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**SENATE COMMITTEE ON APPROPRIATIONS**

**Senator Ricardo Lara, Chair**

**2017 - 2018 Regular Session**

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**AB 398 (Eduardo Garcia) - California Global Warming Solutions Act of 2006:  
market-based compliance mechanisms: fire prevention fees: sales and use tax  
manufacturing exemption**

**Version:** July 14, 2017

**Urgency:** Yes

**Hearing Date:** July 17, 2017

**Policy Vote:** E.Q. 5 - 2

**Mandate:** No

**Consultant:** Narisha Bonakdar

**This bill meets the criteria for referral to the Suspense File.**

**Bill Summary:** AB 398 make numerous, substantive changes to the California Global Warming Solutions Act of 2006, including the following:

- 1) Requires the Air Resources Board (ARB), no later than January 1, 2018, to update the scoping plan, and requires all greenhouse gas rules and regulations adopted by ARB to be consistent with the scoping plan.
- 2) Extends ARB's authority to establish and utilize, through regulations, a market-based mechanism
- 3) Specifically authorizes a system of market-based declining annual aggregate emissions limits for sources or categories of sources that emit greenhouse gases (cap-and-trade) until December 31, 2030.
- 4) Extends, and expands upon, the 3.94 percent state sales and use tax (SUT) exemption available to qualified manufacturers and specified research and development firms for an additional eight years, until July 1, 2030.
- 5) Clarifies the definition of useful life to ensure that businesses that expensed some qualifying purchases also receive the SUT exemption.
- 6) Effective 2017-18, suspends the fire prevention fee and repeals the fire prevention fee statutes on January 1, 2031.

**Fiscal Impact:**

- Unknown significant revenue, likely in the hundreds of millions of dollars annually (Greenhouse Gas Reduction Fund).
- The Air Resources Board (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).
- The California Department of Tax and Fee Administration (CDTFA) estimates that this bill's expansion of the SUT exemption related to electric power generation and agricultural businesses would result in an annual General Fund revenue loss of \$89 million.
- Unknown, likely significant revenue loss resulting from useful life language that likely expands the number of business that qualify for the SUT exemption.

- The suspension of the fire prevention fee revenues would reduce revenues by \$83 million annually beginning in 2017-18 (State Responsibility Area Fire Prevention Fund).
- 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.
- 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.
- 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.

### **Background:**

#### *Implementing AB 32: The California Global Warming Solutions Act of 2006.*

In addition to calling on the ARB to inventory GHGs in California and approve a statewide GHG emissions limit, to be achieved by December 31, 2020, equivalent to the level of 1990 emissions, AB 32 (Núñez, Pavley, Chapter 488, Statutes of 2006) also requires ARB to (1) implement regulations that achieve the maximum technologically feasible and cost-effective reduction of GHG emissions, (2) identify and adopt regulations for discrete early-action measures, and (3) prepare and approve a Scoping Plan, to be updated every five years, to achieve the maximum technologically feasible and cost-effective reduction of GHG emissions by 2020.

The statute also specifies that ARB *may* include market-based compliance mechanisms. The Legislature defined “market-based compliance mechanism” as either (1) “a system of market-based declining annual aggregate emissions limitations for sources or categories of sources that emit greenhouse gases”, or (2) “greenhouse gas emissions exchanges, banking, credits, and other transactions, governed by rules and protocols established by the state board, that result in the same greenhouse gas emission reduction, over the same time period, as direct compliance with a greenhouse gas emission limit or emission reduction measure adopted by the state board pursuant to this division.”

The Legislature further specified that prior to the inclusion of any market-based compliance mechanism in the regulations, the ARB was required to (1) “consider the potential for direct, indirect, and cumulative emission impacts from these mechanisms, including localized impacts in communities that are already adversely impacted by air pollution,” (2) “design any market-based compliance mechanism to prevent any increase in the emissions of toxic air contaminants or criteria air pollutants,” and (3) “maximize additional environmental and economic benefits for California, as appropriate.”

The cap-and-trade program was recommended in the Scoping Plan as a central approach to flexibly and iteratively reduce emissions over time. Pursuant to legal authority under AB 32, ARB adopted cap-and-trade regulations and those regulations were approved on December 13, 2011.

Beginning on January 1, 2013, the cap-and-trade regulation sets a firm, declining cap on total GHG emissions from sources that make up approximately 85% of all statewide GHG emissions. Sources included under the cap are termed “covered” entities. The cap is enforced by requiring each covered entity to surrender one “compliance instrument” for every emissions unit (i.e., metric ton of carbon dioxide equivalent) that it emits at the end of a compliance period.

Over time, the cap declines, resulting in GHG emission reductions. Two forms of compliance instruments are used: allowances and offsets. Allowances are generated by the state in an amount equal to the cap and may be “banked” (i.e., allowing current allowances to be used for future compliance). An offset is a credit for a real, verified, permanent, and enforceable emission reduction project from a source outside a capped sector (e.g., a certified carbon-storing forestry project). Offsets may be used to satisfy up to 8% of a covered entity’s compliance obligation. Some fraction of allowances are allocated freely to covered entities, a small portion is set aside as part of an allowance price-containment reserve, and the rest is auctioned off quarterly.

*Use of Cap-and-Trade Auction Revenue.* Since November 2012, ARB has conducted eight California-only and nine joint California-Québec cap-and-trade auctions. To date, \$3.4 billion has been appropriated by the Legislature to 12 state agencies that have distributed \$1.2 billion to projects that have been completed or are under way.

Existing state law specifies that the auction revenues must be used to facilitate the achievement of measurable GHG emissions reductions and outlines various categories of allowable expenditures. Statute further requires the Department of Finance to develop a three-year investment plan for the auction proceeds, which are deposited in the GGRF.

Proceeds from cap-and-trade auctions provide an opportunity for the state to invest in projects that help California achieve its climate goals and provide benefits to disadvantaged communities. Several bills provide legislative direction for the expenditure of auction proceeds including SB 535 (de León, Chapter 830, Statutes of 2012), AB 1532 (J. Pérez, Chapter 807, Statutes of 2012), SB 1018 (Committee on Budget and Fiscal Review, Chapter 39, Statutes of 2012), SB 862 (Committee on Budget and Fiscal Review, Chapter 36, Statutes of 2014), and AB 1550 (Gomez, Chapter 369, Statutes of 2016).

These statutes also require a state agency to prepare a description of 1) proposed expenditures, 2) how they will further the regulatory purposes of AB 32, 3) how they will achieve specified greenhouse gas emission reductions, 4) how the agency considered other objectives of that act, and 5) how the agency will document expenditure results.

*Sales and use Tax Exemptions.* Except where a specific exemption or exclusion is provided, current law imposes the SUT on all retailers for the privilege of selling tangible

personal property (TPP) at retail in California, or on the storage, use, or other consumption in this state of TPP purchased from a retailer.

After CDTFA collects SUT revenue (\$51 billion in 2014-15), it allocates the money to various state and local funds. Roughly half—collected from an approximately 3.94 percent rate—goes to the General Fund and can be spent on any state program, such as education, health care, and criminal justice. Another 1.25 percent, known as the Bradley-Burns rate, goes to cities and counties for general purposes. Three sales tax funds have uniform state rates and support specified programs—an approximately 1.1 percent rate for 2011 realignment (county-administered criminal justice, mental health, and social service programs); a 0.5 percent rate for 1991 realignment (county-administered health and social services programs); and a 0.5 percent rate for city and county public safety programs pursuant to Proposition 172 (1993). Additionally, some local governments levy optional local rates—known as Transactions and Use Taxes (TUTs)—and a small portion of these funds are used for general purposes. As of January 1, 2017, the average statewide SUT rate was 8.21 percent.

State law fully exempts many items from SUT (such as prescription drugs, food, electricity, and poultry litter), while other items are exempted from the state sales tax, but not the local share, such as farm equipment and machinery, diesel fuel used for farming and food processing, teleproduction and postproduction equipment, timber harvesting equipment and machinery, and racehorse breeding stock. Partial SUT exemptions are difficult for both retailers and the CDTFA, and complicate return preparation and processing. Moreover, errors attributable to these partial exemptions occur frequently, resulting in additional return processing workload for CDTFA.

In 2013, the Legislature reformed California's economic development policies; specifically, it eliminated enterprise zones and other geographically-targeted economic development areas, and instead allowed three new tax benefits:

- Tax credits for wages paid by taxpayers to qualified employees within former enterprise zones, and other areas that suffer from high levels of poverty and unemployment. The credit sunsets in 2019.
- The California Competes Tax Credit, an income tax credit available to businesses who want to come, stay, or grow in the State. Tax credit agreements up to an annually capped amount are (1) negotiated by the Governor's Office of Business and Economic Development (GO-Biz), and (2) approved by a statutorily created "California Competes Tax Credit Committee," consisting of the State Treasurer, the Director of the Department of Finance (DOF), the Director of GO-Biz, and one appointee each by the Senate Committee on Rules and the Speaker of the Assembly.
- A partial (the 3.9375 rate that flows to the General Fund) SUT exemption on purchases of manufacturing equipment made by taxpayers within specific North American Industrial Classification System (NAICS) codes, capped at \$200 million annually per taxpayer, effective July 1, 2014, and ending July 1, 2022. This SUT exemption largely superseded existing programs, as they applied to almost all the same taxpayers. Thus, instead of applying to the California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA), taxpayers

simply print a resale certificate from CDTFA's internet site, and present it to the retailer to purchase the property sales-tax free. One restriction of the SUT exemption is that any property treated as having a "useful life" of less than one year is not eligible.

DOF is empowered to reduce the amount of credits the California Competes Tax Credit Committee can allocate to ensure that the above three new tax benefits do not result in a revenue loss that exceeds \$750 million in a given fiscal year, which was the estimated revenue gain from eliminating tax benefits from enterprise zones and similar areas. Thus, the goal of eliminating enterprise zones and replacing them with the three new tax benefits described above was to ensure revenue neutrality. However, if the amount of foregone revenue from the three new tax benefits falls below \$750 million, current law neither enacts a new tax expenditure nor requires expansion of the existing ones; instead, CDTFA must identify options for increasing SUT exemptions to meet estimated amounts as part of existing reporting requirements to the Joint Legislative Budget Committee. FTB must do likewise as part of its annual report regarding the wage credit. DOF has not reported that an adjustment is necessary, as the estimated fiscal loss of the new employee hiring credit (\$3.9 million in 2014; \$1.7 million in 2015), the SUT exemption (an estimated \$180 million in 2018-19), and California Competes Tax Credits added up to significantly less than \$750 million in both fiscal years.

The California Department of Forestry and Fire Protection (CalFIRE) provides wildland fire protection on non-federal lands in California beyond city boundaries. Toward this end, the State Board of Forestry and Fire Protection designates State Responsibility Areas (SRAs) every five years. SRAs are generally defined to include most nonfederal timberlands, rangelands and watersheds thinly populated and not within the boundaries of a city. Over 31 million acres, much privately owned, are located in SRA. In the past, SRA lands were largely unpopulated. In recent years, however, local governments have allowed increased housing development in SRAs but at a level of density that maintains the state's obligation to provide wildland fire protection.

In 2010, the Legislature imposed the fire prevention fee on owners of structures in SRAs to pay for the State's costs of protecting SRAs against fires, and directed the CDTFA to collect it in accordance with the state's Fee Collection Procedures Law. The fee (adjusted annually for inflation) is \$152.33 per structure in 2014-15, though 90 percent of structures located in SRAs are also covered by a local fire protection agency, and consequently receive a \$35 reduction in the fee. The fee is due and payable 30 days from the date of assessment from CDTFA (the date printed on the bill).

While CDTFA collects the fee, it does not determine the fee's amount nor which payers it impacts. Instead, CalFIRE determines both. CDTFA can neither redetermine the fee, nor accept a claim for refund unless the determination has been set aside by CalFIRE, or a court reviews CalFIRE's determination. Currently, owners of structures in SRAs can petition for redetermination within 30 days after service of notice of determination; after that, the amount becomes final. If the owner petitions for redetermination within the 30 day period, CalFIRE must make a determination in writing, and can eliminate the fee if finds the fee doesn't apply.

The Legislative Analyst's Office (LAO) attributes much of the increase in CalFIRE's fire protection costs to increased housing development in SRA. The LAO notes that as

housing development in SRAs has increased, the department has spent greater resources responding to events other than wildfires for which the state is not legally responsible, such as structural fires and medical emergencies. Because the LAO concludes that much of CalFIRE's nonwildfire activities provide private benefits, LAO has long recommended a fee on owners of private land in SRA to pay for a portion of CalFIRE's fire protection costs.

**Proposed Law:** This bill:

- 1) Requires ARB, no later than January 1, 2018, to update the scoping plan, as specified and requires all greenhouse gas rules and regulations adopted by ARB to be consistent with the scoping plan.
- 2) Extends ARB's authority to establish and utilize, through regulations, a market-based mechanism, specifically authorizes a system of market-based declining annual aggregate emissions limits for sources or categories of sources that emit greenhouse gases (cap-and-trade) until December 31, 2030.
  - a) Requires ARB to include specified price ceilings, price containment points, offset credit compliance limits, and industry assistance factors for allowance allocation as part of the regulation.
  - b) Requires ARB to develop approaches to increase offset projects in the state and to make specified reports to the Legislature as part of the regulation.
  - c) Reduces the amount of offsets to 4% between 2020 and 2025 and 6% between 2025 and 2030.
  - d) Requires 50% of all offsets to be in California.
  - e) Declares the intent of the Legislature that moneys collected pursuant to the market-based compliance mechanism be appropriated in accordance with a specified order of priorities.
  - f) Establishes, until January 1, 2031, the Compliance Offsets Protocol Task Force, the Independent Emissions Market Advisory Committee and the California Workforce Development Board, to conduct meetings, advise and report to ARB and the Legislature on matters related to specific provisions and impacts of the regulations.
  - g) Requires, until January 1, 2031, the Legislative Analyst's Office (LAO) to annually report to the Legislature on the economic impacts and benefits of specified greenhouse gas emissions targets.
- 3) Prohibits an AQMD from adopting or implementing an emission reduction rule for carbon dioxide from stationary sources that are also subject to a specified market-based compliance mechanism.
- 4) Suspends the SRA fee until January 1, 2031 and then repeals the fee as of that date.

- 5) Declares that it is the intent of the Legislature that moneys derived from the auction or sale of allowances pursuant to the market-based compliance mechanism replace the fire prevention fee to continue the funding of the fire prevention activities.
- 6) From July 1 2014 to July 1, 2030, provides additional tax exemptions for qualified tangible personal property purchased for use by a qualified person to be used primarily in the generation or production or storage and distribution of electric power or purchased for use by a contractor for the qualified person.
- 7) From 1, 2018 to July 1, 2030, provides additional tax exemptions for special purpose buildings and foundations used for the generation or production or storage and distribution of electric power.
- 8) From 1, 2018 to July 1, 2030, expands the definition of qualified person to include, among others, a person primarily engaged in the business of electric power generation.
- 9) Requires the California Department of Tax and Fee Administration to provide the exemption report and requires the total dollar amount, as reported by the department, with the concurrence of the Department of Finance, to be transferred from GGRF to the General Fund, as provided.
- 10) Clarifies the definition of useful life to ensure that businesses that expensed some qualifying purchases also receive the SUT exemption.
- 11) Makes various nonsubstantive and conforming changes and repeals this tax exemption on January 1, 2031.

**Related Legislation:**

SB 600 (Galgiani, 2017) and SB 13 (Gaines, 2017) both would have expanded the SUT exemption for manufactured goods. Both bills were held under submission on the Suspense File of this Committee.

AB 617 (C. Garcia, 2017) among other things, requires ARB to establish a uniform, statewide system for stationary sources to report their emissions of criteria pollutants and toxic air contaminants; creates an expedited schedule for certain facilities covered under the state's cap-and-trade program to implement best achievable retrofit control technology for criteria pollutants and toxic air contaminants; requires ARB to establish a clearinghouse of information on best achievable control technology and best achievable retrofit control technology; increases civil and criminal penalties for certain types of emissions; and creates community emissions reduction programs for communities with a heavy exposure to criteria pollutants and toxic air contaminants. AB 617 is pending hearing in the Senate Environmental Quality Committee.

SB 775 (Wieckowski, 2017) requires ARB to adopt regulations for a cap-and-trade program post 2020 that would prohibit free allowances and offsets, prohibit allowance banking, put a price ceiling and floor on the cost of allowances that changes predictably over time, and establish an Economic Competitiveness Assurance Program to protect trade-impacted industries in the state and reduce leakage. SB 775 would also establish the California Climate Infrastructure Fund meant to assist the state and local

communities to adjust to the changing environment, California Climate Dividend Fund to provide money directly to all Californians on a quarterly basis, and the California Climate and Clean Energy Research Fund to fund scientific research. SB 775 is in the Senate Environmental Quality Committee.

SB 32 (Pavley, Chapter 249, Statutes of 2016) requires ARB to ensure that statewide GHG emissions are reduced to at least 40% below the 1990 level by December 31, 2030.

AB 32 (Núñez, Pavley, Chapter 488, Statutes of 2006) establishes the California Global Warming Solutions Act of 2006, which requires ARB to monitor and regulate sources of GHG emissions that cause global warming in order to reduce emissions of GHG.

### **Staff Comments:**

*ARB fiscal.* According to the ARB, “New tasks include preparing hearing materials and reports for the Legislature on the Scoping Plan and Cap-and-Trade Regulation, tracking implementation of measures in the Scoping Plan across multiple State agencies, and consulting with various boards and task forces on activities related to the Cap-and-Trade Regulation. CARB will also need to develop new software to track compliance for California entities subject to offset limits that are different from Quebec and Ontario, as well as create a new mechanism for implementing a price ceiling in the auction platform and sale of greenhouse gas emission allowances after exhaustion of the Allowance Price Containment Reserve. CARB estimates the cost of this work will be up to about \$350,000 annually for personnel and up to \$1 million in one-time contract monies.”

*Tax exemption.* This bill adds businesses in several NAICS codes to the partial SUT exemption currently provided to manufacturers. CDTFA’s estimate of resulting revenue loss for 2018-19 is \$85 million. The other \$4 million in revenue loss is related to the bill’s extension of the exemption to certain agricultural businesses.

The CDTFA estimate assumes that all qualified TPP purchased by qualified persons will be claimed as partially exempt. To the extent amounts are not claimed, this estimate may be overstated.

The fire prevention fee program has over 700,000 accounts; thus, it is the second largest one that CDTFA administers (trailing only the SUT). As fire fee imposition is suspended, CDTFA program staff would be redirected, likely toward collection activities.

CWDB indicates that does not have the ability to produce the bill’s required report in-house. It estimates that it would need \$400,000 to contract out the work, and one position to oversee the project. CWDB projects total costs of \$521,000.

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