



# PACIFIC LEGAL FOUNDATION

May 23, 2016

The Honorable Justice Hull, Acting Presiding Justice  
California Court of Appeal, Third Appellate District,  
Stanley Mosk Library and Courts Building  
914 Capitol Mall, 4<sup>th</sup> Floor  
Sacramento, CA 95814

Re: Consolidated Appeals C075930 & C075954; California Chamber of Commerce v. California Air Resources Board and Morning Star Packing Co. v California Air Resources Board; Request for Supplemental Letter Briefs

Dear Justice Hull and the Justices of the California Court of Appeal, Third Appellate District:

Morning Star Packing Co., et al., Appellants in Case Number C075954, respectfully submit the following responses to the Court's questions, as set forth in the Court's letter of April 8, 2016, requesting that the parties provide supplemental letter briefs. To the extent Appellants have been able, they have joined in portions of the supplemental briefs being submitted by Appellants California Chamber of Commerce and National Association of Manufacturers in Case Number C075930.

## INTRODUCTION

As context for the following responses, it is important to distinguish between the emissions Allowances themselves, and the auction payments that are necessary to obtain them. Morning Star's lawsuit challenges the requirement to make auction payments to obtain Allowances, but does not challenge, in this lawsuit, the requirement as a Covered Entity to obtain and then surrender Allowances to match its greenhouse gas emissions under the Cap and Trade Program.

Also as context, Morning Star presents the following brief overview of the Cap and Trade Regulation. The purpose is to identify the precise provisions in the Regulation which violate Proposition 13, so that the Court may then fashion appropriate relief which leaves the Cap and Trade Regulation intact while enjoining further unconstitutional collection of auction revenue.

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**A. The Cap and Trade Regulation limits the aggregate greenhouse gas emissions of Covered Entities by requiring them to surrender Allowances equal to their emissions, and limiting the number of Allowances.**

The Cap and Trade Regulation is Article 5 of Subchapter 10, Chapter 1, Division 3 of Title 17 of the California Code of Regulations. Cal. Code Regs. tit. 17, § 95801, *et seq.*<sup>1</sup> A brief summary of the relevant subarticles follows, with particular focus on Subarticle 8.

Subarticle 3 (Applicability) identifies the covered gases, the Covered Entities (those who must comply with the regulation), and the inclusion threshold for Covered Entities (generally 25,000 tons CO<sub>2</sub>e annual reported emissions). *Id.* §§ 95810-95812.

Subarticle 6 establishes three multi-year compliance periods (2013-2014, 2015-2017, and 2018-2020), and establishes the declining annual greenhouse gas allowance budgets for each year of the program, from 2013 through 2020. *Id.* §§ 95840-95841. This is the central operative provision of the regulation. It limits the aggregate annual emissions of Covered Entities to the amount stated in the allowance budget for that compliance period. *See* table at *id.* § 95841.

Subarticle 7 establishes the compliance requirements for Covered Entities. *Id.* §§ 95850-95858. The basic obligation for Covered Entities is to surrender Allowances (or, for a limited portion of their obligation, offset credits) equal to the amount of their annually reported emissions. Cal. Code Regs. tit. 17, §§ 95850(b), 95854, 95856(a).

Subarticles 6 and 7 are what accomplish the emission reductions and limitations in the Cap and Trade Regulation. Subarticle 6 sets the annual declining emissions cap for Covered Entities, and Subarticle 7 establishes the surrender of Allowances, equal to the amount of emissions, as the means of holding Covered Entities to the cap in the aggregate. Nothing in this case challenges any provision of these two subarticles, and the relief sought in this case will not impede the accomplishment of the emission reductions and limitations required by the Regulation.

**B. The Cap and Trade Regulation requires Covered Entities to obtain Allowances, and then distributes some Allowances for free while auctioning the rest to the highest bidders.**

Covered Entities are required to submit Allowances in order to comply with the Regulation. CARB creates and distributes the Allowances, and this case is only about how CARB does that. Subarticle 8, Section 95870, directs the Executive Officer to distribute Allowances first to various classes of

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<sup>1</sup> Unless otherwise noted, subsequent section references are to Title 17 of the California Code of Regulations.

recipients<sup>2</sup> for free, and then to sell all of the rest of the Allowances at auction.<sup>3</sup> Auctioning the Allowances is what violates Propositions 13, particularly since a large number of identical Allowances are given out for free.

It is important to the discussion on remedies below to note that the auction is the default means of distributing any given allowance which CARB mints. Allowances are auctioned unless they are otherwise specifically distributed for free (under Section 95870(c)-(h)) or through the two special purpose auctions (under Section 95870(a)-(b)). “[A]ll remaining Allowances” not specifically distributed in one of these methods are “designated for sale at auction.” *Id.* § 95870(i)(2).

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<sup>2</sup> Subsection 95870(c) establishes a Voluntary Renewable Electricity Reserve Account, which receives a very small fraction of the Allowances from each annual budget. *Id.* § 95870(c). Subsection 95870(d) allocates a significant portion of each year’s Allowances (97.7 million, modified by a factor set forth in the regulation) to electrical distribution utilities without charge. *Id.* § 95870(d). Subsection 95870(e) distributes Allowances free of charge to several sectors of industrial Covered Entities, according to a formula and factors set forth in a table in the regulations. *Id.* § 95870(e). Subsection 95870(f) allocates Allowances to universities and public institutions, and Subsections 95870(g) and (h) provide other specific free allocations.

<sup>3</sup> Subsections 95870(a), (b), and (i)(2) distribute the balance of the Allowances to an Allowance Price Containment Reserve, funded with from 1-7% of the Allowances for each year, depending on the compliance period, *Id.* § 95870(a), an advance auction for future budget year Allowances, funded with 10% of the Allowances for the second and third compliance periods, *Id.* § 95870(b), and a general auction, funded with all of the Allowances not distributed otherwise, *Id.* § 95870(i)(2).

**RESPONSES TO SUPPLEMENTAL BRIEFING QUESTIONS**

**I**

**THE ALLOWANCES LIMIT  
RATHER THAN CONFER PROPERTY RIGHTS,  
AND THE AUCTION PAYMENTS ARE NOT VALID  
REGULATORY FEES BECAUSE THEY DO NOT REFLECT A  
REASONABLE APPORTIONMENT OF PAYMENTS AMONG COVERED ENTITIES.**

Morning Star joins the responses to this question<sup>4</sup> in the separate briefs filed by the California Chamber of Commerce and the National Association of Manufacturers, and adds the following response.

**A. As to Morning Star, the Allowances limit the use of property rather than conferring property.**

Morning Star is a Covered Entity. Prior to the adoption of the Cap and Trade Regulation, it was able to use its property, specifically the natural gas fired boilers and other equipment in its three facilities, with respect to the total greenhouse gas emissions from the use of that property. The Regulation limits Morning Star's use of its boilers and other emitting facilities, by requiring the surrender of an Allowance for each ton of CO<sub>2</sub>e emitted by them. *Id.* §§ 95850(b), 95854, 95856(a). Morning Star holds Allowances only for the purpose of surrendering them back to CARB in compliance with the Regulation.

Morning Star does not own anything that it did not own prior to obtaining Allowances. When Morning Star surrenders its Allowances, it owns exactly what it did the moment before surrender: boilers, other emitting equipment, and the natural gas or other fuel to operate them. Nor do the Allowances permit Morning Star to acquire any property, such as fuel (as a ration card might), or boilers or other emitting equipment. The Allowances simply and only limit Morning Star's use of its property.

This is the purpose of the Allowances — to limit the use of property to the extent such use creates greenhouse gas emissions. All emissions come from the use of various types of property (boilers,

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<sup>4</sup> The Court's question is directed to "auction credits," which is not a term used in the Regulation. Morning Star understands the Court's question to be directed at why CARB does not consider Allowances to confer any property right. *See Id.* § 95820(c) ("A compliance instrument . . . does not constitute property or a property right."); *Id.* §95802(a)(69) (compliance instrument includes Allowances).

other industrial equipment, automobiles, electrical power plants, home and business heating, and cooking equipment), and the purpose of the Regulation is to limit the aggregate emissions from Covered Entities' use of their property. The overall purpose of AB 32 is to reduce emissions; one can see why CARB would take the view that while the Allowances "represent[] a limited authorization to emit," *Id.* § 95820(c), the agency does not wish to create, or suggest that it is creating, a property right in the authorization to emit.<sup>5</sup>

**B. Even if the Allowances had any characteristics of property, they are essentially permits, and free distribution of some while multi-billion dollar auction payments are made for others is not a fair and reasonable allocation under *Sinclair Paint*.**

Since the Allowances limit the use of Covered Entities' property, the proper view of them is that they are permits, and not property, as stated in the Regulation: "Each [Allowance] . . . represents a limited authorization to emit . . . ." *Id.* § 95820(c). The limited number and transferability of the Allowances, and the resulting market for them, may be unusual attributes for a permit, but any such characteristics are incidental to their fundamental nature as permits for emitting activities. Any regulatory fee incident to the issuance of permits must meet the requirements of *Sinclair Paint Co. v. State Board of Equalization et al.*, 15 Cal. 4th 866, 878 (1997). There is no authority for the proposition that adding novel ancillary attributes to what is essentially a permit excuses the agency from compliance with *Sinclair Paint*, when it imposes a payment for the issuance of that permit.

Also, the ability to trade the permits on a secondary market is unrelated to the requirement that Morning Star and other Covered Entities make auction payments for their initial issuance. CARB issues many Allowances for free. These free Allowances are just as tradeable as the auctioned Allowances, but no auction payment is required for their issuance. So even if there were some aspect of an Allowance under which it could be considered property, the fact that some are issued for free while others are sold to the highest bidders at auction violates *Sinclair Paint*. 15 Cal. 4th at 878 (fair and reasonable apportionment of fees based on payor's burdens or benefits).

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<sup>5</sup> This is without prejudice to whether there are property rights which the Allowances infringe. That question is not posed in this case, and the question posed by the Court is why CARB takes the position that the Allowance confers no property interest.

## II

### **THERE IS NO RELATIONSHIP AT ALL BETWEEN THE AUCTION PAYMENTS AND THE EMISSIONS OF THE COVERED ENTITIES WHO MAKE THE PAYMENTS**

Morning Star joins in the response to this question in the separate brief filed by the National Association of Manufacturers,<sup>6</sup> and adds the following response.

**A. The legally relevant relationship is between the auction payments and the issuance of the emissions Allowances, not the auction payments and the emissions.**

The Allowances have a direct relationship to the permitted emissions of Covered Entities: an Allowance is equal to one ton CO<sub>2</sub>e of emissions. *Id.* § 95820(c). But not all of the Allowances are auctioned. So the auction payments are not related to any Covered Entity's emissions in any way. The only relationship involving the auction is between the auction payments and the issuance of some of the Allowances. And that relationship is merely the desire and financial ability of the winning bidder to make a winning bid, relative to other bidders' desire and ability to do so.

The auction payments are not related in any way to emissions from Covered Entities. They are payments made for initial distribution (or issuance) of the Allowances (or permits), and as such they are not related in any way to a bidding Covered Entity's emissions. Indeed, some winning bidders are not even Compliance Entities, and do not have any compliance obligation under the Regulation, or emit any Greenhouse Gases. There is no way to determine, from the amount of the auction payments, what impact any winning bidder has on global climate change, either in the absolute or relative to any other winning bidder. Indeed, even between competing Covered Entities in the same auction, the fact that a winning bidder obtains Allowances by making an auction payment, while a losing bidder pays (and gets) nothing, tells nothing worth knowing about each Covered Entity's total emissions or compliance obligation.

The August 2, 2013 Rabo Declaration ¶¶ 12-14, establishes that several factors, which are independent of Morning Star's emissions or compliance obligation, drive its participation in the auction, including the prohibitive cost of emissions reduction technology, the higher number of Allowances available in earlier allowance budget years, and uncertainty about future emissions due to factors such as global markets, crop pests, and weather. JA 1398-99. Most or all of these factors will have different specific impacts on other Covered Entities, even those with identical emissions.

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<sup>6</sup> Morning Star particularly joins the argument that CARB has the burden of demonstrating this relationship from the record, that CARB has refused to do so, and that the record has no evidence of such a relationship.

This renders the amount of the auction payment meaningless as a measure of any Covered Entity's emissions or the climate impact of those emissions.

**B. With roughly half the Allowances distributed for free, there is no reasonable relationship between multi-billion dollar auction payments and the issuance of the auctioned Allowances.**

Even if the auction payments were in any sense related to the emissions of Covered Entities, the auction payments still fail under *Sinclair Paint* because the auction does not apportion the cost of allowance issuance fairly or reasonably among Covered Entities. All covered emissions must be matched with Allowances in order to preserve the cap. Some Allowances are distributed for free, while others are distributed only for an auction payment. Yet each allowance is identical: it permits one ton of emissions.

“Free” or “Highest Price Set At Auction” is the way that the Regulation apportions the cost of the Allowances. There is nothing fair or reasonable in this type of binary apportionment. It reflects no differences in the nature or quality of the Allowances (there are none), the Covered Entities (see above discussion of the Rabo Declaration), or the Covered Entities' emissions. Some auction payments are made by bidders with no compliance obligation or emissions. The price paid at auction reveals nothing about how many tons of emissions any particular Covered Entity will emit, and is not fairly or reasonably apportioned with those Allowances that are distributed for free.

### III

**THE EMISSIONS ALLOWANCES  
PERMIT NO NEW DEVELOPMENT WHILE  
LIMITING EXISTING LAND AND OTHER PROPERTY USES  
THAT WERE ALREADY FULLY PERMITTED, NOR WOULD THE  
AUCTION PAYMENTS BE VALID DEVELOPMENT FEES IN ANY EVENT**

Morning Star joins in the response to this question in the separate brief filed by the National Association of Manufacturers, and adds the following response.

**A. Morning Star's boilers and other facilities were fully permitted prior to the imposition of the requirement for emissions Allowances, which permit Morning Star to do nothing it could not before and which actually limit previously permitted land uses.**

As discussed above in response to Question One, the Allowances only limit existing uses of property. They do not permit new uses of property. But a development permit is precisely a permit to put property to new uses. *See generally* Miller and Starr, California Real Estate 4th Edition,

Section 21:8, and cases cited (discussing legal rights to continue existing uses after zoning changes render them non-confirming). There is nothing about the Allowances that is akin to a development fee, because there is no development that is permitted by the Allowances. An Allowance is better considered the opposite of a development permit: it prevents existing uses of property, instead of allowing new uses. All that an Allowance permits is the emission of a ton of CO<sub>2</sub>e. Those permitted emissions occur through the use of equipment that, for Morning Star and most if not all other Covered Entities, was previously fully permitted under applicable local land use laws. The Allowances do not permit Morning Star to use any boiler that was not previously permitted, or even to modify any boiler to the extent a modification would require a land use permit from a county or other local government.

Development permits generally implement local land use laws. *See DeVita v. County of Napa*, 9 Cal. 4th 763, 782 (1995) (local land use authority is inherent, not delegated from state). Other than the California Coastal Commission and Bay Conservation and Development Commission, no state agency issues or approves development permits.<sup>7</sup> *See generally* Miller and Starr, *supra*, Section 21:1 (land use regulation primarily a local matter). It would be a novel departure to consider something like a Cap and Trade Allowance to be a development permit, particularly for the mere purpose of avoiding calling it an illegal tax, and Morning Star is not aware of any authority that would allow such a departure.

One significant consequence of legally classifying the Allowances as development permits would be to subject the auction payments to the Unconstitutional Conditions Doctrine as applied to land use permitting by *Nollan v. California Coastal Commission*, 483 U.S. 825 (1987), *Dolan v. City of Tigard*, 512 U.S. 374 (1994), and *Koontz v. St. Johns River Water Management District*, 133 S. Ct. 2586 (2013). As a consequence, CARB would bear the burden of proving that any given auction payment had a substantial nexus with and was roughly proportional to the emissions of the Covered Entities who make the auction payments. Since, as discussed above, there is no such relationship, classifying the Allowances as development fees would simply expose CARB to additional constitutional liability.

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<sup>7</sup> Many state agencies, for example the State Water Resources Control Board and Regional Water Quality Control Boards, comment on and require mitigation for various impacts of development permits, usually through the California Environmental Quality Act, and may even require environmental or other permits for land use actions, but they are not land use agencies as such, and their permits are not development permits.



**B. Even if the Allowances were development permits, the unfairly apportioned auction payments would not be valid development fees.**

As discussed above, there is no fair or reasonable apportionment of the auction payments either to the emissions of the successful (many of whom have no emissions) or among Covered Entities or across the supply of Allowances. “Free” or “Qualifying Auction Price” is not a fair or reasonable apportionment.

**IV**

**CARB CANNOT AVOID THE REQUIREMENTS  
OF PROPOSITION 13 AND *SINCLAIR PAINT* BY CHARACTERIZING  
THE AUCTION PAYMENTS AS A FEE FOR THE EXERCISE OF A PRIVILEGE**

Morning Star joins the responses to this question in the separate briefs filed by the California Chamber of Commerce and the National Association of Manufacturers, and adds the following response.

Allowing fees for the extension of privileges would vitiate the protections of both Proposition 13 and *Sinclair Paint*, with no limiting principle. It is worth remembering that the privilege CARB is claiming to extend in this case is being auctioned off to the highest qualifying bidder, not simply extended in return for a nominal issuance fee.

Taking the National Association of Manufactures’ example a step further, the ability to impose fees on the issuance of drivers licenses, completely free from both Proposition 13 and *Sinclair Paint*, implies that the Department of Motor Vehicles could not only impose an arbitrary fee for the privilege of driving, but could cap the number of driver licenses to be issued, give roughly half of them away for free, and then auction the rest to the highest bidders. It is precisely because in today’s legal framework nearly anything can be deemed a privilege that charges imposed for exercising these privileges must be limited to either the Proposition 13 voting threshold requirements or the *Sinclair Paint* test for valid regulatory fees.

V

**AUCTION REVENUE COULD ONLY  
BE SPENT FOR CAP AND TRADE PROGRAM PURPOSES  
UNDER *SINCLAIR PAINT*; OTHER EXPENDITURES SHOULD BE  
ENJOINED SO THAT THE FUNDS CAN BE RETURNED TO THOSE COVERED  
ENTITIES FROM WHICH THEY HAVE BEEN ILLEGALLY COLLECTED**

- A. The proper inquiry is whether auction revenues are spent on direct Cap and Trade program purposes, not greenhouse gas reductions more generally.**

Morning Star joins the responses to this question in the separate briefs filed by the California Chamber of Commerce and the National Association of Manufacturers.

- B. Auction revenues replace general fund expenditures if they pay for programs that were previously funded by the General Fund.**

Morning Star joins the responses to this question in the separate briefs filed by the California Chamber of Commerce and the National Association of Manufacturers.

- C. The Court should enjoin the transfer of auction revenue to the Greenhouse Gas Reduction Fund, so that funds can be returned to Covered Entities from whom they were illegally collected.**

Morning Star *generally* concurs in the responses to this question in the separate briefs filed by the California Chamber of Commerce and the National Association of Manufacturers, *but adds* the following response.

Upon ruling that the auction payments are illegal taxes under Proposition 13, the Court should enjoin the further expenditure of any auction revenue funds still in the possession of CARB. In order to prevent the further illegal expenditure of funds from the auction, the Court should enjoin the provision of Section 95870(i)(2), which states: “The proceeds from the sale of these Allowances [those sold at auction] will be deposited into the Greenhouse Gas Reduction Fund created pursuant to Government Code section 16428.8 . . .” This will prevent any auction revenues which have not yet been released for expenditure from being illegally spent. Next, the Court should order CARB to retain all auction revenue funds still in its possession, for the purpose of potential refund to the those who made the payments, with the first priority on refunds to Covered Entities who have filed claims for refunds, and then to remaining Covered Entities in a manner to be determined by the trial Court on remand.

VI

**MORNING STAR'S AUCTION  
PAYMENTS ARE NOT VOLUNTARY BECAUSE  
THEY ARE FOR ALLOWANCES WHICH MERELY ALLOW  
MORNING STAR TO CONTINUE PRE-EXISTING ACTIVITIES**

Morning Star joins the responses to this question in the separate briefs filed by the California Chamber of Commerce and the National Association of Manufacturers, and adds the following response.

Covered Entities must obtain Allowances or cease emitting. For most if not all Covered Entities, certainly for Morning Star, cessation of emissions entirely is tantamount to ceasing operations. August 2, 2013 Rabo Declaration ¶ 14, JA 1399. For the case before the Court, a fine distinction between voluntary and involuntary payments is unnecessary. Morning Star and other Covered Entities were already engaged in their businesses and operating the emitting equipment prior to the adoption of AB 32 and the Cap and Trade Regulation, and before the imposition of the compliance obligation. Morning Star is not seeking to carry out any new activity; it merely needs the Allowances to continue doing what it has been doing. By any standard, the obligation to surrender Allowances (and by implication the need to obtain them) is not voluntary.

Similarly, Morning Star is unable to meet its compliance obligation without buying Allowances at auction. August 2, 2013 Rabo Declaration ¶¶ 14-15, JA 1399. To the extent that a standard for identifying voluntary payments is necessary, the Court should rule that payments related to permits for pre-existing activities are not voluntary.

## VII

**THE COURT SHOULD DECLARE  
THAT THE ALLOWANCE AUCTION  
IS UNCONSTITUTIONAL, ENJOIN FURTHER  
EXPENDITURE OF AUCTION REVENUE, AND REMAND  
THE CASE TO THE TRIAL COURT WITH INSTRUCTIONS TO FASHION  
APPROPRIATE INJUNCTIVE RELIEF AGAINST FURTHER COLLECTION OF  
ALLOWANCE AUCTION REVENUE**

Upon ruling that the Allowance auction violates Proposition 13, the court should declare the auctions unconstitutional, enjoin the transfer of auction proceeds to the Greenhouse Gas Reduction Fund as addressed in response to Question Five above, and remand to the trial Court with instructions for a permanent injunction against further auctions as follows:

The trial court should order CARB, as to any future Allowances auctions under the existing regulation, to refund all auction proceeds to the successful bidders within 30 days of clearing transactions on the auction. The trial Court should also hold a hearing on whether to limit auction participation to Covered Entities

In order to achieve the emissions reductions required by the Cap and Trade Regulation, it is necessary to maintain the compliance obligation. To maintain the compliance obligation, it is necessary to continue distributing the Allowances to the Covered Entities. However, as discussed above in the Introduction, auctioning is the default means of distributing Allowances that are not specifically distributed by other methods. If they cannot be auctioned, there is no way for CARB to distribute these Allowances without amending the regulation. Amendment would take a significant amount of time and permit CARB to evade its legal obligations during the amendment process.

But if the auctions are a means of collecting unconstitutional taxes, the only way to ensure the distribution of Allowances to the Covered Entities who need them, without violating Proposition 13, is to hold the auctions, but then refund the proceeds to the Covered Entities who successfully bid at the auction. The exclusion of bidders other than Covered Entities will reduce demand for Allowances at the auctions and reduce the price necessary for successful bidders to obtain Allowances as well.

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Finally, the permanent injunction could provide a time frame within which CARB could submit proposed revisions to the Regulation to the trial court for approval which eliminate the auctions and provide for another method of distribution of those Allowances, which the Regulation currently distributes through auction.

Respectfully Submitted,

A handwritten signature in blue ink, appearing to read "A. L. François", written over a horizontal line.

ANTHONY L. FRANÇOIS, No. 184100

*Attorney for Plaintiffs and Appellants  
Morning Star Packing Company, et al.*