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M E M O R A N D U M

To: International Emissions Trading Association
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Date: September 20, 2022

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File Number: 081H-252199

Re: California Cap-and-Trade Program Beyond 2030

SUMMARY

Sheppard Mullin has prepared this Memorandum to evaluate whether the California Air Resource Board ("**ARB**") can continue to operate the Cap-and-Trade Program (the "**Program**") beyond December 31, 2030 in the absence of an act of the Legislature to extend the Program. We conclude that the better interpretation of the relevant statutory authority is that ARB can do so, but it is not entirely clear.

The Legislature delegated ARB broad authority to enact regulatory programs that would "achieve the maximum technologically feasible and cost-effective reductions in greenhouse gas emissions," including the authority to adopt market-based programs such as the Cap-and-Trade Program. Cal. Health & Safety Code ("**HSC**") §§ 38560, 38562(a). In the administrative process leading to the promulgation of the Program, ARB adopted findings that the Program will "achieve the maximum technologically feasible and cost-effective reductions in greenhouse gas emissions." Those findings will be afforded substantial deference by any court considering ARB's authority to implement the Program. It follows that there is a strong argument in favor of ARB's continuing authority to implement the Program after 2030 under the Legislature's broad

delegation of rulemaking authority in Sections 38560[1] and 38562(a), neither of which include a sunset provision.

A separate provision, however, specifically permits ARB to establish "a system of market-based declining annual aggregate emissions limits," and arguably limits the applicability of that program to the period from January 1, 2012 to December 31 2030. HSC § 38562(c)(2). It could be argued that, because this provision specifically applies to a cap-and-trade program, it trumps the more general delegation of rulemaking authority in Sections 38560 and 38562(a), and therefore that ARB does not have authority to implement the Program beyond 2030. Although there are major flaws in that argument, the mere existence of a colorable argument that the Program will sunset in 2030 is enough to create uncertainty regarding the long-term future of the Program, as a judicial challenge could be brought were ARB to adopt regulations extending the Program beyond 2030. As discussed below, we believe that a court would reject such a challenge, but it would take time and entail still more uncertainty.

Of course, the Legislature could clarify ARB's authority to implement the Program and thereby avoid having this uncertainty resolved by a future court. Any such Legislative action can be enacted by a simple majority of both chambers. Because uncertainty regarding the future of the Program creates distortions in the value of allowances and threatens to undermine confidence in the market, the sooner the Legislature acts to clarify ARB's authority, the better.

BACKGROUND

The California Global Warming Solutions Act of 2006 (the "**Act**" or "**AB 32**") designates ARB as "the state agency charged with monitoring and regulating sources of emissions of greenhouse gases that cause global warming in order to reduce emissions of greenhouse gases." HSC § 38510. Among other provisions, AB 32 required ARB, by January 1, 2008, to "determine what the statewide greenhouse gas emissions level was in 1990, and approve . . . a

[1] All references to code sections herein are to the HSC, the California Health and Safety Code.

statewide greenhouse gas emissions limit that is equivalent to that level, to be achieved by 2020 [the "**2020 Goal**"]." *Id*. at § 38850. The 2020 Goal was intended to remain in effect indefinitely and the Act expressly calls for continued "reductions in emissions of greenhouse gases beyond 2020." *Id*. at § 38551; *see also Assoc. of Irritated Residents v. Cal. Air Resources Bd.*, 206 Cal.App.4th 1487, 1496 (2012) ("***AIR***") (the 2020 Goal is "neither designed to limit nor do[es it] have the effect of limiting emissions reductions if greater reductions can be achieved.").

To achieve the 2020 Goal, the Act required ARB to prepare a scoping plan for "achieving the maximum technologically feasible and cost-effective reductions in greenhouse gas emissions," which plan would "identify and make recommendations on . . . market-based compliance mechanisms . . . that [ARB] finds are necessary or desirable to facilitate the achievement of the maximum feasible and cost-effective reductions of greenhouse gas emissions by 2020." HSC § 38561 (emphases added). In December 2008 ARB adopted Resolution No. 08-47, which recited that "[t]he recommendations in the Proposed Scoping Plan are necessary or desirable to facilitate the achievement of the maximum feasible and cost-effective reductions of greenhouse gas emissions by 2020." (Emphasis added.) On May 7, 2009, ARB issued Order No. G-09-001 adopting the final scoping plan (the "**Scoping Plan**"). Among the 18 categories of emissions reduction measures recommended in the Scoping Plan was the cap-and-trade program (defined above as the "**Program**").

Echoing the directive of the Scoping Plan, Section 38560 required ARB to adopt regulations "to achieve the maximum technologically feasible and cost-effective greenhouse gas emission reductions . . . subject to the criteria and schedules set forth in this part." Those criteria and schedules are set forth in Section 38562, which required ARB to adopt emission reduction measures by January 1, 2011 and which provided nine statutory guidelines that ARB was required to follow "to the extent feasible and in furtherance of achieving the statewide greenhouse gas emissions limit." The Act also expressly permitted ARB to adopt regulations to establish a cap-and-trade program:

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

HSC § 38562(c) (later amended, as discussed below). Section 38570 further empowered ARB to adopt market-based compliance mechanisms: "The state board may include in the regulations adopted pursuant to Section 38562 the use of market-based compliance mechanisms to comply with the regulations."

In late 2011, following a robust public rulemaking process, ARB promulgated the regulations that created the Program. Cal. Code Regs., tit. 17, § 95801 *et seq*. The October 28, 2010 Staff Report prepared in support of those regulations concluded that the proposed cap-and-trade program would minimize the costs associated with achieving statewide emissions reduction goals. ARB began implementation of the Program on January 1, 2012.

In July 2016, ARB issued proposed regulations that would, among other things, extend the cap-and-trade program beyond 2020. That action triggered a robust debate regarding whether ARB had authority to extend the program, given the language of Section 38562(c), above, which could be interpreted as limiting the applicability of the Program to "January 1, 2012, to December 31, 2020." That debate was never resolved, however, because in July 2017, the Legislature enacted both SB 32, which established a new statewide emission reduction goal to be achieved by 2030 (the "**2030 Goal**"), and AB 398, which replaced the operative language of Section 38562(c) with Section 38562(c)(2):

> The state board may adopt a regulation that establishes a system of market-based declining annual aggregate emissions limits for sources or categories of sources that emit greenhouse gases, applicable from January 1, 2012, to December 31, 2030, inclusive, that the state board determines will achieve the maximum technologically feasible and cost-effective reductions in greenhouse

> gas emissions, in the aggregate, from those sources or categories of sources.

AB 398 also provides that the 2017 version of Section 38562(c)(2) will automatically be repealed as of January 1, 2031, and the former language of Section 38562(c) as enacted in AB 32 will be reinstated. HSC § 38562(h). Notably, however, AB 398 did not substantively amend the broad and open-ended rulemaking authority delegated to ARB in Section 38560, Section 38570, and subsections (a) and (b) of Section 38562.

The California Legislature recently adopted and the Governor signed a suite of new climate-related legislation, including AB 1279 which establishes a new statewide goal of achieving net zero greenhouse gas ("**GHG**") emissions by 2045 with anthropogenic GHG emissions 85% below 1990 levels (the "**2045 Goal**"). Unlike AB 398, however, this legislation does not include any amendment to the outside date in AB 398's Section 38562(c)(2) or AB 32's Section 38562(c). As a result, there is some uncertainty regarding ARB's authority to continue to implement the Program after 2030 under the statutory scheme as currently configured even though ARB now must work to meet the 2045 Goal.

As discussed below, there is a strong argument, rooted in the statutory language, that ARB *does* have the authority to continue to implement the program after 2030. Indeed, we believe it to be the better argument. However, the argument against ARB's continuing authority has enough merit so as to inject uncertainty regarding the continued viability of the Program, as an administrative extension of the Program beyond 2030 could be challenged in court. That uncertainty distorts market incentives and the future value of allowances, and thereby undermines confidence in the Program by market participants.

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ANALYSIS

A. There is Uncertainty Regarding Whether ARB Can Continue to Administer the Cap-and-Trade Program After December 31, 2030.

1. *There is a Strong Argument in Favor of ARB's Authority to Implement the Program Beyond 2030.*

The argument in favor of ARB's continuing authority to implement the Program after 2030 is rooted in the statutory language and regulatory history. Specifically, the Legislature delegated broad authority to ARB to adopt regulations that "achieve the maximum technologically feasible and cost-effective greenhouse gas emission reductions." HSC §§ 38560, 38562(a) & (b), 38570. As the California Court of Appeal has repeatedly recognized, this statutory directive granted ARB rulemaking authority that is "exceptionally broad and open-ended." *AIR*, 206 Cal.App.4th at 1495; *Our Children's Earth Foundation v. State Air Resources Control Bd*., 234 Cal.App.4th 870, 888 (2015) (same); *see also Cal. Chamber of Commerce v. State Air Resources Bd*., 10 Cal.App.5th 604, 619 (2017) ("***Cal. Chamber***") ("the Legislature conferred on the Board extremely broad discretion to craft a distribution system").

Consequently, it could be persuasively argued that ARB adopted and implements the Program pursuant to the broad and open-ended authority granted to the agency under Section 38560, Section 38562(a) & (b), and Section 38570. Notably, none of those provisions include a sunset clause, meaning that ARB's authority under those provisions continues after 2030, consistent with the spirit of Section 38551(b) which provides that "[i]t 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 emission of greenhouse gases beyond 2020."

Further supporting this position, Sections 38560 and 38562(a) both use mandatory language directing ARB to adopt regulations "to achieve the maximum technologically feasible and cost-effective reductions in greenhouse gas emissions." ARB Resolution No. 08-47 included a finding that "[t]he recommendations in the Proposed Scoping Plan are necessary or desirable to facilitate the achievement of the maximum feasible and cost-effective reductions of

greenhouse gas emissions by 2020." The October 28, 2010 Staff Report prepared in support of ARB's regulations creating the Program concluded that the proposed cap-and-trade program would minimize the costs associated with achieving statewide emissions reduction goals. Those administrative findings, and many others, support ARB's authority to adopt regulations creating the Program under Sections 38560 and 38562(b). In any potential litigation challenging ARB's authority, those administrative findings will be afforded "great deference," *Cal. Chamber*, 10 Cal.App.5th at 621, and thus it is likely that a court would uphold any future ARB regulations that extended the Program beyond 2030 (akin to those that ARB proposed in 2016).

In addition, a close reading of Section 38562(c)(2) undermines the argument, discussed in more detail below, that the provision limits ARB's authority to implement the Program to the period of 2012 through 2030. The operative language of Section 38562(c)(2) provides: "The state board may adopt a regulation that establishes a system of market-based declining annual aggregate emissions limits for sources or categories of sources that emit greenhouse gases, applicable from January 1, 2012, to December 31, 2030, inclusive . . . ." Two things stand out. First, unlike Sections 38560 and 38562(b), the provision is discretionary and not mandatory: ARB "*may* adopt a regulation . . . applicable from January 1, 2012, to December 31, 2030 . . . ." The logical corollary is that ARB also may choose to *not* adopt a regulation applicable from 2012 through 2030, but rather an open-ended regulation. Second, the regulation that may be adopted under Section 38562(c)(2) is one "that establishes . . . declining annual aggregate emissions limits." Thus, the statute can be read to mean that it is ARB's authority to reduce the cap, and not its authority to implement the Program, that sunsets in 2030. Under this interpretation, ARB can continue to implement the Program after 2030 so long as the cap does not decline.

That interpretation is further supported by the practicalities of implementing the Program. There is no dispute that AB 398 grants ARB authority to require Covered Entities to surrender compliance instruments for GHG emissions that occur through 2030. Under ARB's regulations,

allowances for emissions that occur in 2030 would not be required to be surrendered until *after* 2030. Further, ARB auctions allowances several years in advance. If ARB's authority to implement the Program were to end altogether in 2030, ARB would not have the authority to require Covered Entities to surrender allowances for GHG emissions that occurred in 2030 and allowances purchased during the Program's lifetime would be rendered valueless. If, however, ARB's authority to implement the Program continued beyond 2030, but Section 38562(c)(2) required that the cap remain at the 2030 level, neither of these significant logistical problems would arise. This is the only reading that is in accord with the intent of the Legislature, as otherwise the Program would have to cease several years before 2030 to prevent such chaos and loss of value, which would render meaningless the provision's 2030 date.

That said, neither this reading nor the one that effectively would require ARB to discontinue the Program several years *before* 2030 is entirely sensible. "The words of a statute should be interpreted to make them workable and reasonable" considering "the consequences that will flow from a particular statutory interpretation." *In re A.M.*, 225 Cal.App.4th 1075, 1081 (2014). If read broadly to provide a hard sunset date for the Program, Section 38562(c)(2) would undermine ARB's ability to implement the Program through 2030, as discussed above. If, on the other hand, only ARB's authority to reduce the cap over time sunsets in 2030, that would hamstring other elements of the Program, including ARB's ability to achieve the 2045 Goal under AB 1279. It's likely that the Legislature did not appreciate these nuances when it adopted AB 398 and AB 1279, as the Program with its system three-year compliance periods has been operating since 2012. This adds further weight to the argument set forth above that Section 38562(c) is essentially discretionary and that ARB has the authority to extend the Program under the mandatory language in Section 38560, Section 38562(a) & (b), and Section 38570, as the language in those provisions is crystal clear and has been upheld by the Court of Appeal on several occasions.

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2. *Section 38562(c)(2) Creates Uncertainty Regarding ARB's Authority to Implement the Program Beyond 2030.*

Although ARB has broad authority to adopt and implement regulations under the Act, there is an argument that its authority with respect to a cap-and-trade program sunsets in 2030. A common maxim of statutory construction provides that "[w]here general and specific statutory provisions are conflicting, the specific provision prevails over the general one." *Nelson v. City of Gridley*, 113 Cal.App.3 87, 94 (1980). Section 38562(c)(2) and its predecessor under AB 32 both apply specifically to ARB's promulgation of regulations "that establish[] a system of market-based declining annual aggregate emissions limits for sources or categories of sources that emit greenhouse gases." That section includes a qualification that arguably means such a regulation would be "applicable from January 1, 2012, to December 31, 2030, inclusive." Sections 38560 and 38562(a), by contrast, apply more generally to ARB's promulgation of regulations establishing "emissions reduction measures" and include no sunset provision. It could be argued that ARB's authority to adopt and implement a cap-and-trade program arises exclusively from Section 38562(c)(2), the more specific provision, and that that authority sunsets in 2030.

That argument, while perhaps compelling at first blush, suffers from a couple infirmities. First, as noted above, Section 38562(c)(2) is permissive, rather than mandatory. It provides that ARB "may" adopt a regulation establishing a cap-and-trade program effective from 2012 through 2030, but it does not require ARB to do so. Sections 38560 and 38562(a), on the other hand, use mandatory language providing that ARB "shall" adopt regulations establishing emission reduction measures "to achieve the maximum technologically feasible and cost-effective reductions in greenhouse gas emissions."

Second, and perhaps most compellingly, the "specific over general" maxim governs only in limited circumstances. "A specific provision controls over a general provision when the provisions are 'irreconcilable.' For that reason, the application of the rule stated above requires

an inquiry into whether the provisions can be harmonized in a manner reflecting the Legislature's intent." *Flowers v. Prasad*, 238 Cal.App.4th 930, 936 (2015). Here, there is a reasonable interpretation that reconciles the broad general delegation of rulemaking authority to ARB in Sections 38560 and 38562(a) and the more specific provision of Section 38562(c). As discussed above, one viable interpretation of Section 38562(c)(2) is that the sunset provision applies only to ARB's establishment of "declining annual aggregate emissions limits." Because this interpretation harmonizes the various statutory provisions and gives effect to each, it undermines application of the "specific over general" maxim. For these reasons, we believe it likely that a court would reject a challenge on this basis to any future regulations that extended the Program beyond 2030.

B. **The Uncertainty Regarding the Program's Future Could be Resolved by the Legislature with a Simple Majority Vote in Each Chamber.**

Regardless of which interpretation best reflects the intent of the Legislature, the mere existence of a colorable argument that ARB's authority to implement the Program sunsets in 2030 casts a cloud of uncertainty over the future of the Program. That is all the more the case now because in 2022 the Legislature established the 2045 Goal but made no accompanying change to Section 38562 as it had when it adopted the 2030 Goal in 2017. It could be argued that not extending Section 38562(c)(2) through 2045 reflected the Legislature's understanding that ARB already has authority to implement the Program beyond 2030. Or it could be interpreted as purposeful inaction to allow the Program to sunset. The 2045 Goal thus only heightens the uncertainty surrounding the Program's future.

The market is already beginning to see distortions due to these uncertainties. The potential for the Program to sunset in 2030 is leading to skewed incentives, with some stakeholders making decisions regarding the disposition of allowances on the basis of a possible sunset in 2030. If the Program were to sunset, it would not be long before the value of allowances would be degraded, which may lead stakeholders to divest allowances they

otherwise would bank beyond 2030 in anticipation of increased value and utility as compliance instruments. The uncertainty regarding the Program's future is creating volatility in a market that requires stability for efficient functioning. The closer we come to 2030, the more pronounced these distortions are likely to become.

Some have argued that any legislative action to extend the Program would require a two-thirds majority vote by each chamber under Proposition 26, but that position ignores binding precedent of the California Court of Appeal. Proposition 26 requires a two-thirds majority vote of both chambers of the Legislature to enact any "change in state statute which results in any taxpayer paying a higher tax." Cal. Const., article XIII A, § 3. Proposition 26 defines a "tax" as "any levy, charge, or exaction or any kind." *Id*.

The two-thirds majority rule of Proposition 26, however, applies only where a tax, fee or charge is "imposed by the State." Cal. Const., article XIII A, § 3. Although the term "imposed" is not defined, its common meaning is to "forcibly put (a restriction) in place" or to "require (a duty, charge, or penalty) to be undertaken or paid." Oxford English Dictionary, 2022.

Proposition 26 would not apply to a Legislative extension of the Program because no levy, charge or exaction is "imposed by the State" under the Program. The Court of Appeal has held that the auction of GHG emission allowances "is *a voluntary decision* driven by business judgments as to whether it is more beneficial to the company to make the purchase than to reduce emissions." *Cal. Chamber*, 10 Cal.App.5th at 614 (emphasis added). The Court expressly rejected the notion that participation in the auction is compulsory, noting that Covered Entities "can comply with the cap-and-trade rule without participating in the auction or reserve, including by reducing emissions, purchasing allowances from third parties, using banked allowances from prior years, and purchasing or earning emission offsets." *Id*. at 642.

Although the *Cal. Chamber* case was decided under Proposition 13, its holding that the purchase of GHG emission allowances is voluntary is binding on future courts that may address challenges to the allowance auctions under Proposition 26. Further, although the *Cal. Chamber*

case was decided by the Third Appellate District, one of several such districts in the State, its holding is binding on all trial courts statewide. There is only one Court of Appeal in California.

The auction of allowances is the only provision of a Program extension that would arguably invoke Proposition 26. Because it is established law that participation in the auction of allowances to comply with the State's GHG emission reduction requirements is voluntary, it follows that the purchase of allowances is not "imposed" by the State, and therefore is not subject to the two-thirds majority vote requirement of Proposition 26. The Legislature can pass an extension of the Program by a simple majority vote in each chamber.

CONCLUSION

While there is a colorable argument that ARB lacks the authority to extend the Cap-and-Trade Program by regulatory action, the better interpretation of the relevant statutory authority is that it does possess the authority to do so. As discussed above, this reading is both more sensible and practicable, and it aligns with AB 32's "exceptionally broad and open-ended" grant of rulemaking authority to ARB. *AIR*, 206 Cal.App.4th at 1495; *see also Cal. Chamber*, 10 Cal.App.5th at 619. Nonetheless, as long as there is a colorable argument that ARB lacks the authority to do so, there is the possibility of a judicial challenge to any regulatory extension of the Program. This creates uncertainty that distorts the market and thus undermines the purposes of the Program. It would be preferable for the Legislature to clarify ARB's authority to extend the Program beyond 2030, just as it did in 2017 when it adopted the 2030 Goal but did not do when it recently adopted the 2045 Goal. Lastly, under the binding precedent of the *Cal. Chamber* decision, it is quite clear that Proposition 26 would not apply to such an act by the Legislature; it can do so by a simple majority vote.