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The 2024-25 Budget:
Cap-and-Trade Expenditure Plan

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SUMMARY

The Governor proposes a roughly $2.3 billion discretionary cap-and-trade expenditure plan. The plan would dedicate most of this funding for fund shifts to backfill General Fund reductions, including $557 million proposed for early action in the current year. The proposal also includes an intention to commit a significant amount of out-year Greenhouse Gas Reduction Fund (GGRF) revenues to backfill future spending for activities related to zero-emission vehicles (ZEVs) that previous budget agreements had initially planned to provide from the General Fund.

We find the Governor's overall approach of using GGRF primarily to achieve General Fund solutions to be sensible, but the Legislature ultimately could choose a different package of programs to protect. Moreover, if the General Fund condition continues to deteriorate and the Legislature has to consider making ongoing reductions to base programs, it may want to consider using GGRF to preserve more urgent and ongoing needs rather than backfilling spending for one-time discretionary activities. We recommend the Legislature adopt a GGRF spending plan that reflects its priorities and maximizes General Fund savings. We also recommend the Legislature minimize its out-year GGRF commitments. Retaining its traditional flexibility over these future funds will leave the Legislature better positioned to respond should other priorities emerge, especially in light of projected General Fund deficits over the next couple of years. While we believe more GGRF revenues ultimately might be available for discretionary expenditures in 2024-25, considerable uncertainty exists around these estimates. With this uncertainty in mind, we recommend the Legislature continue to closely monitor quarterly cap-and-trade auctions to assess how revenues are materializing and set its annual GGRF spending levels accordingly for both the budget year and future years. For 2024-25, this could mean spending at somewhat higher levels than proposed by the Governor, but as the potential for volatility grows in the out-years, a more conservative spending approach in the future could be prudent.

Background

Cap-and-Trade Auction Revenue. Revenues from quarterly cap-and-trade auctions are deposited into GGRF and the funds generally are allocated to climate-related programs. Over the past three years, individual quarterly auctions have generated an average of $1.1 billion in revenue, with annual amounts averaging $4.2 billion. Under current law, about 65 percent of auction revenue is continuously appropriated to certain projects and programs, including for the state's high-speed rail project, affordable housing, transit, and safe drinking water. In addition, $200 million is continuously appropriated each year for forest health and wildfire prevention activities. The remaining revenue is available for appropriation by the Legislature through the annual budget for other ongoing funding commitments (such as state administrative costs and statutory transfers) as well as discretionary spending priorities.

Governor's Proposal

Proposes $2.3 Billion in Discretionary Spending. The Governor assumes the state will have about $5.1 billion in GGRF monies available to spend in 2024-25. This total includes (1) unallocated revenues from higher-than-anticipated proceeds the state received in the August 2023 auction, (2) short-term investment proceeds earned on prior-year funds before they were spent, and

(3) anticipated revenues from 2024-25 auctions and investment earnings. Of this amount, as shown in Figure 1, the proposal commits $2.5 billion for continuous appropriations; $2.3 billion for discretionary spending; and $284 million for other existing commitments, including baseline operations.

Includes $557 Million Proposed for Early Action, Primarily for ZEV Activities. The budget proposes spending $557 million of available GGRF revenues in 2023-24, primarily for activities included in the multiyear ZEV package that was part of recent budget agreements. The Governor proposes that the Legislature take early action and use these funds to achieve current-year General Fund savings through the following fund shifts:

- ***ZEV Activities ($476 Million).*** The Governor proposes shifting current-year funding from the General Fund to GGRF for four programs adopted as part of the ZEV package in recent budgets, all administered by the California Energy Commission (CEC): ZEV fueling infrastructure grants ($219 million); drayage trucks and infrastructure ($157 million); clean trucks, buses, and off-road equipment ($71 million); and transit buses and infrastructure ($29 million). The administration has directed CEC to pause its spending of authorized General Fund for these programs to avoid eroding these potential current-year savings.

- ***California Department of Forestry and Fire Protection Fire Prevention Grants ($81 Million).*** The budget also would reduce General Fund and instead provide GGRF for the fire prevention grants program, which both aims to reduce the risk of wildfires to homes and communities and reduce carbon emissions from forest fires.

Figure 1

Governor's Proposed 2024-25 Cap-and-Trade Spending Plan

(In Millions)

	Department	Funding
Continuous Appropriations		**$2,518**
High-speed rail project	HSRA	$912
Affordable Housing and Sustainable Communities	SGC	729
TIRCP	CalSTA	365
Healthy and resilient forests	CalFire	200
Low Carbon Transit Operations Program	CARB	182
Safe and Affordable Drinking Water Program	SWRCB	130
Other Existing Commitments		**$284**
Baseline Operations	Various	$100
Manufacturing tax credit	N/A	97
State Responsibility Area fee backfill	CalFire	87
Discretionary Appropriations		**$2,279**
Early Action Fund Shifts (2023-24)		**$557**
ZEV fueling infrastructure grants (ZEV package)	CEC	$219
Drayage trucks and infrastructure (ZEV package)	CEC	157
Fire prevention grants	CalFire	81
Clean trucks, buses, off-road equipment (ZEV package)	CEC	71
Transit buses and infrastructure (ZEV package)	CEC	29
Budget-Year Fund Shifts (2024-25)		**$1,242**
TIRCP and other transportation programs	CalSTA	$791
Energy package activities	CEC	144
Extreme heat package activities	CNRA/SGC	94
Wildfire package activities	Various	81
Oil well plug and abandonment	DOC	50
Coastal resilience package activities	CNRA	37
Livestock methane reduction program	CDFA	24
Water and drought package activities	CDFA	21
Other Discretionary Spending		**$480**
AB 617	CARB	$250
Zero-Emission Transit Capital Program	CalSTA	230
Total		**$5,081**

HSRA = High Speed Rail Authority; SGC = Strategic Growth Council; TIRCP = Transit and Intercity Rail Capital Program; CalSTA = California State Transportation Agency; CalFire = California Department of Forestry and Fire Prevention; CARB = California Air Resources Board; SWRCB = State Water Resources Control Board; N/A = not available; ZEV = zero-emission vehicle; CEC = California Energy Commission; CNRA = California Natural Resources Agency; DOC = Department of Conservation; CDFA = California Department of Food and Agriculture; and AB 617 = Assembly Bill 617 Community Air Protection Program.

Uses Discretionary Funds Primarily to Swap Out Planned General Fund Spending. As shown in Figure 1, similar to the proposed current-year fund swaps, the Governor uses most of the remaining discretionary spending ($1.2 billion) to backfill General Fund reductions in 2024-25 for various programs, including those related to transportation as well as activities included in a number of climate budget packages. (We discuss these specific proposals and programs in our companion publications, *The 2024-25 Budget: Crafting Climate, Resources, and Environmental Budget Solutions* and *The 2024-25 Budget: Transportation Budget Solutions*.) The two main exceptions to this approach are $250 million for the AB 617 Community Air Protection program and $230 million for the Zero-Emission Transit Capital Program administered by the California State Transportation Agency. The former is a program initiated through Chapter 136 of 2017 (AB 617, C. Garcia) to monitor and reduce air pollution in vulnerable communities. This program has received regular support from GGRF over the past several years. The latter is a new program initiated in the 2023-24 budget intended to provide four years of formula funding to transit agencies which they can use to support zero-emission buses and related infrastructure and/or to cover their operating expenses.

Delays $600 Million in Planned GGRF Funding. The Governor proposes to delay $600 million in planned GGRF spending for the ZEV package from 2024-25 to 2027-28. This delay frees up this funding in 2024-25, making an additional $600 million available for achieving budget solutions through other General Fund reductions and backfills. This $600 million is part of the $2.3 billion in resources used for discretionary spending.

Commits $3.5 Billion in Out-Year GGRF. Reflecting actions agreed to as part of the 2023-24 budget package, the Governor's proposal commits out-year discretionary GGRF for various programs. Specifically, as shown in **Figure 2** and consistent with the 2023-24 budget agreement with the Legislature, the Governor's proposal includes intent to commit funding annually for the ZEV package and the Zero-Emission Transit Capital Program from 2025-26 through 2026-27. The figure also shows the new $600 million the Governor is proposing to provide for ZEV programs in 2027-28 (reflecting the proposed delay from the budget year) as well as a new proposed intention to provide annual appropriations of $250 million for the AB 617 program through 2029-30.

Assessment

Use of GGRF to Achieve General Fund Savings Has Merit, but Legislature Could Choose an Alternative Mix. Given the General Fund deficit, the Governor's proposal to use most discretionary GGRF to achieve General Fund savings and sustain some program activities makes sense. However, the Legislature could adopt this same strategy in a somewhat different way to align with its priorities. Specifically, it could achieve the same amount of savings as the Governor through directing GGRF funds to backfill a different mix of General Fund reductions. For example, the Governor proposes using a total of $1.8 billion from GGRF to backfill essentially *all* the proposed General Fund reductions to the ZEV package across the next three years, but only $37 million in 2024-25 to sustain a mere 8 percent of the proposed reductions to certain coastal resilience activities that had been included in previous budget agreements.

Figure 2

Governor's Proposed Out-Year GGRF Commitments

(In Millions)

Program	Department	2025-26	2026-27	2027-28	2028-29	2029-30	Totals
AB 617	CARB	$250	$250	$250	$250	$250	$1,250
ZEV package	CARB	215	301	213	—	—	729
	CEC	385	299	387	—	—	1,071
Zero-Emission Transit Capital	CalSTA	230	230	—	—	—	460
Totals		**$1,080**	**$1,080**	**$850**	**$250**	**$250**	**$3,510**

GGRF = Greenhouse Gas Reduction Fund; AB 617 = Assembly Bill 617 Community Air Protection Program; CARB = California Air Resources Board; ZEV = zero-emission vehicle; CEC = California Energy Commission; and CalSTA = California State Transportation Agency.

Based on its highest priorities, the Legislature could choose a different allocation. The Legislature has flexibility around how it is able to direct GGRF revenues because the program was authorized in a way that is akin to a tax, meaning the funds can legally be used for broad purposes. Moreover, if the General Fund condition continues to deteriorate and the Legislature has to consider making ongoing reductions to base programs, it may want to prioritize GGRF monies differently. Specifically, the Legislature may need to consider using these funds to preserve more urgent and ongoing needs rather than backfilling spending for one-time discretionary activities.

Extensive Reliance on Out-Year GGRF Makes Assumptions About Future State Priorities and Revenues. While the state dedicates a share of annual GGRF revenues to recurring ongoing activities (such as the high-speed rail project, sustainable housing and transit programs, and activities to improve drinking water quality and availability), it generally has maintained about 35 percent for discretionary spending decisions agreed upon by the Legislature and Governor as part of each year's budget negotiations. The 2023-24 budget package broke with historical practice somewhat by including plans to dedicate a notable share of out-year discretionary GGRF revenues for specific purposes rather than deferring that decision to future legislative and administration negotiations, including $600 million annually for three years beginning in 2024-25 to backfill General Fund reductions within the ZEV package. As noted above, the Governor's proposal includes $3.5 billion in out-year GGRF discretionary spending commitments. While this approach allows the state to maintain long-term intended ZEV spending plans and save General Fund, it does raise two key concerns:

- ***Limits Legislative Flexibility to Respond to Potential Changes in Out-Year Priorities.*** Given the projected budget deficits in the coming years, the Legislature could face some very difficult choices around its expenditures—including a potential need to reduce General Fund support for core ongoing programs. In such a case, the Legislature could find that it has higher priorities for GGRF revenues than sustaining planned one-time program expansions. While nothing precludes it from revisiting these spending intentions in a future year, leaving them in its multiyear spending plan for now could set unrealistic expectations and make redirecting the funds in the coming years more challenging. In contrast, holding off on making spending commitments until it has more information about the budget situation it faces in each given fiscal year would preserve more flexibility for the Legislature to target available discretionary GGRF funds to its pressing and emerging priorities.
- ***Uncertainty Around Future Revenues.*** As we discuss below, considerable uncertainty exists around how much GGRF revenue will be available in future years. A precipitous drop in these revenues could jeopardize not only planned out-year ZEV and Zero-Emission Transit Capital Program spending but also other longstanding state priorities for which the state has historically relied upon this funding source—raising further questions about the wisdom of committing these additional funds so many years in advance.

Legislature Could Revisit Existing Statutory Commitments if Its Priorities Have Changed. Besides revisiting whether it wants to maintain out-year, limited-term discretionary commitments for ZEV activities and other programs, the Legislature also could reconsider the degree to which both current continuous appropriations (which receive about 65 percent of total GGRF revenues) and ongoing discretionary spending commitments continue to be consistent with its current priorities. Most of the continuous appropriations were established as part of the 2014-15 budget, and legislative priorities may have changed over the last decade. Particularly in the context of the General Fund deficit and proposed spending reductions to other programs, the Legislature can consider all GGRF expenditures "on the table" and within its purview for reevaluation and potential modification.

Administration's New Revenue Estimate Methodology Less Conservative, Likely More Accurate. As part of developing its annual budget proposal, each year the Department of Finance (DOF) estimates how much revenue it believes will be generated for GGRF at cap-and-trade auctions in the coming fiscal year. This estimate forms the basis for the Governor's annual GGRF spending plan. DOF recently changed the methodology it uses to calculate this projection. Prior to spring 2023, the administration based its estimates on an assumption that all cap-and-trade allowances would sell at the auction floor price. This methodology resulted in DOF regularly underestimating revenues quite notably, as allowances have sold well above the floor price for the last several years. (In contrast, our office historically has developed cap-and-trade revenue estimates based on an assumption of stable allowance prices. In recent years, this approach has led our projections of annual discretionary GGRF revenues to exceed the Governor's by several hundreds of millions of dollars—and also has resulted in our estimates more closely aligning with actual auction results, as compared to the administration's projections.) DOF's new approach uses an average of actual allowance prices from auctions that occurred in the previous calendar year. For 2024-25, this new approach has resulted in the administration basing its spending plan on higher estimates compared to its previous practice. We believe DOF's new approach is likely to yield more accurate revenue predictions.

We Estimate More GGRF Could Be Available for Discretionary Spending, but Projections Carry Considerable Uncertainty. Even with DOF's new approach, we believe the administration still could be underestimating the amount of GGRF revenue that cap-and-trade auctions will generate in 2024-25. Our conclusion is based on recent auction trends, in which allowance prices have been trending upward (as of this writing). Should these trends continue, the state could have additional GGRF to spend in both the current and budget years compared to the Governor's proposal—perhaps including several hundreds of millions of dollars more for discretionary spending. However, considerable uncertainty exists around these estimates. The Legislature will be able to incorporate additional information from the February and May 2024 auctions before it needs to make its final budget decisions for 2024-25.

Increasing Degree of Uncertainty Around Revenues. A couple of factors may contribute to more volatility than usual for cap-and-trade revenues over the next several years. The Legislature may want to keep these uncertainties in mind as it makes its GGRF budgeting decisions for 2024-25 and in the coming years.

- ***California Air Resources Board (CARB) Considering Cap-and-Trade Program Changes.*** CARB is in the process of considering amendments to the cap-and-trade program that would influence allowance prices. These include potential changes to the emissions cap, the number of allowances the state makes available, and the allocation of those allowances. Scenarios that CARB has presented suggest allowance auction prices will increase, which likely would mean more revenues for GGRF. However, the way in which CARB makes changes to its allocation of allowances (such as modifying the mix of allowances given away for free to certain industries like utilities versus the number sold at the state-run auctions) ultimately will determine the impacts on prices and state revenues.
- ***2030 Expiration.*** Before the Legislature last extended the statutory authorization for the cap-and-trade program in 2018, revenues from GGRF began to decline due to investor uncertainty about the status of the program. Should considerable uncertainty about the fate of the program exist as its next statutory end-date approaches (2030), a similar change in revenue trends could reemerge. Such volatility related to reauthorization questions is not likely to be a significant risk this year, but could develop over the next several years closer to 2030.

Recommendations

Adopt GGRF Spending Plan That Focuses on Legislative Priorities and Maximizes General Fund Solutions. We recommend the Legislature adopt the Governor's overall strategy of using GGRF to help backfill General Fund reductions for certain programs. This approach allows the state to achieve necessary budget savings while continuing important activities. However, we recommend the Legislature adopt a GGRF spending package that ultimately preserves funding for its highest-priority activities, which may represent a different mix from that proposed by the Governor. For example, instead of prioritizing GGRF to sustain nearly all of the original intended funding for ZEV activities, the Legislature could redirect some of those funds to protect some additional funding for other program areas proposed for deeper reductions, especially given the significant amount of federal funds available for ZEVs. Depending on how quickly and severely the General Fund condition worsens, the Legislature also could consider using GGRF to backfill General Fund reductions to core ongoing programs rather than to sustain discretionary one-time climate and environment spending. In addition, the Legislature could consider revisiting GGRF continuous appropriations and ongoing spending commitments, most of which were established in 2014-15. The Legislature's highest priorities may now be different.

Minimize Out-Year GGRF Commitments. The state faces considerable uncertainty about future GGRF revenues due to the factors mentioned above. In addition, committing out-year GGRF funds, while useful to provide some assurance regarding future programs, limits legislative flexibility over the use of these funds in upcoming years should other priorities emerge. This is especially important in this fiscal environment, where the budget situation is expected to be difficult for the next few years. As such, we recommend that—for now—the Legislature consider both reducing planned out-year GGRF funding that has not yet been appropriated, and reducing rather than delaying GGRF expenditures and revisiting them in a future year when it has a better sense of its available fiscal resources and highest spending priorities. This would help avoid creating spending expectations that the state may not be able to fulfill.

Monitor Auctions and Adopt Spending Levels That Reflect Evolving Revenue Trends. Given the growing uncertainty around cap-and-trade revenues, we recommend the Legislature continue to closely monitor quarterly auctions to assess how revenues are materializing and set its annual GGRF spending levels accordingly. For 2024-25, this will mean incorporating the results of the February and May 2024 auctions. (The results from February were not yet available at the time of this writing.) If allowance prices continue to trend upward at that point, the Legislature could have some additional comfort in potentially adopting a plan that spends at a slightly higher level than the Governor's proposal. For future years, the Legislature may want to adopt a more conservative approach with its GGRF spending assumptions, given the growing uncertainty around allowance prices and potential for revenue volatility. As discussed above, avoiding making significant out-year GGRF commitments is another tool that can help preserve legislative flexibility to respond to unknown and evolving future revenue trends.

LAO PUBLICATIONS

This report was prepared by Sarah Cornett and reviewed by Rachel Ehlers. 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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