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Proposed Amendments to the Cap-and-Invest Program

PRESENTED TO: Assembly Budget Subcommittee No. 4 on Climate Crisis, Resources, Energy, and Transportation
Hon. Steve Bennett, Chair

LEGISLATIVE ANALYST'S OFFICE

Background: Cap-and-Invest Allowances and Greenhouse Gas Reduction Fund

State Has Ambitious Greenhouse Gas (GHG) Reduction Goals. California has established statutory goals for reducing statewide GHG emissions—down to at least 40 percent below the 1990 level by 2030, and to at least 85 percent below the 1990 level by 2045.

Cap-and-Invest Is a Key State Program Aimed at Achieving GHG-Reduction Goals. The California Air Resources Board (CARB) sets a declining, aggregate cap on the amount of GHGs allowed to be emitted under the program. CARB issues a set number of allowances each year equal to the annual cap. Entities covered by the program can comply with the program by (1) reducing their emissions, (2) purchasing allowances, or (3) purchasing offsets. (Each allowance is essentially a permit to emit one ton of carbon dioxide equivalent.)

Allowances Have Significant Value, Similar to Tax Revenues. Emitters pay for allowances, similar to the way they would pay a tax on their GHG emissions. A key difference between allowances and taxes is how the revenues are allocated. In the case of taxes, all of the revenues come directly to the state. In contrast, in the case of allowances, the revenues go to whichever entity is provided the allowances.

Under CARB Regulations, State Has Historically Given Away Roughly Half of Allowances and Provided Residual to the Greenhouse Gas Reduction Fund (GGRF). The Legislature has given CARB relatively broad authority to determine how to allocate allowances through regulation. Historically, under CARB's regulations:

- About half of allowances have been given away for free to electric utilities, natural gas suppliers, and industrial facilities. These are intended to protect consumers from significant cost increases and prevent emissions leakage (that is, to keep companies from moving their operations outside of California).
- The remaining half of allowances have been available for CARB to sell at quarterly auctions, with revenues deposited into GGRF. Because GGRF gets the residual, increases in allocations of allowances for industry and/or utilities result in fewer for GGRF.

Background: Recent Legislation

Recent Legislation Extended and Modified Program. In September 2025, the Legislature adopted Chapter 117 (AB 1207, Irwin) and Chapter 121 (SB 840, Limón), which extended and made various changes to the cap-and-invest program. These changes: (1) modified the program's design features and allowance allocations; (2) changed the allocation of GGRF revenues; and (3) added reporting, evaluation, and oversight provisions.

Legislation Made Various Changes to the Program's Design Features and Allowance Allocations. For instance:

- ***Modified Guidance for Allocating Allowances to Utilities and Industry.*** For example, AB 1207 requires that CARB design regulations that by January 1, 2031, shift the free allowances that natural gas utilities currently receive to instead be allocated to electric utilities. Also, starting January 1, 2031, it replaces a requirement that CARB assume the highest leakage risk for all industries with a requirement that CARB distribute allowances in a way that reduces leakage risk to cost-effectively meeting the state's GHG reduction goals.
- ***Modified Design Features.*** For example, AB 1207 specifies that for each offset that is used to meet a compliance obligation, an allowance is removed from the subsequent year's allowance budget. (This approach is often referred to as placing offsets "under the cap.")

Changed the Framework for Allocating GGRF Revenues. Senate Bill 840 changed some statutory allocations from being set percentages of annual GGRF revenues to fixed dollar amounts. It also modified the order in which certain allocations are made, including setting aside $1 billion for discretionary allocations earlier in the prioritization process.

Background: Recent Legislation

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Key Changes in Cap-and-Invest Design Features and Allowance Allocations

Prior Law and/or Regulation	AB 1207 and SB 840[a]
Program Sunset and Name	
• Sunset date of January 1, 2031.	• Sunset date of January 1, 2046.
• Program named "cap-and-trade."	• Expresses intent to rename the program "cap-and-invest."
Linkage to State Climate Goals	
• General guidance to CARB to set emission limits to meet the state's GHG reduction goals.	• Explicit requirement that CARB set emission limits to ensure the state meets, at a minimum, its 2030 and 2045 goals.
Use of Offsets	
• Use of offsets does not affect allowance budget.	• Reduces the subsequent year's allowance budget for each offset used.
• Covered entities can meet 6 percent of compliance obligations with offsets in 2026 through 2030.	• CARB to determine the degree to which covered entities can meet compliance obligations with offsets (no more than 6 percent).
• No requirement that CARB update its offset protocols.	• CARB must update its offset compliance protocols by January 1, 2029, evaluate them for potential update every five years thereafter, and consider expanding protocols to new sectors.
• No requirement for CARB to prepare a study on offsets.	• CARB must prepare a study on offsets by December 31, 2026.
Allowances Provided to Utilities	
• Electric and natural gas utilities allocated free allowances (roughly one-quarter and one-eighth of total allowances, respectively) to benefit ratepayers.	• CARB must develop regulations to transition gas utilities' free allowances to electric utilities by January 1, 2031.
• 15 percent of electric IOU allowances may be provided for clean energy and energy efficiency.	• 5 percent of electric IOU allowances must be provided to support a California Transmission Accelerator Revolving Fund through July 1, 2031.
• Electric IOU rebates must be provided to residential, small business, and emissions-intensive trade-exposed retail customers.	• Electric IOU rebates must be provided to residential customers. Small business and certain retail customers may also be provided rebates, as determined by CPUC.
• Electric IOU rebates provided twice annually (in April and October) and natural gas rebates provided once annually (in April).	• Residential electric IOU rebates must be provided in up to the four highest-billed months.
• Electric IOUs required to adopt and implement customer outreach plans to inform the public about utility rebates.	• Electric IOUs required to update their customer outreach plans.
• POUs can use allowances for various purposes that benefit ratepayers.	• POUs must use the incremental allowances they receive from the transition away from natural gas allowances for customer rebates. (No changes to requirements for POUs' other allowances.)
Allowances Provided to Industry	
• CARB must assume the highest leakage risk for all industries.	• Starting in 2031, CARB must distribute allowances to minimize leakage risk to cost-effectively meeting the state's climate goals.
Price Ceiling	
• Proceeds from permits sold at the price ceiling must be used to purchase offsets.	• Proceeds from permits sold at the price ceiling must be deposited into Climate Mitigation Fund to be appropriated by the Legislature to reduce energy costs and for other purposes.
• General direction for CARB to consider avoiding adverse impacts on households, businesses, and the economy (among various other factors) when establishing the price ceiling.	• CARB also directed to consider actions to ensure consumers are protected if it finds that the price ceiling and/or price containment reserve do not adequately protect consumers.

[a] Most changes in the program design and allowance allocations are pursuant to Chapter 117 of 2025 (AB 1207, Irwin). However, some offset-related provisions are also included in Chapter 121 of 2025 (SB 840, Limón).

CARB = California Air Resources Board; GHG = greenhouse gas; IOUs = investor-owned utilities; CPUC = California Public Utilities Commission; and POUs = publicly owned utilities.

Background: Recent Legislation

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Modifications to Statutorily Required GGRF Appropriations Pursuant to SB 840[a]

Program	Department	Prior Statutory Allocations	Starting in 2026-27[b]
Tier 1: Starting in 2026-27, funding will be allocated first to the following programs:			
Manufacturing tax exemption	N/A	• Roughly $160 million. • Sunsets on July 1, 2030.	• No changes (maintains sunset).
State Responsibility Area fee backfill	CalFire	• Roughly $90 million. • Sunsets on January 1, 2031.	• No changes (maintains sunset).
Legislative Counsel Climate Bureau	Legislative Counsel	• None.	• $3 million annually.
Tier 2: Then second to the following programs:			
High-speed rail project	HSRA	• 25 percent of annual revenues. • No sunset.	• $1 billion annually.
Unspecified programs subject to appropriation	Various	• None.	• $1 billion annually.
Tier 3: Then third, if funding is available, to the following programs:[c]			
Affordable Housing and Sustainable Communities Program	SGC	• 20 percent of annual revenues. • No sunset.	• $800 million annually.
TIRCP	CalSTA	• 10 percent of annual revenues. • No sunset.	• $400 million annually.
Community Air Protection Program—AB 617[d]	CARB	• None.[e]	• $250 million annually.
Low Carbon Transit Operations Program	Caltrans	• 5 percent of annual revenues. • No sunset.	• $200 million annually.
Wildfire and forest resilience—SB 901[f]	CalFire	• $200 million annually. • Sunsets on June 30, 2029.	• $200 million annually.
Safe and Affordable Drinking Water Program	SWRCB	• 5 percent of annual revenues (up to $130 million). • Sunsets on June 30, 2030.	• $130 million annually.
Tier 4: Then fourth, remaining funding is subject to legislative appropriation for discretionary purposes.			

[a] Chapter 121 of 2025 (SB 840, Limón).
[b] No sunset date unless otherwise noted.
[c] Senate Bill 840 requires the Department of Finance to proportionately reduce the amounts for these programs if funding is not sufficient to fully support them and pay for state administrative costs.
[d] Chapter 136 of 2017 (AB 617, C. Garcia).
[e] AB 617 did not have a prior statutory allocation, but the program historically has received roughly $250 million annually on a discretionary basis.
[f] Chapter 626 of 2018 (SB 901, Dodd).

GGRF = Greenhouse Gas Reduction Fund; CalFire = California Department of Forestry and Fire Protection; HSRA = High-Speed Rail Authority; SGC = Strategic Growth Council; TIRCP = Transit and Intercity Rail Capital Program; CalSTA = California State Transportation Agency; Caltrans = California Department of Transportation; and SWRCB = State Water Resources Control Board.

Background: CARB's Rulemaking

CARB Proposed Amendments to the Cap-and-Invest Regulations in January 2026. This included changes in response to AB 1207, as well as some other modifications. Some key provisions would have:

- ***Established Allowance Budgets and Removal of Allowances.*** Would have updated allowance budgets through 2045, including removing 118 million allowances through 2030 to meet the state's 2030 goals.
- ***Modified Allowance Allocations Past 2030.*** Would have extended the assumption that all sectors are at highest risk for leakage through 2035. Also, would have revised electric utility allocations downward in recognition of the grid becoming cleaner.
- ***Implemented Requirements of AB 1207.*** Would have gradually increased the share of allowances transferred from natural gas to electric utilities from 2029 through 2037. Also, would have placed offsets under the cap.
- ***Established Limited Manufacturing Decarbonization Incentive (MDI) Program.*** Would have created a new, relatively narrow incentive program for certain industrial facilities (refineries and oil/gas excluded). Program was expected to be funded by 40 million allowances borrowed from future years.

CARB Revised Proposal After Receiving Comments on January Version. In response to comments received on the January version of the amendments, CARB published a modified version on April 14, 2026. The April revisions included several significant, substantive changes to the proposed regulations, including some aimed at reducing leakage (industry leaving the state to avoid complying with the program) and addressing affordability concerns.

CARB Anticipates Vote on Revised Regulations in Late May 2026. The 15-day comment period for the modified regulations ended on May 4, 2026. CARB is scheduled to vote on the April version of the regulations on May 28, 2026.

April Proposed Amendments: Key Components

Establishes Total Number of Allowances Through 2045, Including Removing 118 Million Allowances Through 2030… Defines the number of allowances anticipated to be provided annually through 2045, including removing a total of 118 million allowances through 2030.

…But Adds Back Up to 118 Million Allowances "Above the Cap" for Larger and Broader MDI Program. Industrial entities could apply to receive MDI allowances from CARB to support decarbonization-related projects. Half of these allowances would be reserved for refining and similar industries and the other half would be reserved for other industries. CARB estimates the program value at $4 billion.

Changes Allocation of Allowances, but Only Through 2030. Compared to existing regulations:

- ***Increases Allowances for Industry.*** Would change the formula for calculating the allowances for industry (including by increasing what is known as the "cap adjustment factor"), thereby increasing the number of their allowances. (These changes are in addition to the MDI allowances.)
- ***Reduces Allowances for Electric Utilities.*** Would provide a net reduction to the number of allowances to electric utilities.

Creates Optional Delay for Refinery Compliance. Independent merchant refineries could delay certain compliance obligations by two years (to 2029).

Implements Various Changes Made in AB 1207. These include:

- ***Shifting Allowances From Natural Gas to Electric Utilities.*** Transition would begin in 2028 and be 70 percent complete by 2031. The remaining 30 percent of allowances would be reserved for low-income natural gas customers.
- ***Putting Offsets Under the Cap.*** Would remove an allowance from the market for every offset used for compliance.

April Proposed Amendments Could Have Significant Implications

Proposed Amendments Represent Significant Modifications to Program. The April amendments propose significant changes relative to current regulations, as well as to the January proposal. They could affect key legislative priorities, such as:

- ***Environmental Ambition.*** By adding MDI allowances outside of the cap, the proposed regulations would allow for additional emissions above the capped level and reduce certainty that the state will meet its 2030 GHG reduction target. In contrast, the placement of offsets under the cap would remove allowances from annual budgets.
- ***Industry and Leakage.*** Would provide additional support for industry, such as by increasing its number of free allowances and making an estimated $4 billion in MDI allowances available to support decarbonization activities. A recent analysis by the Chair of the Independent Emissions Market Advisory Committee suggests that some emitters could receive free allowances well in excess of their emissions.
- ***Utilities and Climate Credit.*** Would transition natural gas allowances to electric utilities and continue to provide free allowances to electric utility customers aimed at offsetting their compliance costs. On net, the smaller number of allowances for electric utilities relative to existing regulations could somewhat reduce the overall amount of Climate Credit. (Some utilities would receive more allowances while others would receive fewer compared to existing regulations.)
- ***GGRF.*** Would significantly reduce the number of allowances anticipated to be dedicated to GGRF. Also, the MDI proposal would effectively increase the allowance supply, thereby potentially putting downward pressure on allowance prices.
  - GGRF revenues are subject to substantial uncertainty, but CARB's estimates suggest they would total about $2 billion per year—roughly half the amount in recent years. This amount would be inadequate to fully support Tier 2 programs within SB 840's framework and leave no funding for Tier 3 programs.

Key Questions for Legislative Consideration

Do The April Proposed Amendments Strike the Legislature's Preferred Balance Between Certainty and Flexibility? Specifying allowance allocations for a shorter period of time—only through 2030 rather than at least 2035—provides less certainty but allows additional time for evaluation and increases flexibility for making future program changes.

Do They Strike the Legislature's Preferred Balance Between Environmental Ambition and Other Priorities? For example, adding allowances beyond the cap—through the MDI program—likely will reduce the pace of statewide GHG reductions but could help address affordability concerns by lowering allowance prices and the associated costs that businesses pass along to consumers.

Does the Allocation of Allowances Reflect Legislative Priorities? The Legislature will want to be sure that the distribution of allowances—and associated revenues from the program—aligns with its multiple priorities. For example, under CARB's proposal, industry would get a greater number of allowances and GGRF would get fewer.

Is the MDI Program Structured to Achieve Legislative Goals? The new proposed program is relatively broad and has the potential to be large, particularly if emitters take full advantage of it. Are the program's targeted sectors and size consistent with legislative preferences? Is the Legislature comfortable that the program will achieve benefits that outweigh its costs and will provide additional, verifiable, and cost-effective emission reductions? If it wants to allow CARB to proceed in establishing this program, the Legislature could consider adding statutory parameters to guide its design.

How Should GGRF Be Prioritized? If GGRF revenues likely will be significantly lower than previously anticipated, the Legislature may want to consider whether the SB 840 framework still prioritizes its highest-priority programs, or whether some revisions would be merited.