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Cap-and-Trade Program: Key Choices Ahead

PRESENTED TO:

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Hon. Ben Allen, Chair

Senate Environmental Quality Committee
Hon. Catherine Blakespear, Chair

LEGISLATIVE ANALYST'S OFFICE

Background

Cap-and-Trade Program Represents Key Component of State's Efforts to Meet Its Climate Goals. Over the past 20 years, California has taken a leadership role in global climate policy. The state has established a series of increasingly ambitious greenhouse gas (GHG)-reduction goals and created a variety of policies and programs aimed at meeting these goals. Of particular importance is the cap-and-trade program, which was created through the passage of Chapter 488 of 2006 (AB 32, Núñez) and extended through 2030 by Chapter 135 of 2017 (AB 398, Garcia).

Cap-and-Trade Helps Ensure State Meets GHG-Reduction Goals Cost-Effectively. The program serves as a "backstop" within the state's overall suite of climate efforts. That is, to the degree other policies collectively fall short of meeting the state's GHG reduction goals, cap-and-trade can ensure that covered entities reduce emissions further to makeup the difference. The program also helps the state meet its GHG reduction goals in a relatively cost-effective manner, as the requirement to purchase allowances incentivizes emitters to undertake the least costly reductions. Should the program expire in 2030, the state would need to identify other—likely less cost-effective—activities and policies to attain additional GHG emissions reductions in order to meet its climate goals.

Cap-and-Trade Reduces GHG Emissions by Pricing Them, Which Raises Consumer Costs... By pricing emissions, the program provides a financial incentive for emitters to reduce their GHGs, but also raises their cost of doing business. Historically, they have passed most of these compliance costs on to consumers. If the program were to be extended through 2045, we estimate that emitters would need to pay a couple hundred billion dollars for allowances during this period. Many of these charges likely would be passed on to California consumers in the form of higher prices, such as for gasoline and diesel fuel.

...But Also Produces Revenues the Legislature Can Direct. Since the passage of AB 398 (with a vote of two-thirds of the Legislature), the revenues from the sale of allowances have been considered akin to tax revenues and have been able to be used for any purpose. Also, importantly, the Legislature is able to direct these revenues to address its priorities, such as offsetting the costs to consumers of the program, further reducing GHG emissions, and/or addressing other urgent needs. This feature is unlike the state's other GHG-reduction programs.

Legislature Faces Important Choices Around Reauthorization of Program

Legislature Faces Key Decisions as Sunset Date Approaches. Reauthorization could shape the program for many years to come. Also, in light of the dollar amounts at stake, choices around how the program is structured could have significant implications for various legislative priorities.

Legislature May Have Various Policy Priorities for Reauthorization. For example, the Legislature may want to prioritize GHG reductions, mitigating the program's effects on affordability, and/or addressing other policy priorities, such as improving local air pollution or adapting to climate change impacts.

Reauthorization Offers Two Key Tools to Achieve Legislative Policy Priorities. Broadly, the Legislature has two main types of tools at its disposal to achieve its policy priorities. First, it could make changes to the design of the program, such as related to the level of the cap and/or the levels of the price floor and ceiling. Historically, the Legislature has deferred most of these program design decisions to the California Air Resources Board (CARB). Second, it could direct the use of the value of the program's allowances. This could include shifting the balance of free allowances provided to various recipients versus those sold to benefit the Greenhouse Gas Reduction Fund (GGRF), and/or modifying GGRF's statutory spending allocations.

Legislature Has Various Reauthorization Options Depending on Its Policy Priorities. In the figure on the next page, we summarize some examples of options the Legislature could pursue to help achieve its policy priorities through cap-and-trade reauthorization.

Legislature Faces Important Choices Around Reauthorization of Program

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Summary of Some Options for Addressing Potential Legislative Priorities in Cap-and-Trade

Category	Options
Policy Priority: Greenhouse Gas Reductions	
Program Design	✓ Lower cap on emissions. ✓ Modify treatment of offsets, such as by putting offsets "under the cap" or strengthening requirements for their use.
Use of Allowance Value	✓ Spend GGRF revenues on cost-effective activities to reduce emissions in uncapped sectors.
Policy Priority: Affordability	
Program Design	✓ Lower price ceiling to prevent potential for high allowance prices.
Use of Allowance Value	✓ Spend GGRF revenues to offset or reduce costs of the program, such as by providing rebates to households. ✓ Increase number of free allowances dedicated to offsetting costs, such as by increasing the amount of electricity rebates or paying for utility wildfire mitigation costs.
Other Policy Priorities	
Use of Allowance Value	✓ Reduce number of free allowances to sell more and thereby generate additional funding for GGRF to spend on other priorities. ✓ Modify current GGRF spending, such as by eliminating some continuous appropriations or reducing some statutory funding levels, and direct funding for other priorities.

GGRF = Greenhouse Gas Reduction Fund.

Legislature Faces Important Choices Around Reauthorization of Program

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Options Generally Involve Notable Trade-Offs. Many of the options for addressing legislative priorities come with important trade-offs. For example, some actions focused on reducing additional GHG emissions could put upward pressure on allowance prices, thereby affecting affordability. The Legislature will want to carefully weigh these trade-offs given the implications involved.

Important for Legislature's Priorities to Be Reflected in Reauthorization. We encourage the Legislature to ensure that its key policy priorities are reflected in the design and operation of the program going forward, including providing clear statutory direction as applicable. In areas where the Legislature does not provide such direction, it will essentially defer to CARB to weigh the associated trade-offs and make program design choices. This could be appropriate in some cases, particularly when the decisions are highly technical and do not affect key legislative priorities. However, in other cases, it could result in decisions that are not consistent with legislative priorities.