The 2012-13 Budget:
Cap-and-Trade Auction Revenues

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Summary

The Global Warming Solutions Act of 2006 (Chapter 488, Statutes of 2006 [AB 32, Núñez/Pavley]), commonly referred to as AB 32, established the goal of reducing greenhouse gas (GHG) emissions statewide to 1990 levels by 2020. In order to help achieve this goal, the California Air Resources Board (ARB) recently adopted regulations to establish a new cap-and-trade program that places a "cap" on aggregate GHG emissions from entities responsible for roughly 80 percent of the state's GHG emissions. The ARB will issue carbon allowances that these entities will, in turn, be able to "trade" (buy and sell) on the open market.

As part of its plan to issue allowances, ARB will hold quarterly auctions at which time a portion of these allowances will be made available for purchase. For 2012-13, ARB's auctions are estimated to generate roughly $660 million to upwards of $3 billion. The Governor's budget for 2012-13 assumes that the state will receive $1 billion from such auctions. Of this amount, the budget assumes that $500 million of the total revenue will be used to offset existing General Fund costs of current GHG mitigation activities, and the remaining revenues will be used on new or expanded programs intended to reduce GHG emissions.

Given the state's fiscal condition, we believe that the Legislature should first use the revenues in 2012-13 to offset General Fund costs of existing programs designed to mitigate GHG emissions. Since the Legislature will need to decide which General Fund costs to offset as part of the 2012-13 budget process, such decisions are best made this spring. In addition, the Legislature will need to begin the process of determining how effectively to allocate the remaining auction revenues on new or expanded programs. However, these latter decisions, which require an array of information to make, do not need to be done as part of the 2012-13 budget process.

BACKGROUND

Overview of Cap-and-Trade Program

Assembly Bill 32, established the goal of reducing GHG emissions statewide to 1990 levels by 2020. Among other provisions, the legislation directed the ARB to develop a plan to meet this goal. The legislation also authorized (but did not require) the board to include, as part of its plan, a market-based mechanism to reduce the state's GHG emissions. Assembly Bill 32 defines a market-based mechanism as a system that includes an annually declining limit on GHG emissions, as well as a trading component whereby sources of GHG emissions may buy and sell carbon allowances in order to comply with the regulation. Such a system is commonly referred to as a cap-and-trade program.

Under a cap-and-trade program, the regulator sets an aggregate limit or cap on total GHG emissions allowed. In turn, the regulator issues (either through auctions or free allocation) one "allowance" for each ton of the total carbon dioxide equivalent (CO_2e) emissions allowable. An emissions source that is subject to the regulation must possess one allowance (or equivalent thereof) for each ton of CO_2e emissions it produces within a given compliance period in order to comply with the regulation.

The ARB Will Enforce Cap-and-Trade Regulation Beginning January 2013. Recently, ARB adopted a regulation that establishes a cap-and-trade program, which it plans to enforce beginning in January 2013. (Please see our recent report, *Evaluating the Policy Trade-Offs in ARB's Cap-and-Trade Program,* for a detailed description of the design of ARB's cap-and-trade program and analysis of the important policy choices inherent in this design.) In general, the program is designed to cap the aggregate amount of GHGs emitted from the state's largest emissions sources that collectively represent roughly 80 percent of the state's total GHG emissions. While they are not assigned an individual emissions reduction target, entities that emit at least 25,000 metric tons or more of CO_2e per year are subject to the cap-and-trade regulation and are therefore considered to be a "covered entity." When the program is fully operational, approximately 350 of the state's largest emitters of GHGs will be subject to the regulation, including oil producers, refiners, electricity generators, as well as other large industrial entities. The remaining 20 percent of GHG emissions come from entities in other economic sectors such as agriculture and forestry. These sectors are not subject to the cap-and-trade regulation and, thus, are referred to as the uncapped sectors.

Compliance With the Cap-and-Trade Program. The ARB's cap-and-trade program contains three distinct compliance periods during which each covered entity must comply with the regulation by obtaining one allowance for each ton of CO_2e that it emits during a given compliance period. By the end of each compliance period, covered entities must have turned in to ARB a total number of allowances that match the level of their reported emissions for the entire compliance period. The first opportunity to obtain allowances will either be through ARB's free allocation scheme or through ARB's allowance auction (discussed below in more detail). After the initial auction, covered entities will have the opportunity to obtain allowances by buying and selling them in the open market and through subsequent auctions which will be held on a quarterly basis, in order to provide covered entities regularly scheduled opportunities to purchase additional allowances. In addition, covered entities will be allowed to use a relatively small portion of offset credits—which are derived from GHG emission reduction projects that are undertaken by emissions sources not subject to the cap-and-trade program's GHG emissions cap—to comply with the regulation. The ARB intends to phase in sectors of the economy that are covered under the cap-and-trade regulation and ultimately reduce emissions by reducing the annual limit of allowances.

Allocation of Allowances. As indicated above, ARB intends to do a combination of auction and free allocation of allowances. Initially, a majority of allowances will be allocated for free. The intent is to reduce what is called economic leakage—the decision by firms to relocate outside of California as a result of perceived competitive disadvantage imposed by the cap-and-trade policy. In addition, the ARB will provide electricity distribution utilities free allowances to help reduce the cost burden on electricity users from electricity price increases expected to result from the implementation of the cap-and-trade program. In total, between 2012 and 2020, it is currently estimated that the ARB will both auction and allocate for free a total of up to 2.5 billion allowances, with roughly 50 percent auctioned and 50 percent given away for free.

Specifically, the ARB intends to hold quarterly auctions of a set number of allowances beginning in 2012. In August of this year, ARB plans to auction 20 million allowances for use in 2015 and beyond ("vintage 2015" allowances). A similar auction will be held in November in which 20 million vintage 2015 allowances will be made available. By auctioning these future-year allowances, ARB intends to provide greater transparency to the market regarding potential future prices, thus providing covered entities more information to use in planning for future compliance with the regulation. In February 2013, ARB plans to auction 3 million current-year allowances, as well as an additional 10 million vintage 2016 allowances. In May 2013, ARB plans to hold a similar auction where another 3 million current-year allowances, as well as an additional 10 million vintage 2016 allowances will be offered. In addition, ARB plans to allocate approximately 150 million free allowances in 2012-13. For example, electricity distribution utilities will receive almost 100 million allowances, with 65 million allowances to be given to the states Investor Owned Utilities (IOUs) who must then sell their allowances at auction.

Auction Revenues. The ARB has included in its regulation a targeted price range for allowances from a low of $10 to a high of $50 per ton of emissions. This price range will guide the amount that covered entities bid at auction. Thus, billions of dollars in revenues from the auction of allowances will likely become available as a result of ARB's cap-and-trade program. The amount of revenues could range greatly depending upon the cost of directly reducing GHG emissions, the state of the economy, and other factors. Using ARB's floor and ceiling prices for allowances, the actual cap-and-trade revenues from ARB's auctions for 2012-13 could range from roughly $660 million to upwards of approximately $3 billion.

Use of Cap-and-Trade Auction Revenues

Background on Fees and Taxes. Over the years, the definition of what constitutes a regulatory fee or tax has evolved. In 1991, the state began imposing a regulatory fee on paint companies and other businesses that make or previously made products containing lead. The state uses this money for lead poisoning programs. In court, the Sinclair Paint Company argued that this regulatory fee was a tax because (1) the program provides a broad public benefit, not a benefit to the regulated business, and (2) the companies that pay the fee have no duties regarding the lead poisoning program other than payment of the fee. In 1997, the California Supreme Court ruled that this charge on businesses was a regulatory fee (requiring only a majority vote in each house of the Legislature) not a tax (requiring a two-thirds majority vote). The court confirmed that government may impose regulatory fees on companies that make contaminating products and use those proceeds for broad public purposes in order to mitigate the adverse effects related to those products.

In November 2010, voters approved Proposition 26, which expanded the definition of what constitutes a tax and a tax increase so that more proposals would require approval by two-thirds of the Legislature (or, in some cases, by local voters). Therefore, some regulatory charges that benefit the public broadly would, if passed now, be considered taxes instead of fees. Also, Proposition 26 did not change an existing provision in the State Constitution, known as Proposition 98, that generally requires that a minimum share of General Fund tax revenues be provided to public schools and community colleges.

Auction Revenues Subject to "Sinclair Nexus Test." Based on an opinion that we received from Legislative Counsel, the revenues generated from ARB's cap-and-trade auctions would constitute "mitigation fee" revenues. Because AB 32 was enacted by a majority vote of the Legislature prior to the voter approval of Proposition 26—and well before its specified retroactive date of January 1, 2010—we are told that the provisions of Proposition 26 would not apply. Also, because the proceeds from the auctions are fee revenues and not the proceeds of taxes, we are also advised that the state's receipt of these monies would not affect the state's Proposition 98 funding obligation for K-12 schools and community colleges.

As the auction revenues are deemed to be mitigation fee revenues, we are further advised that their use would be subject to the so-called Sinclair nexus test, a concept which is derived from the Sinclair Paint court case referenced above. This test requires that a clear nexus must exist between an activity for which a mitigation fee is used and the adverse effects related to the activity on which that fee is levied. Therefore, in order for their use to be valid as mitigation fees, revenues from the cap-and-trade auctions must be used only to mitigate GHG emissions or the harms caused by GHG emissions.

GOVERNOR'S BUDGET PROPOSAL

Assumes $1 Billion in Cap-and-Trade Auction Revenues. As previously mentioned, the ARB's cap-and-trade auctions are estimated to generate revenues ranging from roughly $660 million to $3 billion in 2012-13. The Governor's budget for 2012-13 assumes that the state will receive $1 billion from such auctions, which would be deposited in a new Greenhouse Gas Reduction Account within the existing Air Pollution Control Fund. The budget assumes that $500 million of the total revenue will be used to offset existing General Fund costs of GHG mitigation activities. Under the administration's plan, the remaining $500 million in revenues would be invested in (1) clean and efficient energy, (2) low-carbon transportation, (3) natural resource protection, and (4) sustainable infrastructure development.

According to the administration, since actual cap-and-trade revenues will not be known until late in 2012-13, the planned expenditures are not specified by program in the proposed budget. Instead, the administration plans to submit an expenditure plan to the Legislature after the first cap-and-trade auction. As discussed earlier, the first auction is currently planned for August of this year—which would be after the 2012-13 budget is enacted. The administration plans to allocate funds to specific programs not sooner than 30 days after submitting its expenditure plan to the Legislature. According to the administration's proposed budget trailer legislation, the expenditure plan could include funding for such areas as low-carbon vehicle technologies, residential energy efficiency programs, local and regional sustainable development efforts, and certain projects undertaken by public universities and schools.

Assumes $650 Million in California Public Utilities Commission (CPUC) Directed Revenues. In addition, the administration expects that $650 million will be generated in 2012-13 as a result of the free allocation of cap-and-trade allowances to the state's IOUs. As we discussed earlier, ARB plans to give 65 million allowances to IOUs, which, as a condition of the free allocation, are then mandated to sell those allowances in ARB's auction.

The CPUC, which regulates the state's IOUs, has produced estimates of potential 2012-13 revenues using both ARB's auction floor price of $10 per ton (which would generate $650 million) and its own internal estimated price of $16 per ton (which would generate roughly $1 billion). We note, however, that if allowances were sold at ARB's ceiling price of $40 per ton, revenues could be much higher—potentially up to $2.6 billion.

The CPUC has opened an official proceeding to determine how IOUs should use the above revenues. While the commission has yet to decide how these revenues should be spent, it has indicated that it believes, in general, that the funds should be used in ways that benefit electricity consumers in California (such as to augment investments in energy efficiency and renewable energy). The CPUC expects to issue a decision in April 2012.

GOVERNOR'S PROPOSAL RAISES SOME CONCERNS

Given that ARB intends to hold quarterly cap-and-trade auctions beginning later this year, we find that it is reasonable to assume that the revenues generated from these auctions will be available for expenditure in the budget year, as assumed in the Governor's budget. However, as we discuss below, the Governor's proposal regarding the allocation of the revenues raises some concerns.

Limits Legislative Budgetary Discretion and Oversight

Under the Governor's proposal, the Legislature would have little opportunity to review a detailed plan on the use of the auction revenues. This is because the Legislature would only be provided an expenditure plan and notification 30 days before the administration allocates the revenues to specific programs. Such an approach would make it difficult to ensure that the plan is aligned with legislative priorities. This is particularly concerning given that the particular uses of the auction revenues could impact—positively and negatively—the effectiveness and efficiency of the cap-and-trade program in meeting the goals of AB 32. Thus, we believe it is important that the Legislature have an opportunity to review and approve an annual expenditure plan regarding the allocation of cap-and-trade revenues.

Likely Overestimates Potential General Fund Relief

Given the state's fiscal condition, we believe that using cap-and-trade auction revenues to offset certain programs currently funded from the General Fund merits legislative consideration. However, our analysis indicates that the Governor's budget likely overestimates the magnitude of potential General Fund relief. For instance, since the administration has not yet submitted a plan on how it proposes to spend the cap-and-trade auction revenues in 2012-13, it remains uncertain at this time how much of the $500 million in assumed General Fund savings could be achieved. As indicated above, any use of revenues (whether to initiate new programs or offset the costs of existing programs) will be subject to the Sinclair nexus test and, thus, must be used to mitigate GHG emissions.

Based on our preliminary analysis of GHG mitigation activities that are currently funded by the General Fund, we have identified only a handful of programs—totaling around $100 million—that could potentially meet the above legal requirements. These programs include:

- ***University of California (UC)—Energy Efficiency Program***. The UC currently operates the Statewide Energy Partnership Program, which supports various capital outlay projects that seek to improve the energy efficiency of the university's facilities. By reducing energy consumption, these projects have the effect of reducing GHG emissions. Based on the Governor's proposed budget, the university plans to spend roughly $15 million from the General Fund to support such projects in 2012-13.

- ***Department of Water Resources (DWR)—Water Use Efficiency Program.*** The DWR currently operates several programs targeted at improving water use efficiency. These programs primarily fall into three categories: (1) evaluating irrigation systems to identify opportunities for reducing water use, (2) researching and demonstrating water-efficient technologies, and (3) increasing water use efficiency. According to the California Energy Commission, roughly 20 percent of the state's electricity is consumed in the process of storing, transporting, and treating water. Therefore, reducing water use—particularly in Southern California—could potentially reduce GHG emissions. The Governor's budget for 2012-13 includes $1.2 million from the General Fund for DWR staff to support the above programs. In addition, DWR has provided $132 million in water use efficiency grants to local entities that were paid for with Proposition 50 and Proposition 84 bond funding. The Legislature may want to consider the possibility of using cap-and-trade revenues (rather than General Fund revenues) to pay some of the debt service on these bond expenditures.

- ***California Department of Forestry and Fire Protection (CalFire)—Resource Management Program.*** Under its Resource Management Program, CalFire manages forests, forest health, and reforestation, and regulates the timber industry. In some instances, this involves forests actively removing GHGs from the atmosphere through a process referred to as "forest carbon sequestration." This occurs when trees absorb carbon dioxide during photosynthesis, storing the carbon as wood. According to CalFire, through the process of forest carbon sequestration, California forest land is predicted to remove 5 million metric tons of CO_2e by 2020. Four million metric tons will occur on state forest land. The Governor's budget for 2012-13 proposes $21 million from the General Fund to support CalFire's Resource Management Program.

LAO RECOMMENDATIONS

As previously discussed, the amount of revenues that the state will receive from the cap-and trade auctions will be significant, particularly in the long run. Given the state's fiscal condition, we believe that the Legislature should first use the revenues in 2012-13 to offset the General Fund costs of existing programs designed to mitigate GHG emissions. Since the Legislature will need to decide which General Fund costs to offset as part of 2012-13 budget process, such decisions are best made this spring. In addition, the Legislature will need to begin the process of determining how effectively to allocate the remaining auction revenues to expand existing programs or establish new programs intended to reduce GHG emissions. However, as we discuss in more detail below, these latter decisions do not need to be done as part of the 2012-13 budget process.

Maximize General Fund Offsets. To the extent possible, we recommend that the Legislature maximize the use of the cap-and-trade auction revenues to offset the General Fund costs of existing programs that help mitigate GHG emissions. Towards this end, we recommend that the Legislature direct the administration to provide a list by April 1, 2012 of all current programs whose spending could be offset by auction revenues. This would allow sufficient time for the Legislature to review the administration's proposals and consider alternatives in its deliberations on the 2012-13 budget. The ability to use the auction revenues to offset General Fund costs will have important implications for adopting the 2012-13 budget. For instance, if $500 million worth of offsets is not identified, the Legislature would need to consider additional solutions to balance the budget. (Alternatively, as we discuss in our recent report, *Evaluating the Policy Trade-Offs in ARB's Cap-and-Trade Program*, the Legislature could use the auction revenues for purposes unrelated to GHG emissions mitigation, such as part of a multiyear approach to reducing the state's projected General Fund deficit. Such an action, however, would require a two-thirds vote of the Legislature.)

Allow Sufficient Time to Decide Which Programs to Establish or Expand. For those auction revenues not used to generate General Fund savings, the administration proposes that they be spent on various energy and resources protection programs. As discussed earlier, the Governor's proposal does not provide the Legislature time to thoughtfully review and analyze how these auction revenues will be allocated. For this reason, we recommend that the Legislature reject the Governor's proposal to allow the administration to allocate the revenues to specific programs following a 30-day notification to the Legislature. We also note that existing state law does not require that the cap-and-trade auction revenues be spent within a certain time frame. Thus, there is nothing that prevents the Legislature from taking its time to carefully review its options and appropriating such revenues in legislation later on or as part of the 2013-14 budget process. As we discuss below, we believe that there are several reasons why the Legislature should consider such a longer-term approach.

Given the sheer magnitude of the amount of auction revenues that will be available to either expand or establish new programs related to the GHG emission reductions, the Legislature will need certain key pieces of information in order to make informed decisions. Specifically, the Legislature will need:

- ***Greater Certainty About Available Revenues.*** The revenues from the cap-and trade auctions in 2012-13 are estimated to range anywhere from $660 million to $3 billion. Waiting to appropriate the revenues after the 2012-13 auctions are completed would provide the Legislature with greater certainty on how much revenues will be available for expenditure.

- ***Detailed Expenditure Plan.*** The Legislature will need to adopt a detailed expenditure plan that specifies by program how the revenues will be allocated based on an overall strategy of achieving the goals of AB 32. In order to initiate this process, we recommend that the Legislature direct the administration to provide an expenditure plan outlining its suggested use of the revenues to expand or establish new programs. However, to the extent that the Legislature finds that the administration's proposed plan is insufficient or not aligned to legislative priorities, it will want to consider alternative proposals and develop its own expenditure plan. In order to assist the Legislature in this process, we will analyze the administration's pending expenditure plan and put forward alternative proposals that merit consideration.

- ***Data on Potential Return of Investment.*** In allocating these revenues, we recommend the Legislature prioritize those programs that have the greatest potential return on investment in terms of GHG emission reductions relative to the proposed funding investment. Specifically, we suggest that the above expenditure plan rank potential programs to be funded based on this criteria. This would help ensure that the state is able to meet the emission reduction goal specified in AB 32. Thus, the Legislature will need an impact analysis for each proposed use of the revenues it considers.

- ***Legal Implications.*** As previously mentioned, it is essential that the proposed use of cap-and-trade revenues pass the Sinclair nexus test and be used to mitigate GHG emissions. Thus, it will be important for the Legislature to seek the advice of Legislative Counsel and consider any potential legal risks.

- ***Plan on How IOU Revenues Will Be Allocated.*** The Legislature will also want to ensure that the cap-and-trade auction revenues are used in coordination with the use of the IOU cap-and-trade revenues, particularly in order to avoid unnecessary duplication of efforts. Thus, the Legislature will want to obtain information on how the CPUC intends to allocate the IOU revenues *prior* to approving an expenditure plan for the auction revenues. This would help ensure that these revenues are used in accordance with an overall statewide plan to mitigate GHG emissions.

In view of the array of information the Legislature will need to make effective decisions regarding the allocation of the auction revenues, we believe the Legislature should take its time regarding the appropriation of these funds. This would allow the Legislature to take a more thoughtful, comprehensive approach to spending these large sums on its GHG mitigation efforts.

LAO Publications

This brief was prepared by Tiffany Roberts and reviewed by Anthony Simbol. The Legislative Analyst's Office (LAO) is a nonpartisan office that provides fiscal and policy information and advice to the Legislature.

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