

FEBRUARY 10, 2021

# **The 2021-22 Budget: Cap-and-Trade Expenditure Plan**

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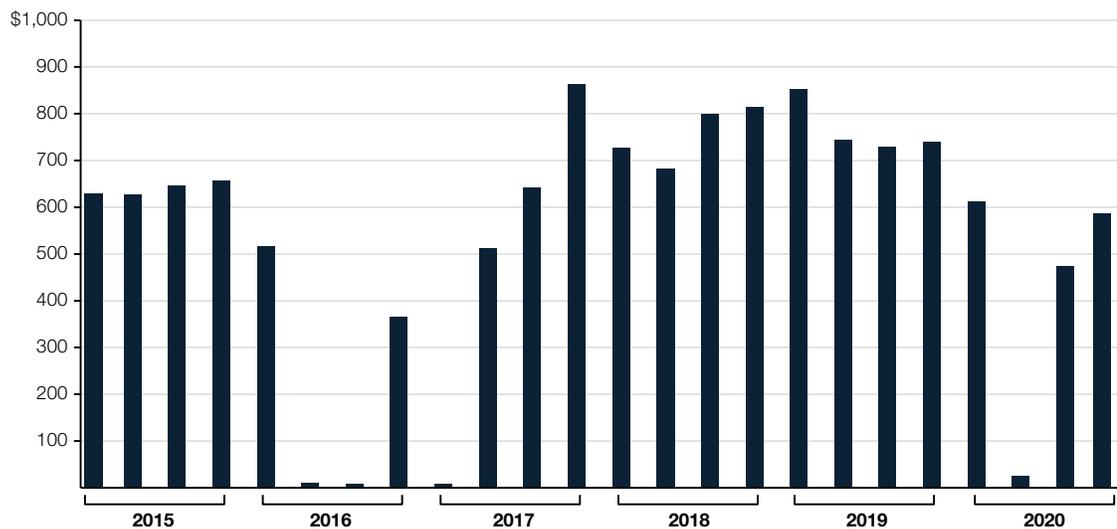


LEGISLATIVE ANALYST'S OFFICE

## Background

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### Quarterly Cap-and-Trade Auction Revenue Has Been Volatile (In Millions)



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### Cap-and-Trade Auction Revenue Deposited in the Greenhouse Gas Reduction Fund (GGRF)

- Funds are spent on a variety of environmental programs.
- About 65 percent of auction revenue is continuously appropriated to certain programs and projects, including high-speed rail, transit-related activities, and a program to provide safe and affordable drinking water.
- About \$185 million is spent on annual state administrative costs and other ongoing statutory allocations, such as backfilling revenue losses associated with 2017 legislation that suspended (1) a fee to support fire protection activities and (2) sales taxes for certain manufacturing equipment.
- The remaining revenue is available for expenditure in the annual budget—sometimes referred to as “discretionary expenditures.”



## Background

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### **2020-21 Budget Provided Limited Discretionary Funding Due to Revenue Uncertainty**

- Given uncertainty about auction revenue, the 2020-21 GGRF budget was limited to: (1) continuous appropriations, (2) about \$125 million for ongoing statutory allocations, (3) \$75 million for wildfire activities related to Chapter 626 of 2018 (SB 901, Dodd), and (4) \$59 million to continue state administrative activities.
- The budget also authorized a loan from the Underground Storage Tank Clean-Up (USTC) Fund to the Safe and Affordable Drinking Water Fund to ensure the program received \$130 million in total funding even in the event that GGRF revenues were insufficient. The loan will be repaid by GGRF at a future date.



# Governor's Proposal

| <b>Governor's Cap-and-Trade Expenditure Plan</b>      |                           |                 |                |
|---|---------------------------|-----------------|----------------|
| <i>(In Millions)</i>                                  |                           |                 |                |
| <b>Program</b>  | <b>Department</b>         | <b>2020-21</b>  | <b>2021-22</b> |
| <b>Existing Spending Commitments</b>                  |                           | <b>\$1,556</b>  | <b>\$1,571</b> |
| <b>Continuous Appropriations<sup>a</sup></b>          |                           | <b>\$1,297</b>  | <b>\$1,383</b> |
| High-speed rail                                       | High-Speed Rail Authority | 499             | 532            |
| Affordable housing and sustainable communities        | Strategic Growth Council  | 399             | 425            |
| Transit and intercity rail capital                    | Transportation Agency     | 200             | 213            |
| Transit operations                                    | Caltrans                  | 100             | 106            |
| Safe drinking water program                           | State Water Board         | 100             | 106            |
| <b>Statutory Allocations and Administrative Costs</b> |                           | <b>\$259</b>    | <b>\$188</b>   |
| SRA fee backfill                                      | CalFire/CCC               | 74              | 77             |
| Manufacturing sales tax exemption backfill            | N/A                       | 51              | 52             |
| State administrative costs                            | Various                   | 59              | 59             |
| Healthy and resilient forest (SB 901)                 | CalFire                   | 75 <sup>b</sup> | —              |
| <b>Proposed Discretionary Spending</b>                |                           | <b>\$624</b>    | <b>\$745</b>   |
| <b>Forests</b>  |                           |                 |                |
| Healthy and resilient forests (SB 901)                | CalFire                   | \$125           | \$200          |
| <b>Low Carbon Transportation</b>                      |                           |                 |                |
| Heavy-duty vehicle and off-road equipment             | Air Resources Board       | 165             | 150            |
| Transportation equity programs                        | Air Resources Board       | 74              | 76             |
| <b>Community Air Protection Program (AB 617)</b>      |                           |                 |                |
| Local air district programs to reduce air pollution   | Air Resources Board       | \$125           | \$140          |
| Local air district administrative costs               | Air Resources Board       | — <sup>c</sup>  | 50             |
| Technical assistance to community groups              | Air Resources Board       | —               | 10             |
| <b>Agriculture</b>                                    |                           |                 |                |
| Agricultural diesel engine replacement                | Air Resources Board       | \$90            | \$80           |
| Healthy Soils   | Food and Agriculture      | 15              | 15             |
| <b>Safe Drinking Water</b>                            |                           |                 |                |
| Safe Drinking Water Program <sup>d</sup>              | State Water Board         | \$30            | \$24           |
| <b>Totals</b>   |                           | <b>\$2,180</b>  | <b>\$2,316</b> |

<sup>a</sup> Allocations based on Governor's revenue estimate of \$2.1 billion in 2020-21 and \$2.3 billion in 2021-22.

<sup>b</sup> Reflects SB 901 state operations funding included in *2020-21 Budget Act*. The 2021-22 state operations costs are included in the proposed discretionary spending for SB 901.

<sup>c</sup> \$50 million was provided from Air Pollution Control Fund.

<sup>d</sup> Estimated amount needed to provide total of \$130 million annually, including continuous appropriation.

Caltrans = California Department of Transportation; SRA = state responsibility area; CalFire = California Department of Forestry and Fire Protection; CCC = California Conservation Corps; N/A = not applicable; Chapter 626 of 2018 (SB 901, Dodd); and Chapter 136 of 2017 (AB 617, C. Garcia).



# Governor's Proposal

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## **Expenditure Plan Assumes Lower Revenue Than Prior Years**

- Revenue is down from a high of \$3.2 billion in 2018-19 to an estimated \$2.1 billion in 2020-21 and \$2.3 billion in 2021-22.

## **Less Funding Available for Discretionary Spending**

- The Governor's budget plan includes additional "early action" discretionary spending of \$624 million in 2020-21, as well as total discretionary spending of \$745 million in 2021-22.
- Discretionary spending in 2021-22 is only about half of what was provided in 2019-20 (\$1.4 billion). Discretionary spending in the budget year is lower than previously primarily because lower revenue reduces the amount of funding available for spending—including for both continuous appropriations and discretionary spending.
- In addition, as part of the 2019-20 budget, the Legislature added a 5 percent continuous appropriation for safe and affordable drinking water, beginning in 2020-21. This reduces the amount of funding available for discretionary spending by about \$100 million in 2021-22.

## **Funding Would Go to Programs That Have Received GGRF in Recent Years**

- Funding would go to a mix of programs that commonly receive discretionary GGRF funding. The administration is not proposing funding for any new programs.
- Plan prioritizes repayment of USTC Fund loan in 2020-21 (estimated to be \$30 million) and additional funding to ensure the safe drinking water program receives a total of \$130 million in 2021-22.



## Governor's Proposal

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### **Other Programs That Commonly Received GGRF Are Not Included**

- Notably, the plan does not include funding for the Clean Vehicle Rebate Project (CVRP)—the state's main program to provide rebates for zero-emission vehicles. The expenditure plan has included funding for CVRP every year from 2014-15 to 2019-20.
- Other programs that have frequently received substantial annual GGRF allocations, but that are not included in this year's plan include waste diversion, dairy methane emission reductions, and Transformative Climate Communities.
- The administration indicates that other programs will help support some of the activities that would not receive GGRF. For example, the newly implemented Clean Fuel Rewards Program administered by utilities provides \$1,500 rebates for electric vehicles, and the Governor is proposing a new loan program through the Climate Catalyst Fund for dairy methane projects.



# Assessment

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## Revenue Estimates Are Reasonable, but Significant Uncertainty Remains

- Revenue could be several hundred million dollars higher or lower in both the current year and budget year.
- A decline in overall economic conditions and/or financial markets can result in dramatic drops in quarterly auction revenue, as witnessed last year.
- On the other hand, it is possible that there is a substantial increase in revenue. For example, the Secretary of the California Environmental Protection Agency has expressed his intent to work with California Air Resources Board to evaluate potential changes to the cap-and-trade program that might be necessary to achieve the state's greenhouse gas (GHG) goals. Depending on the specific outcomes of this evaluation, changes could increase demand for allowances and prices.

## Proposal Would Leave Small Fund Balance

- Under the Governor's proposal, the GGRF fund balance would be slightly more than \$100 million at the end of current year and budget year—roughly 5 percent of estimated annual revenue.
- This is a small fund balance, particularly given the ongoing uncertainty and potential volatility of the revenue.



# Assessment

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## Early Action More Justified for Some Programs Than Others

- **Early Action Presents Trade-Offs.** The main benefit of providing funding through early actions is that projects could be implemented a few months earlier than if funding were provided in the 2021-22 budget. However, early action reduces the Legislature’s time to deliberate the merits and trade-offs associated with each proposal.
- **Most Cap-and-Trade Expenditures Not Addressing Urgent Needs.** There could be a strong rationale for approving some funding a few months early. For example, early action can make sense if spending is needed to address an urgent public safety or economic challenges, such as those related to the pandemic. Most cap-and-trade programs do not fit these criteria.
- **Early Action on Wildfire-Related Funding Could Make Sense.** As discussed in our analysis, [The 2021-22 Budget: Wildfire Resilience Package](#), there could be merit in providing funding for some forest health and resilience activities a few months earlier than if they were included in the 2021-22 budget. This allocation would be consistent with the direction in SB 901 to provide \$200 million annually for these programs. In addition, based on discussions with the administration, allocating GGRF funding this spring—before the 2021 fire season begins—could make it more likely that some high-priority projects are in place in advance of the 2022 fire season.



# Recommendations

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## Consider Reducing Amount Provided in 2020-21 Expenditure Plan

- Given ongoing revenue uncertainty and a lack of urgency around many of the programs, we recommend the Legislature consider limiting early action to an amount less than the \$624 million proposed by the Governor.
- A couple of alternative early action plans that the Legislature could consider are:
  - **Alternative No. 1—Augment Only for Wildfire-Related Programs.** Limit additional current-year funding to only those activities where a strong rationale for early action exists, such as the \$125 million for healthy and resilient forests.
  - **Alternative No. 2—Limit Early Action Spending to What Is “In the Bank.”** For example, we estimate there is currently about \$300 million GGRF that has already been raised from earlier auctions, but that has not yet been allocated to other programs. This amount will likely increase after the upcoming auction in February. The Legislature could allocate up to \$300 million—plus a portion of discretionary revenue collected from the February auction—in 2020-21 for programs that it determines to be high priorities.



## Recommendations

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### **Assess Resources Available for 2021-22 Expenditure Plan After Upcoming Auctions**

- The Legislature might want to re-assess the amount proposed in the 2021-22 cap-and-trade expenditure plan until after the results of the February and May auctions are available (late May). The state will have complete information about 2020-21 auction revenue at that time, including how much funding is available from the year-end fund reserves.
- These auction results could also help inform 2021-22 revenue estimates, although there will likely continue to be significant revenue uncertainty.



## Recommendations

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### **Consider Larger Reserve to Promote Long-Term Fund Solvency and Funding Predictability**

- Over the last several years, revenue volatility has resulted in unpredictable funding for many GGRF programs and administrative actions. For example, after the May 2020 auction generated very little revenue, the Department of Finance reduced over \$100 million in GGRF allocations to select programs to ensure fund solvency, consistent with the authority it was given in the 2019-20 budget. We recommend the Legislature consider alternative strategies to better ensure long-term fund solvency, as well as greater funding stability for high priority programs.
- For example, the Legislature could begin building a larger reserve in the fund that would serve as a buffer against future revenue volatility. This is similar in concept to the approach the state has enacted for the General Fund, which relies heavily on volatile personal income tax revenues.
- The “right” size of the reserve depends on the Legislature’s overall risk tolerance, but we think a target of 10 percent of annual revenue—which would be over \$200 million for the GGRF—is a reasonable starting goal. However, the Legislature might want to consider a somewhat higher target, given the revenue volatility.



## Recommendations

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### Allocate Discretionary Funding Based on Legislative Priorities

- The Legislature will have to weigh many different priorities when considering how to allocate funds, including GHG reductions, local air quality improvements, safe drinking water, and forest health.
- The state has multiple funding and regulatory programs designed to achieve many of these goals. So, once the Legislature determines its priorities for GGRF funds, it will want to try to identify the mix of programs that achieve those goals most effectively and, therefore, where GGRF funds can best be targeted.
- For example, to the extent the Legislature considers GHG emission reductions the highest priority use of GGRF funds, it will want to identify the programs that achieve those goals most effectively. In prior reports ([The 2018 19 Budget: Resources and Environmental Protection](#), for example), we have identified some key factors the Legislature might want to consider when spending GGRF funds on GHG emission reduction efforts. For instance, the Legislature could:
  - Consider targeting funds to address other “market failures” that current regulations do not address. For example, it could target funds to pilots and demonstrations for GHG reducing technologies because private companies do not always invest in these activities at a level that is socially optimal.
  - Target funds to achieve GHG reductions from sources that are not currently covered by the cap-and-trade regulation. For example, it could prioritize programs aimed at reducing methane emissions from dairies or sequestering carbon in natural and working lands.

