AGENDA

Assembly Budget Subcommittee No. 3 on Resources and Transportation

Assemblyman Richard S. Gordon, Chair

February 29, 2012

9:00 a.m. - State Capitol Room 447

Cap and Trade Auction Revenues

The purpose of this hearing is to discuss the pending Cap and Trade auction and anticipated reviews, review parameters for spending such revenues, and outline a process moving forward to develop an expenditure plan.

9:00 – 9:15	**Welcome & Introductions**
9:15 – 9:45	**Overview of Cap and Trade Issue** Tiffany Roberts, Analyst, Resources & Environmental Protection, Legislative Analyst's Office
9:45 – 10:15	**California Air Resources Board/Department of Finance** Department of Finance Richard Corey, Deputy Executive Officer, ARB Edie Chang, Assistant Division Chief, ARB
10:15 – 10:45	**California Public Utilities Commission** Peter Allen, Legal Division, Public Utilities Commission Andy Schwartz, Energy Division, Public Utilities Commission
10:45 – 11:15	**Public Comments**

BACKGROUND

The cap-and-trade program is a key element in the State's climate plan to reduce greenhouse gas (GHG) emissions to 1990 levels by the end of this decade. It sets a limit on major sources of greenhouse gases and establishes a financial incentive for long-term investments in cleaner fuels and more efficient energy use. As part of its program, California Air Resources (ARB) will give free allowances to the State's large industrial emitters as well as the State's electric utilities in order to reduce the economic impact of the cap-and-trade program.

In 2012, the ARB will begin auctioning GHG emission allowances as part of the cap-and-trade program. The first of four auctions in the 2012-13 budget year, is scheduled to take place in August. According to the LAO, because the auction rules developed by ARB include both floor and ceiling prices for allowances, actual cap-and-trade revenues for 2012-13 could range from roughly $650 million to almost $3 billion.

The Governor's Budget requests up to $1 billion in Air Pollution Control Fund expenditure authority for programs to reduce GHG emissions pursuant to the Global Warming Solutions Act of 2006 (AB 32). The Budget assumes that $500 million of the $1 billion will be used to offset existing General Fund costs of GHG mitigation activities.

The proposal puts forth broad categories for which revenues might be used, including: clean and efficient energy; low-carbon transportation; natural resource protection; and sustainable infrastructure development. However, it does not include an expenditure plan for these funds. Instead, the budget proposal directs the Department of Finance (DOF) and the ARB to submit a plan, outlining specific expenditures, to the Assembly and Senate Appropriations Committees and the Joint Legislative Budget Committee after at least the first auction and not fewer than 30 days prior to allocating funds.

Trailer Bill Language (TBL) submitted by the Administration in early February establishes a deposit account for auction proceeds (Greenhouse Gas Reduction Account) and lays out, in more detail than the budget proposal, parameters to develop an expenditure plan. The proposed TBL suggests that the expenditure plan may include, but is not limited to, any of the following:

- Industrial and manufacturing facilities to reduce GHG emissions by investment in energy efficiency, energy storage, and clean and renewable energy projects;

- Public universities, schools, water agencies, and other public facilities and fleets to reduce GHG emissions by investment in energy and water use efficiency, energy storage, and clean and renewable energy and fuel projects;

- The federal Energy Efficiency and Conservation Block Grant Program and the federal Weatherization Assistance Program;

- Residential and commercial energy efficiency and distributed generation programs that serve to reduce greenhouse gas emissions;

- Public transportation and sustainable transportation and infrastructure development;

- Programs for clean vehicles and the advancement of transportation technologies, including, but not limited to, the Air Quality Improvement Program;

- Advanced transportation and fueling infrastructure for zero-emission vehicles, including hydrogen fuel cell vehicles;

- Local and regional sustainable development efforts;

- Low-carbon goods movement and freight vehicle technologies and infrastructure, including, but not limited to, locomotives and heavy-duty trucks;

- Natural resource management programs and projects;

- Land conservation and restoration; and,

- Development and implementation of sustainable agriculture, forestry, and related water, land, and resource management practices.

Although the TBL provides some parameters for the types of programs the revenue could be used for, it lacks specific details, like priorities or what portion of funds will go to specific programs. Speaker Pérez has introduced AB 1532, while not an expenditure plan, will likely contain broad parameters of allowable uses for cap-and-trade auction revenue and a process by which the ARB/DOF would prepare an expenditure plan.

Because auction revenues are derived from mitigation fees, they are subject to the "Sinclair nexus test." *Sinclair Paint Co. v State Board of Equalization* was a court case in which the California Supreme Court ruled 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. Thus, the proposed TBL also specifies that these revenues must only be used for programs related to the reduction of GHG emissions.

In addition to the proposed $1 billion that is included in the Governor's Budget, the Administration expects an additional $650 million will be generated in 2012-13 as a result of a free allocation of carbon allowances to the state's electric distribution utilities (i.e., Investor Owned Utilities (IOUs) and publicly owned utilities). Per ARB's cap-and-trade regulations, ARB will give 65 million allowances to IOUs who are then required to sell those allowances in ARB's auction. If these allowances were to sell at the ARB's auction floor price of $10 per ton, the revenue generated would be $650 million. However, ARB has also included an auction ceiling price of $40 per ton and, as such, the sale of these allowances could result in higher revenues – potentially up to $2.6 billion.

While AB 32 does not specifically address the cap-and-trade program, it does grant ARB broad authority to administer the State's climate plan, including establishing regulations to conduct the auction. The ARB claims it has authority to grant allowances to electrical utilities, as well as other regulated sectors, pursuant to its cap-and-trade regulations (Title 17, section 95890). But, the ARB also requires that the allowances granted to utilities be auctioned and the revenues be used exclusively for the benefit of retail ratepayers. What is unclear is whether the ARB has the authority to require how the allowances are used once they are granted to the utilities, except that they be used consistent with the purposes of AB 32.

The California Public Utilities Commission (CPUC or Commission) claims it has statutory authority to determine how auction revenues are spent and has opened an official proceeding to determine how the IOUs should use these revenues without formally engaging the Legislature. 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. Unlike ARB's auction revenues, CPUC does not believe it is bound tightly by the nexus test of mitigating or reducing GHG emissions. Rather, its spending plan for auction revenue need only be consistent with AB 32. However, since the stated purpose of AB 32 is to reduce greenhouse gas emissions, there may be no difference between these two standards. Regardless, the Legislature certainly has the authority to give the CPUC guidance or direction on how the auction revenues can be spent.

Staff Comments

The Governor's proposal asks the Legislature to approve up to $1 billion in spending authority without knowing what the revenues will be used for. Because the first cap-and-trade auction occurs in August, after the 2012-13 budget is enacted, the Administration argues that submitting an expenditure plan prior to the auction would be premature because it does not know how much money the auction will generate. However, ARB's own regulations establish a floor and ceiling price for allowances. Thus, the Administration could provide an expenditure plan for $650 million (the low-end revenue estimate), construct a tiered plan that has graduated spending based on revenue levels (low-high), or propose a proportionate allocation method, where program appropriations are based on a percentage of total funds.

The State is currently sitting on large cash balances from past bond sales. With the depressed construction industry starved for work, the State benefits by engaging in as many infrastructure projects at this time as possible. It not only stimulates the economy with needed jobs, the State also is benefitting from historically low construction costs. Just as spending down bond funds now will help the State meet its infrastructure needs at lower costs than in the past, the same can be said for getting a jump start on projects and programs that reduce GHG emissions.

The Subcommittee should ask DOF to confirm its projected revenue estimate ranges for the auction. The Subcommittee should also request that DOF clarify whether the Administration plans to submit an expenditure plan to the Legislature for consideration during the normal budget process.

Should the Administration provide the Legislature with an expenditure plan in time for thoughtful review and analysis, the Legislative Analyst's Office (LAO) suggests a number of helpful criteria by which to evaluate a plan, such as ensuring all funds are used to mitigate (reduce) GHG emissions or harms caused by GHG emissions (i.e., meet the Sinclair nexus test). LAO also recommends prioritizing funding activities, which are currently funded by the General Fund in order to maximize General Fund relief and programs that have the greatest potential to reduce GHG emissions.

Without a detailed expenditure plan, approving a $1 billion expenditure authorization would forgo the Legislature's right to appropriate revenues based on Legislative priorities. The Administration current proposal would submit a specific expenditure plan to the Legislature after the budget is enacted and allow a 30 day review period. This approach lacks transparency. Not only would it limit the Legislature's opportunity to make changes to the plan, it would deny the public the opportunity to review and provide comment.

Over the coming months, the Legislature and the Administration should work together to try to come up with a process for developing an expenditure plan that balances the need for transparency with the advantages of getting the cap-and-trade auction revenues out the door as quickly as possible.

However, absent an expenditure plan in time to evaluate during the normal budget process for that portion of the auction revenues not dedicated to General Fund offsets, LAO's recommendation to hold off making any decisions about which programs to establish and expand until the 2013-14 budget process makes sense. This would give the Legislature a greater certainty about available revenues and would provide the Administration time after the first cap-and-trade auction to develop a detailed expenditure plan. It would also ensure a transparent process that incorporates Legislative priorities and allows the public the opportunity to review and provide comment.