allow them to recover that cost. There are provisions that provide rebates to utility customers using payments from other sectors of the California economy. ARB has agreed to review these and other open issues at some later point in time. These unresolved issues open the door to arguments that the program is not feasible, or cost-effective, or equitable, and is therefore not consistent with its authorizing legislation.

CONSISTENCY WITH OTHER FEDERAL AND STATE LAWS

There is a question of whether California's regulations conflict with (or complement) federal actions to combat climate change. New and modified power plants and large industrial sources are subject to recently implemented EPA regulations under the Clean Air Act. EPA has identified additional regulations that would address GHG emissions under the Clean Air Act. These federal regulations apply or would apply in California to some of the same entities that are subject to the cap-and-trade program, raising the potential for inconsistencies.

State air quality regulations must

generally conform to federal standards. States may implement requirements more stringent (but not less stringent) than those implemented by EPA. It is unclear whether ARB's rules are "more restrictive" than EPA's regulations. Other cap-and-trade programs implemented under the Clean Air Act have been struck down by courts on the basis that they did not adequately implement the act's health-based requirements. It is possible that California's program could be deemed less restrictive than the Clean Air Act, and therefore be inconsistent with or preempted by federal law.

There are also reasonable arguments that the cap-and-trade program conflicts with California state laws other than AB32. The California Environmental Quality Act requires agencies to comprehensively review the environmental impacts of new regulations. ARB's rules have been reviewed multiple times under CEQA to assess their environmental effects, but the analyses have not necessarily included all issues that could be relevant for a program that will affect California's entire economy. For example, the State Water Project pumps water in part to maintain habitat. If it cuts back on such pumping in response to increased electricity costs resulting from the program, there could be adverse environmental effects. These and other indirect effects were not considered in the CEQA review of the cap-and-trade program.

The cap-and-trade program is also arguably a new tax imposed in violation of Proposition 26, which was enacted by the voters on Nov. 2, 2010, to amend the state Constitution. Prop 26 requires a two-thirds legislative vote to effect a "change in a state statute" that results in any taxpayer paying a higher tax. Under the cap-and-trade program, ARB imposes a minimum fee of \$10 per allowance (equivalent to a metric ton of carbon dioxide equivalents), that is escalated over time. This minimum fee equates to approximately 0.7 cents/kWh for gas-fired generation and over one cent/kWh for coal-fired generation

(which supplies much imported electricity to California). This is the kind of hidden fee that Prop 26 was intended to address — regulatory costs that raise revenue for governmental programs. It looks and sounds a lot like a tax.

The strongest argument that Prop 26 does not apply to the cap-and-trade minimum allowance price is that AB32 predated Prop 26, so the minimum fee was not imposed pursuant to change in a statute. This argument raises the question, however, of whether an agency can by regulation impose a new fee or tax at all. While AB32 broadly delegates to ARB the authority to implement a "market-based" program, there is no authorization for the imposition of a minimum auction price for allowances. The argument that the fee/tax can be imposed by an agency without a change in a statute raises the question of whether agencies can impose new taxes at all, and whether Prop 26 should be interpreted to prohibit such actions even without a change in a statute.

CONCLUSION

Suits challenging the cap-and-trade rules will likely be filed soon. The state's Office of Administrative Law is expected to finally adopt the rules by mid-December. Some claims, like those arising under CEQA, must be filed as soon as 30 days after the Office of Administrative Law posts the CEQA notice of determination.

A complaining party must have participated in the rulemaking process to assert certain claims. Hundreds (and perhaps thousands) of persons did so, representing diverse interests, groups and business sectors. It is entirely possible that dozens of suits could be filed by those persons most motivated to oppose the rules and the groups with which they affiliate. Depending upon the claims and the sympathies of the courts in which such suits are filed, enforcement of the cap-and-trade regulations could be delayed beyond the current implementation date of Jan. 1, 2013.