As the California legislative session came to an end last week, Assembly and Senate leaders released a last-minute deal on formally extending California's Cap-and-Trade Program for the next two decades through Assembly Bill (AB) 1207. The bill received the required supermajority vote on Saturday, September 13, and now moves to Governor Newsom's desk for signature.

What is Cap-and-Trade?

The Cap-and-Trade Program works by establishing a declining limit (or cap) on greenhouse gas (GHG) emissions from major emitting sources in California along with a steadily increasing price on each metric ton of GHG emissions to help the state achieve its emission reduction targets. The California Air Resources Board (CARB) – the agency charged with designing and implementing the Cap-and-Trade Regulation – creates emissions allowances equal to the cap and distributes them through a combination of quarterly auctions (the primary method) and limited free allocation to emitting companies (to prevent emissions leakage and protect electric and natural gas ratepayers).

The price signal created by the decreasing allowance supply over time, along with a minimum price for the sale of allowances at auction (currently set at $25.87 per metric ton), provides emitting companies with a long-term planning horizon to prompt action and investment to reduce GHG emissions. The Program also includes important cost-containment mechanisms such as the limited use of compliance offset credits (subject to strict percentage limitations), the auction reserve (or floor) price, multi-year compliance periods, program linkage (currently linked with the program in Québec), and a price ceiling, among other measures.

To date, the Cap-and-Trade Program has been an essential tool within the State's overall climate portfolio and has helped the state meet its 2020 GHG reduction target early and continue to advance toward its 2030 target. [*Full disclosure: Prior to joining the faculty at the Emmett Institute on Climate Change and the Environment, I served as the chief of the Cap-and-Trade Program at CARB from 2016-2022 and worked on regulatory design and implementation as an attorney and manager from 2010-2016.*]

AB 1207 Extends California's Climate Leadership

AB 1207's extension of the program through 2045 is aligned with the state's emission reduction targets through 2045 and provides much needed long-term market certainty and further evidence of the state's climate leadership. On news of the extension, allowance prices on the secondary market have already seen an increase.

This extension maintains the most important design features of the market, while making a few key modifications:

- **New Name.** The Cap-and-Trade Program will now be officially called the Cap-and-Invest Program, making good on Governor Newsom's rebrand that recognizes the importance of how proceeds from the sale of California allowances at auction (nearly $33 billion to date) are a critical fiscal tool in the fight against the climate crisis and how these investments can best be used to support cost-effective emission reduction measures. This also draws from how Washington State calls their program, which was developed as a near carbon copy (pun intended!) of California's long-standing program.
- **Recognizing importance of nature-based solutions and other carbon offset methodologies.** The Program will continue to include a small, but critical role for carbon offset projects from sectors that are not covered by the cap directly. Emitting companies can currently purchase and retire offset credits issued by CARB to projects that reduce emissions through activities such as forest protection and methane destruction to match up to 4% of their previous year's emissions through the end of 2025 and up to 6% per year starting in 2026. Offsets provide important cost-containment (they typically sell at a discount to allowances, as they involve some risk), while helping drive vital investment into GHG reductions that would not otherwise occur. Similar to Washington's program, these offsets will now be included "within the cap," meaning that allowances will be removed from future years' budgets in the same amount as offset credits that are retired, effectively tightening the cap.
- **Assessing for Emissions Leakage.** From its inception, the Program has included limited free allowances to hard-to-abate industrial sources based on a number of factors, including a statutory mandate to mitigate emissions leakage (essentially, to prevent a company from picking up shop and moving its operations and emissions outside of California). Prior legislation required CARB to use an older methodology for this allocation that did not differentiate for leakage risk across and between sectors, whereas AB 1207 reintroduces an explicit requirement to take into account leakage risk.
- **Affordability and Electricity.** The Program has always included free allocation to electric and natural gas utilities to help protect ratepayers. AB 1207 specifically requires a transition away from gas utilities to electric distribution utilities to minimize ratepayer impacts. It also provides further direction to the California Public Utilities Commission on maximizing the California Climate Credit to residential customers

during the hottest months of the year, a measure that takes into account affordability considerations of increasing electricity prices. (To date, the sale of these utility allowances at auction has generated more than $20 billion for ratepayer protections and investments.)

The increased certainty from AB 1207 will ensure that California's efforts continue to serve as a model for carbon market and climate policy design as other jurisdictions at the national and subnational level consider developing their own market-based programs to ensure cost-effective emission reductions. It will also support ongoing linkage with Québec's program and possible linkages with other jurisdictions.

Next Steps Toward Implementation

AB 1207 now moves to the Governor's desk for his consideration and likely signature by October 13. Assuming the bill is signed, CARB will need to move forward with a regulatory process to implement the updated statutory provisions. California will also continue to battle against federal agency rollbacks on climate reporting and emission reduction programs and attempts to undermine long-standing state air pollution and climate laws.

See here and here and here for excellent assessments by Emmett Institute colleagues on the ongoing legal wrangling and the increasing importance of subnational actions on climate.