Question 1
Provide whatever thoughts you might have as to the institutional potential for writing legislation that guarantees that a certain proportion of auction revenue is devoted to income tax cuts. How can such linkage be assured? Are there legal or institutional impediments (beyond the political challenges) here?

Any revenue generated by a state-run auction is likely to be considered a tax and subject to the two-thirds vote requirement. However, if those revenues are used to reduce other taxes by the same amount (i.e., a revenue neutral approach), most legal experts argue that this would require only a majority vote. Specific legislation would establish a linkage between the auction revenues and tax cuts; there are no other apparent legal or institutional impediments.

Even if allowances were given freely to utilities, refiners, et al. for the benefit of their customers (with a subsequent 3rd party auction to put allowances into the market), linkage to tax cuts would clearly require legislative action.

Question 2
Go over AB 32 and determine what it requires in terms of allowance value provision or allowance distribution methods. In arriving at recommendations, it will help to know what is mandatory under AB 32, and what is discretionary. From our initial discussion last Wednesday, it appears that just a few of the options are mandatory. If you could send a short memo with your conclusions along these lines, that would be good.

Vicki's memo is below. My only comments are:

- *To emphasize the requirement for early action credit. My recollection is that early action has not been an emphasis of the EAAC's discussions.*
- *WCI remains speculative at this point, so while we should be aware of WCI "requirements," as it has no legal/enforcement powers.*

The Global Warming Solutions Act Allocation and Distribution Design Requirements

The Global Warming Solutions Act (also known as AB 32)[1] permits the state Air Resources Board (ARB) to adopt market-based compliance mechanism (or cap-and-trade) regulations that the board determines "will achieve the maximum technologically feasible and cost-effective reductions in greenhouse gas emissions" from covered sources.[2] The act itself provides only general requirements for such a cap-and-trade program, however some of these

[1] Global Warming Solutions Act, CAL. HEALTH & SAF. CODE § 38500 *et. seq.* (Deering 2009).
[2] Global Warming Solutions Act § 38562 (c).

requirements do inform or constrain the design of allowance allocation and distribution mechanisms.

The Global Warming Solutions Act requires that in adopting regulations to reduce greenhouse gas emissions, the state Air Resources Board (CARB) shall, to the extent feasible:

1. *Design the regulations, including the distribution of emissions allowances, in a manner that is equitable, seeks to minimize costs and maximize the total benefits to California, and encourages early action to reduce greenhouse gas emissions;*
2. *Ensures that activities undertaken to comply with the regulations do not disproportionately impact low-income communities;*
3. *Ensures that entities receive appropriate credit for early voluntary reductions;*
4. *Ensures that activities undertaken pursuant to the regulations complement, and do not interfere with, other federal and state pollution reduction or prevention programs;*
5. *Considers cost-effectiveness of the proposed regulations;*
6. *Considers overall societal benefits, including reductions in other air pollutants, diversification of energy sources, and other benefits to the economy, environment, and public health;*
7. *Minimizes the administrative burden of implementing and complying with the regulations;*
8. *Minimizes leakage; and*
9. *Considers the significance of the contribution of each source or category of sources to statewide emissions of greenhouse gases.*[3]

The act also requires that ARB ensure, where applicable and to the extent feasible, that any greenhouse gas emission reduction programs and mechanisms "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 gas emissions."[4]

The Global Warming Solution Act further requires that prior to including a market-based compliance mechanism in its regulations, ARB "maximizes additional environmental and economic benefits for California, as appropriate."[5]

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[3] Global Warming Solutions Act §§ 38562 (b)(1-9).
[4] Global Warming Solutions Act §§ 38565.
[5] Global Warming Solutions Act §§ 38570.

Western Climate Initiative Design Recommendations Relevant to Allocation and Distribution of Allowances

In addition to its requirements under the Global Warming Solutions Act, California has voluntarily agreed to adhere, where possible, to the Western Climate Initiative's design recommendations for a regional cap-and-trade program. These recommendations also include several components that bear on the design of allowance distribution and allocation mechanisms, most notably a requirement to auction a minimum percentage of California's "allowance budget."

Pursuant to the Global Warming Solutions Act, the ARB recommended the implementation of a cap-and-trade program linked to the Western Climate Initiative in its Climate Change Scoping Plan, approved on Dec. 11, 2008.[6] As a WCI partner, California participated in creating WCI Design Recommendations that apply to all WCI partner jurisdictions.[7] ARB has affirmed its intention to work within the recommendations in its Scoping Plan,[8] and most recently, in its Preliminary Draft Regulations for California Cap-and-Trade Program. [9]

The WCI Design Recommendations calls for partners to auction a minimum of 10% of the allowance budget in the first compliance period beginning in 2012, and a minimum of 25% in 2020, "consistent with applicable state and provincial law."[10] In addition, the framework states that the partner jurisdictions "aspire to a higher auction percentage over time, possibly to 100%"[11] The ARB's Scoping Plan and Cap and Trade Regulation Preliminary Review Draft reflect this commitment to auction at least 10% of allowances in the first compliance period.[12] In addition, the Scoping Plan stated that "a transition to a 100% auction (with auction proceeds going to further the policy objectives of California's climate change program) was a worthwhile goal," and the ARB stated in the Preliminary Review Draft that it "expects that California will auction significantly more than the WCI minimum levels."[13]

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6 CAL. AIR RESOURCES BOARD, CLIMATE CHANGE SCOPING PLAN 30 (2008), available at http://www.arb.ca.gov/cc/scopingplan/document/adopted_scoping_plan.pdf [hereinafter SCOPING PLAN].

7 WESTERN CLIMATE INITIATIVE, DESIGN RECOMMENDATIONS FOR THE WCI REGIONAL CAP AND TRADE PROGRAM (2008), *available at* http://www.arb.ca.gov/cc/scopingplan/document/appendices_volume1.pdf (as Appendix D to SCOPING PLAN, *supra* note 6) [hereinafter WCI DESIGN RECOMMENDATIONS];

8 SCOPING PLAN, *supra* note 6, at 34.

9 CAL. AIR RESOURCES BOARD, PRELIMINARY DRAFT REGULATION FOR A CALIFORNIA CAP-AND-TRADE PROGRAM 47 (2009), http://www.arb.ca.gov/cc/capandtrade/meetings/121409/pdr.pdf [hereinafter CAP-AND-TRADE PDR].

10 WCI DESIGN RECOMMENDATIONS, *supra* note 7, at 8.7, p. 8.; *see also* Scoping Plan at 34.

11 *Id.* at 8.7.1, p. 8.

12 SCOPING PLAN, *supra* note 6, at 34; CAP-AND-TRADE PDR, *supra* note 9, at 47.

13 CAP-AND-TRADE PDR, *supra* note 9, at 47.

In addition, the Design Recommendations require that 5% of auctioned allowances must be offered at a reserve or minimum price, and if unsold at auction, a fraction of these allowances must be retired. The remaining portion of unsold allowances offered a minimum price may be auctioned or disposed of as a jurisdiction sees fit in later compliance periods. [14]

The WCI Design Recommendations also require that an unspecified portion of the value of each partner's allowance budget (either an allowance set-aside or use of revenues from allowance auction) be dedicated to one or more of the following purpose that would provide region-wide benefits:

- *Energy efficiency and renewable energy incentives and achievement;*
- *Research, development, demonstrations, and deployment (RDD&D) with particular reference to carbon capture & sequestration (CCS);*
- *renewable energy generation, transmission and storage; and energy efficiency;*
- *Promoting emission reductions and sequestration in agriculture, forestry and other uncapped sources; and*
- *Human and natural community adaptation to climate change impacts.*[15]

Finally, the Design Recommendations require that if analysis demonstrates that certain sectors should be treated similarly to address competitiveness issues, then WCI partner jurisdictions "will standardize the distribution of allowances as necessary to address competitive impacts sufficiently, in advance of the first compliance period." [16] *Examples of industries with potential competitiveness concerns include aluminum, steel, cement, lime, pulp and paper, and oil refining.*[17]

Question 3 (from Knittel)
(These assume that an emitter receives cash from customers and allowances from the state.)

My questions dealt whether the tax implications were different (for cash v. permits) once the costs were taken into account. For example:

Suppose cash is taxed and permits are not. My guess would be that the cost of buying permits is deductible, since this is an expense. Now let's think about 3 scenarios:

Scenario 1. More cash/permits than you need. You get $100 in cash, but need to buy $40 in permits. If cash is taxed, then you are taxed on $60. If you were given $100 worth in permits, wouldn't the $60 from the sale of the excess permits be

[14] WCI DESIGN RECOMMENDATIONS, *supra* note 7, at 8.10, p. 8-9.
[15] *Id.* at 8.2, p. 6.
[16] *Id.* at 8.5, p. 7-8.
[17] *Id.*

taxed too? If so, even though there are tax differences, nothing changes.
Answer: If one were to receive more cash than needed and then spent $40 to buy permits, that entity would be taxed on $100, but also receive a deduction for the $40 spent on permits only if they submitted or sold them.

Scenario 2. Less cash/permits than you need. You get $40 in cash/permits, but need $100. Aren't the excess costs tax deductible in both cases?
Answer: The receipt of $40 cash from customers is taxable on accrual, and the $100 spent to buy permits is deductible when submitted or sold.

3. Scenario 3. Just right.
Answer: Same as Scenario 2. The receipt of cash from customers is taxable on accrual, and any expense spent to buy permits is deductible when submitted or sold.