

(Without Reference to File)

CONCURRENCE IN SENATE AMENDMENTS

AB 398 (Eduardo Garcia, et al.)

As Amended July 14, 2017

2/3 vote. Urgency

ASSEMBLY: 75-0 (June 1, 2017)

SENATE: 28-12 (July 17, 2017)

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Original Committee Reference: **NAT. RES.**

**SUMMARY:** Extends the Air Resources Board's (ARB) cap and trade authority through 2030. Requires ARB to establish a price ceiling on greenhouse gas (GHG) emission allowances in consideration of specified factors, adds several new conditions governing the management and allocation of allowances, reduces limits on compliance offsets, requires ARB to designate the cap and trade regulation as the GHG emission reduction rule for petroleum refineries and oil and gas production facilities, prohibits an air district from adopting or implementing an emission reduction rule for carbon dioxide from stationary sources that are also subject to the cap and trade regulation, and make other related changes. Suspends the State Responsibility Area (SRA) fire prevention fee from July 1, 2017 to January 1, 2031, and sunsets the SRA fee thereafter. Extends and expands the existing manufacturer's partial sales and use tax exemption from July 1, 2022 to July 1, 2030.

**The Senate amendments** delete the Assembly version of the bill and add the following provisions:

- 1) Extends ARB's cap and trade authority to 2030.
- 2) Requires ARB, in adopting a cap and trade regulation applicable from 2021 to 2030, to do all of the following:
  - a) Establish a price ceiling, considering all of the following:
    - i) The need to avoid adverse impacts on resident households, businesses, and the state's economy.
    - ii) The 2020 tier prices of the allowance price containment reserve (APCR).
    - iii) The full social cost associated with emitting a metric ton of GHG.
    - iv) The auction reserve price.
    - v) The potential for environmental and economic leakage.
    - vi) The cost per metric ton of GHG emissions reductions to achieve the 2030 statewide emissions targets.
  - b) Develop a mechanism to implement the price ceiling that consists of both of the following:

- i) Utilize allowances remaining in the APCR as of December 31, 2020 solely for the purpose of sale at the price ceiling.
- ii) If the allowances from the APCR are exhausted, additional metric tons shall be offered to covered entities at the price ceiling if needed for compliance. All moneys generated pursuant to this clause shall be expended by ARB to achieve emissions reductions, on at least a metric ton for metric ton basis, that are real, permanent, quantifiable, verifiable, enforceable by ARB, and in addition to any GHG emission reduction otherwise required by law or regulation and any other GHG emission reduction that otherwise would occur.
- c) Establish two price containment points at levels below the price ceiling (i.e., "speed bumps"). Requires ARB to offer to covered entities non-tradable allowances for sale at these speed bumps, which shall be established using two-thirds, divided equally, of the allowances in the APCR as of December 31, 2017.
- d) Transfer current vintage allowances designated for auction that remain unsold in the auction holding account for more than 24 months to the APCR.
- e) Evaluate and address concerns related to over-allocation in ARB's determination of the number of available allowances for years 2021 to 2030, inclusive, as appropriate.
- f) Establish offset credit limits. From January 1, 2021 to December 31, 2025, a total of 4%, and from January 1, 2026 to December 31, 2030, a total of 6%, of a covered entity's compliance obligation may be met by surrendering offset credits of which no more than one-half may be sourced from projects that do not provide direct environmental benefits in state (i.e., the reduction or avoidance of emissions of any air pollutant in the state or the reduction or avoidance of any pollutant that could have an adverse impact on waters of the state).
- g) Develop approaches to increase offset projects in the state considering guidance provided by the Compliance Offsets Protocol Task Force.
- h) Set industry assistance factors for allowance allocation commencing in 2021 at the levels applicable in the compliance period of 2015 to 2017, inclusive. ARB shall apply a declining cap adjustment factor to the industry allocation equivalent to the overall statewide emissions declining cap using the methodology from the compliance period of 2015 to 2017, inclusive.
- i) Establish allowance banking rules that discourage speculation, avoid financial windfalls, and consider the impact on complying entities and volatility in the market.
- j) Report to the Legislature, by December 31, 2025, on the progress toward meeting the 2030 GHG emissions reduction targets and the leakage risk posed by the regulation. ARB shall include recommendations to the Legislature on necessary statutory changes to the program to reduce leakage, including the potential for a border carbon adjustment, while maintaining the state's ability to reach its targets.
- k) Report to the Legislature, in consultation with the Independent Emissions Market Advisory Committee, if two consecutive auctions exceed the lower of the speed bump

levels. The report shall assess the potential for allowance prices to reach the price ceiling for multiple auctions.

- l) Report to the relevant fiscal and policy committees of the Legislature, including the Joint Committee on Climate Change Policies, with updates on scoping plan adoption and implementation, as well as implementation of the cap and trade regulation.
- 3) Establishes the following priorities for expenditure of cap and trade auction revenue through 2030:
    - a) Air toxic and criteria air pollutants from stationary and mobile sources.
    - b) Low- and zero-carbon transportation alternatives.
    - c) Sustainable agricultural practices that promote the transitions to clean technology, water efficiency, and improved air quality.
    - d) Healthy forests and urban greening.
    - e) Short-lived climate pollutants.
    - f) Climate adaptation and resiliency.
    - g) Climate and clean energy research.
  - 4) Establishes the Compliance Offsets Protocol Task Force, consisting of specified stakeholders, to provide guidance to ARB in approving new offset protocols for purposes of increasing offset projects with direct environmental benefits in the state while prioritizing disadvantaged communities.
  - 5) Establishes the Independent Emissions Market Advisory Committee (IEMAC) within the California Environmental Protection Agency, and requires the IEMAC to hold a public meeting at least annually and report to both ARB and the Joint Legislative Committee on Climate Change Policies on the environmental and economic performance of the cap and trade regulation and other relevant climate policies. Requires the IEMAC to be composed of at least five experts on emissions trading market design appointed according to the following:
    - a) Three members appointed by the Governor.
    - b) One member appointed by the Senate Committee on Rules.
    - c) One member appointed by the Speaker of the Assembly.
    - d) Requires IEMAC to include a representative from the Legislative Analyst's Office, and requires members to meet all of the following requirements:
  - 6) Have academic, nonprofit, and other relevant backgrounds.
  - 7) Lack financial conflicts of interest with entities subject to the cap and trade regulation.

- 8) Requires the California Workforce Development Board, in consultation with ARB, no later than January 1, 2019, to report to the Legislature on the need for increased education, career technical education, job training, and workforce development resources or capacity to help industry, workers, and communities transition to economic and labor-market changes related to statewide GHG emissions reduction goals.
- 9) Requires ARB, no later than January 1, 2018, to update the scoping plan and designate the cap and trade regulation as the rule for petroleum refineries and oil and gas production facilities to achieve their GHG emissions reductions. Requires all GHG rules and regulations adopted by ARB to be consistent with the updated scoping plan. Provides that nothing in this section shall limit ARB's authority to adopt, maintain, or revise any other measure, including, but not limited to, any of the following:
  - a) Measures governing methane and fugitive emissions at refineries and oil and gas facilities.
  - b) Advanced clean cars program adopted by ARB.
  - c) Low-Carbon Fuel Standard regulations.
  - d) Regulations addressing short-lived climate pollutants.
  - e) Implementation of the sustainable freight action plan.
- 10) Requires the Legislative Analyst's Office, until January 1, 2030, to annually report to the Legislature on the economic impacts and benefits of the 2030 GHG emissions targets.
- 11) Prohibits an air district from adopting or implementing an emission reduction rule for carbon dioxide from stationary sources that are also subject to the cap and trade regulation. Provides that nothing in this section affects in any manner the authority of a district to adopt or implement, as applicable, any of the following:
  - a) A rule, regulation, standard, or requirement authorized or required for a district to adopt under Division 26 (commencing with Health and Safety Code Section 39000) for purposes other than to reduce carbon dioxide from sources subject the cap and trade regulation.
  - b) A rule, regulation, standard, or requirement authorized pursuant to a law affecting emissions associated with landfills, refrigerants, natural gas or methane, volatile organic compounds, or a rule required to comply with the federal Clean Air Act or regulations implementing that act.
  - c) A rule, regulation, standard, or requirement authorized pursuant to a law to reduce vehicle trips, vehicle miles traveled, parking, or vehicular air emissions.
  - d) A rule, regulation, standard, or requirement established pursuant to the California Environmental Quality Act.
  - e) A rule, regulation, standard, or requirement adopted by any state agency.

- f) Provides that this section shall become inoperative if ARB repeals the cap and trade regulation.
- 12) Adds a statement of legislative intent that ARB extend the cap and trade regulation from January 1, 2021, to December 31, 2030, inclusive, in a manner that effectively reduces GHG emissions; minimizes any adverse impacts on state consumers, businesses, and the economy; and continues elements of the current program that protect state utility ratepayers.
- 13) Suspends the SRA fire prevention fee from July 1, 2017 to January 1, 2031, and sunsets the SRA fee thereafter. Declares the intent of the Legislature that cap and trade auction revenues be used to replace funds that would have otherwise been collected from the SRA fee.
- 14) Extends the existing manufacturer's partial sales and use tax exemption from July 1, 2022 to July 1, 2030; broadens the scope of eligible individuals and tangible personal property to include generation or production, or storage and distribution, of electric power; removes the exclusion for an agricultural business activity; and requires the total dollar amount of exemptions, as reported by the Department of Tax and Fee Administration, with the concurrence of the Department of Finance, to be transferred from the Greenhouse Gas Reduction Fund (cap and trade auction revenues) to the General Fund.
- 15) Sunsets each of the provisions above January 1, 2031.
- 16) Takes effect immediately as an urgency measure (2/3 vote).

**EXISTING LAW:**

- 1) Requires ARB to adopt a statewide GHG emissions limit equivalent to 1990 levels by 2020 and to adopt rules and regulations to achieve maximum technologically feasible and cost-effective GHG emission reductions.
- 2) Requires ARB, in adopting rules and regulations to achieve the maximum technologically feasible and cost-effective GHG emissions reductions, to ensure that statewide GHG emissions are reduced to at least 40% below the 2020 statewide limit no later than December 31, 2030.
- 3) Requires ARB, when it adopts regulations to achieve GHG emission reductions beyond the 2020 statewide limit, to consider social costs and prioritize direct emission reductions at large stationary, mobile, and other sources.
- 4) Authorizes ARB, in furtherance of achieving the 2020 statewide limit, to adopt a regulation that establishes a system of market-based declining annual aggregate emission limits for sources or categories of sources that emit GHG emissions, applicable from January 1, 2012, to December 31, 2020, to comply with GHG reduction regulations, once specified conditions are met. ARB has adopted a cap and trade regulation which applies to large industrial facilities and electricity generators emitting more than 25,000 metric tons of CO<sub>2</sub> equivalent per year, as well as distributors of fuels, including gasoline, diesel, and natural gas.

- 5) Requires ARB to prepare and approve a scoping plan, on or before January 1, 2009, and once every five years thereafter, for achieving the maximum technologically feasible and cost-effective reductions in GHG emissions from sources or categories of sources of GHGs by 2020.
- 6) Requires any direct regulation or market-based compliance mechanism to achieve GHG reductions that are real, permanent, quantifiable, verifiable, and enforceable by ARB.
- 7) Requires ARB to adopt methodologies for the quantification of voluntary GHG emission reductions, and adopt regulations to verify and enforce any voluntary GHG emission reductions that are used to comply with GHG emission limits established by ARB.

**FISCAL EFFECT:** Unknown significant revenue, likely in the hundreds of millions of dollars annually (Greenhouse Gas Reduction Fund).

- 2) The ARB estimates one-time costs of \$1 million (Greenhouse Gas Reduction Fund or Cost of Implementation Fund) and annual staffing costs of up to \$350,000 (Greenhouse Gas Reduction Fund or Cost of Implementation Fund).
- 3) The California Department of Tax and Fee Administration (CDTFA) estimates that this bill's expansion of the sales and use tax exemption (SUT) exemption related to electric power generation and agricultural businesses would result in an annual General Fund revenue loss of \$89 million.
- 4) Unknown, likely significant revenue loss resulting from useful life language that likely expands the number of business that qualify for the SUT exemption.
- 5) The suspension of the fire prevention fee revenues would reduce revenues by \$83 million annually beginning in 2017 to 18 (State Responsibility Area Fire Prevention Fund).
- 6) However, this bill would replace all these revenues with proceeds from the Greenhouse Gas Reduction Fund (GGRF); specifically, the bill would not result in lower General Fund revenues. Additionally, the bill would backfill the General Fund reduction associated with the *current-law* SUT manufacturing exemption with GGRF funds. Thus, the *net revenue impact* to the General Fund resulting from this bill would be an increase of about \$180 million annually.
- 7) CDTFA's administrative costs to implement the bill have yet to be determined, but would likely be in the hundreds of thousands of dollars annually, and would also likely be funded by the GGRF.
- 8) The California Workforce Development Board (CWDB) would incur one-time costs of \$521,000 to produce the report specified in the bill, the funding for which would likely come from the GGRF.

**COMMENTS:**

- 1) **Cap and trade.** The cap and trade regulation is an important element of ARB's strategy to achieve the 2020 statewide GHG limit. The regulation sets a statewide cap on GHG emissions from sources responsible for approximately 85% of California's GHG emissions

(large industrial facilities and electricity generators emitting more than 25,000 metric tons of CO<sub>2</sub> equivalent per year, as well as distributors of fuels, including gasoline, diesel, and natural gas). The cap declines at a rate of about 3% annually, ultimately arriving at the target emission level in 2020. To implement the regulation, ARB issues GHG emission allowances equal to the cap through a combination of free allocation to industrial facilities, consignment to electric and gas utilities on behalf of ratepayers, and quarterly auctions. ARB sets a price floor for auctioned allowances (currently \$13.57), and maintains allowances in a price containment reserve, to be sold to mitigate price spikes if allowances prices reach a specified level (currently \$50.69). Allowance price floor and ceiling escalate at 5% per year plus inflation.

Once issued, allowances may be traded among entities. At the end of each compliance period, covered entities are required to surrender enough allowances to match their emissions for the period.

ARB allocates free allowances to large industrial facilities. Allocation of allowances for most industrial sectors is set at about 90% of average emissions, based on benchmarks that reward efficient facilities. For most industrial sectors, distribution of allowances is updated annually according to the production at each facility.

ARB consigns allowances to electrical distribution and natural gas utilities, with the requirement that the value of allowances must be used to benefit ratepayers and achieve GHG emissions reduction. For electrical distribution utilities, free allocation is set at about 90% of average emissions. For natural gas utilities, free allocation is based on a 2011 supply benchmark.

- 2) **Offsets.** In addition to allowances, voluntary, additional emission reductions from sources that are outside the cap, called offsets, can be used to meet up to 8% of a facility's compliance obligation. The 8% limit applies to total emissions, not the reduction obligation. In practice, a facility may increase its GHG emissions and purchase offsets (and/or allowances) to cover excess emissions. Unlike allowances sold at ARB's auctions, purchase of offsets generates no revenue for the state.

To assure that offsets achieve GHG reductions that are real, permanent, quantifiable, verifiable, additional, and enforceable, ARB recognizes only compliance offsets generated by sources that adhere to a compliance offset protocol adopted by ARB. To date, ARB has adopted protocols for the following six project types: livestock manure management, ozone depleting substances (ODS), urban forests, United States (U.S.) forests, mine methane capture (MMC), and rice cultivation. U.S. forests projects are the largest source of compliance offsets by far, followed by ODS, livestock, and MMC. No compliance offsets have been issued for urban forests or rice cultivation projects.

The majority (76%) of compliance offsets used to date have been generated by projects located outside of California. Arkansas accounts for about one-third of offsets, from large ODS projects. Another one-third are generated by forest projects in states such as Michigan, New Hampshire, and Ohio. California accounts for 24% of offsets, ranging from forest projects on the North Coast to appliance recycling (ODS) in Compton.

The use of offsets for compliance in the cap and trade regulation has been invented by ARB with little statutory guidance. While ARB has justified the reliance on compliance offsets as

an opportunity for low-cost reductions from outside the cap, others have questioned how offsets, particularly from sources outside the state, might meet AB 32's (Núñez), Chapter 488, Statutes of 2006, requirements or otherwise produce benefits in California. ARB staff has recently suggested reducing the offset usage limit to support more air quality co-benefits.

- 3) **2030 Scoping Plan.** In January 2017, ARB published a scoping plan update, *Proposed Strategy for Achieving California's 2030 Greenhouse Gas Target*,<sup>1</sup>. The scoping plan update proposes the following major elements:
- a) SB 350 (De León), Chapter 547, Statutes of 2015: Achieve 50% Renewables Portfolio Standard (RPS), and double energy efficiency savings, by 2030;
  - b) Low Carbon Fuel Standard (LCFS): Increased stringency (reducing carbon intensity 18% by 2030, up from 10% in 2020);
  - c) Mobile Source Strategy (Cleaner Technology and Fuels Scenario): Maintain existing GHG standards for light- and heavy-duty vehicles. Put 4.2 million zero-emission vehicles (ZEVs) on the roads. Increase ZEV buses, delivery and other trucks;
  - d) Sustainable Freight Action Plan: Improve freight system efficiency. Maximize use of near-zero emission vehicles and equipment powered by renewable energy. Deploy over 100,000 zero-emission trucks and equipment by 2030;
  - e) Short-Lived Climate Pollutant (SLCP) Reduction Strategy: Reduce emissions of methane and hydrofluorocarbons 40% below 2013 levels by 2030. Reduce emissions of black carbon 50% below 2013 levels by 2030;
  - f) SB 375 (Steinberg), Chapter 728, Statutes of 2008, Sustainable Communities Strategies: Increased stringency of 2035 targets;
  - g) Post-2020 Cap-and-Trade Program. Declining caps, continued linkage with Québec, and linkage to Ontario, Canada. ARB will look for opportunities to strengthen the program to support more air quality co-benefits, including specific program design elements. In fall 2016, ARB staff described potential future amendments, including reducing the offset usage limit, redesigning the allocation strategy to reduce free allocation to support increased technology and energy investment at covered entities, and reducing allocation if the covered entity increases criteria or toxics emissions over some baseline. The scoping plan proposes a 20% reduction in GHG emissions from the refinery sector; and,
  - h) By 2018, develop Integrated Natural and Working Lands Action Plan to secure California's land base as a net carbon sink.

The scoping plan update includes a proposed scenario and four alternatives:

- a) Proposed Scenario: Continuing the Cap-and-Trade Program combined with an additional 20% reduction of GHG emissions in the refinery sector;

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<sup>1</sup> [https://www.arb.ca.gov/cc/scopingplan/2030sp\\_pp\\_final.pdf](https://www.arb.ca.gov/cc/scopingplan/2030sp_pp_final.pdf)



- b) Alternative 1: Direct regulations on a wide variety of sectors, such as specific required reductions for all large GHG sources, more renewables, etc.;
  - c) Alternative 2: A carbon tax to put a price on carbon, instead of the Cap-and-Trade Program;
  - d) Alternative 3: All Cap-and-Trade. This would remove the refinery measure and keep the LCFS at 10%; and,
  - e) Alternative 4: Cap-and-Tax. This would place a declining cap on industry and natural gas and fuel suppliers while also requiring them to pay a tax on each ton of GHG emitted.
- 4) **Much ado about preemption.** The bill includes two new provisions which purport to limit the authority of ARB and air districts to require direct GHG emissions reductions for specified sources covered by the cap and trade regulation.

The first, Section 10, requires ARB to designate cap and trade as the rule for petroleum refineries and oil and gas production facilities to achieve their GHG emissions reductions. This is apparently intended to preempt the 20% GHG reduction from the refinery sector in the proposed 2030 Scoping Plan. It also appears to conflict with, but does not repeal, Section 38562.5 of the Health and Safety Code, added by AB 197 (E. Garcia), Chapter 250, Statutes of 2016, which requires ARB to prioritize direct emission reductions at large stationary, mobile, and other sources. At the same time, Section 10, does not say that cap and trade must be the *only* rule for petroleum refineries and oil and gas production facilities. In fact, it specifically confirms ARB's authority to adopt, maintain, or revise other measures, including measures governing methane and fugitive emissions at refineries and oil and gas facilities, the LCFS, and regulations addressing short-lived climate pollutants (e.g., methane, black carbon, and fluorinated gases). Nothing in the bill prohibits ARB from adjusting any of those regulations to achieve greater emission reductions from the oil and gas industry if necessary to achieve the 2030 target.

The second, Section 12, generally prohibits an air district from adopting or implementing an emission *reduction* rule for carbon dioxide from stationary sources that are also subject to the cap and trade regulation. There are several broad exceptions, including rules districts are authorized to adopt under state air pollution laws for purposes other than to reduce carbon dioxide and rules required to comply with the Clean Air Act. These exceptions apply even if there are incidental CO<sub>2</sub> reductions attributable to an otherwise authorized air pollution rule. Though its effect is potentially broader, this provision is apparently intended to preempt the Bay Area Air Quality Management District's (BAAQMD) proposed Regulation 12, Rule 16, which would cap emission *increases* at refineries. However, it's not clear Section 12, which applies to emission *reduction* rules, does preempt the BAAQMD Regulation 12, Rule 16, which proposes to limit future emission *increases*, and does not require emission *reductions*.

In a July 11, 2017 letter to Alan Abbs, Executive Director of the California Pollution Control Officers Association, Richard Corey, Executive Officer of ARB, wrote regarding Section 12:

Importantly, AB 398 does not limit the existing authority of districts in any way with regard to emissions of any pollutant other than carbon dioxide. Districts maintain their full power and responsibility to regulate criteria and toxic air

pollutants and must adopt new rules and enforce existing rules to do so, even if their rules have the incidental effect of reducing carbon dioxide emissions.

**Analysis Prepared by:** Lawrence Lingbloom / NAT. RES. / (916) 319-2092      FN: 0001205