
SENATE COMMITTEE ON ENVIRONMENTAL QUALITY

Senator Blakespear, Chair

2025 - 2026 Regular

Bill No: AB 1207

Author: Irwin, et al.

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Urgency: Yes

Fiscal: Yes

Consultant: Heather Walters

SUBJECT: Climate change: market-based compliance mechanism: extension

DIGEST: This bill reauthorizes California's Cap-and-Trade program, hereafter to be known as Cap-and-Invest, through 2045, with a number of reforms to program elements including but not limited to the use and accounting of offsets, the distribution of allocated allowances, and the allowable uses of compliance instruments sold at the price ceiling, among other things.

ANALYSIS:

Existing law:

- 1) Requires the California Air Resources Board (CARB) to adopt a statewide greenhouse gas (GHG) emissions limit equivalent to 1990 levels by 2020, to ensure that statewide GHG emissions are reduced to at least 40% below the 2020 statewide limit no later than December 31, 2030, and to adopt rules and regulations to achieve maximum technologically feasible and cost-effective GHG emission reductions. (Health and Safety Code (HSC) 38500 et seq.)
- 2) Declares the policy of the state to achieve net zero GHG emissions as soon as possible, but no later than 2045, and to achieve and maintain net negative GHG emissions thereafter. (HSC 38562.2)
- 3) Requires any direct regulation or market-based compliance mechanism to achieve GHG reductions that are real, permanent, quantifiable, verifiable, and enforceable by CARB. (HSC 38562)
- 4) Authorizes CARB, 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.

- 5) Extended, pursuant to AB 398 (E. Garcia, Chapter 135, Statutes of 2017), CARB's cap-and-trade authority to 2030, and further, among other changes:
 - a) Required ARB to establish a price ceiling on GHG emission allowances in consideration of specified factors, including the social cost of carbon; and
 - b) Added several new conditions governing the management and allocation of allowances.

This bill:

- 1) Renames Cap-and-Trade as Cap-and-Invest, extends the program's sunset date to 2045, and makes other changes to Legislative intent regarding the program.
- 2) Updates provisions regarding compliance offsets, including:
 - a) Placing offsets "under the cap," meaning the supply of allowances issued in a given year is reduced by the number of offsets used for compliance in the previous year;
 - b) Directing CARB to consider developing additional compliance offset protocols for other sectors, including carbon dioxide removal.
- 3) Updates provisions regarding the program's price ceiling, originally established pursuant to AB 398, including:
 - a) Establishing the California Climate Mitigation Fund, which is to be used for purposes including but not limited to providing rebates and investments in household energy costs, and deposits any moneys generated by the sale of compliance instruments at the price ceiling in that fund; and
 - b) Directing CARB to, if they find that the price containment reserve or ceiling do not adequately protect California consumers, to consider additional actions regarding the price floor and ceiling.
- 4) Updates provisions regarding the allocation of allowances, including:
 - a) From January 1, 2031 onwards, directing CARB to distribute industrial sector allowances in a manner that minimizes emissions leakage risk, rather than in line with the levels applicable in the 2015-2017 compliance period;
 - b) Directing CARB to transition support from gas corporations to electrical distribution utilities to minimize ratepayer impacts.
- 5) Makes other changes to the allowable uses of the consigned allowances allocated to electric utilities, including:
 - a) Which entities are eligible to receive the credit,
 - b) Allowing the California Public Utilities Commission to provide credits to residential customers on no more than four high-billed months of the year to maximize affordability;

- c) Requiring electrical corporations to update their customer outreach plan;
 - d) Taking 5% of electrical corporations revenues from the sale of consigned allowances to be deposited in the California Transmission Accelerator Revolving Fund, for specified purposes.
- 6) Directs CARB to include specified considerations about the Cap-and-Invest program in subsequent Scoping Plan updates.
 - 7) Requires CARB and any other agencies using GGRF moneys to appear before certain committees of the Legislature if requested.
 - 8) Requires members of the Independent Emissions Market Advisory Committee to file Form 700.

Background

- 1) *Cap-and-trade.* Cap-and-trade is California’s flagship GHG emission reduction program. Cap-and-trade establishes a declining limit on roughly 80% of the sources of GHG emissions throughout California (called “covered entities”), and it creates a powerful economic incentive for significant investment in cleaner, more efficient technologies. CARB creates allowances equal to the total amount of permissible annual emissions (i.e., the “cap”). One allowance equals one metric ton of carbon dioxide equivalent emissions (using the 100-year global warming potential). Each year, fewer allowances are created and the annual cap declines.

First authorized in 2006 under AB 32’s authority to create a “market-based compliance mechanism”, and reauthorized with reforms via AB 398 (E. Garcia, Chapter 135, Statutes of 2017), cap-and-trade has operated continuously for over ten years. The first auction of allowances occurred November of 2014, where roughly 23 million allowances were sold at a price of \$12.10 each, the proceeds of which went into the Greenhouse Gas Reduction Fund (GGRF) to be appropriated by the Legislature. In contrast, the latest auction—August 2025—saw over 51 million allowances sold at a price of \$28.76 each (down from a high point of \$41.76 in the February 2024 auction), bringing over \$841 million into GGRF. All in all, the program has funded over \$31 billion in investments across the state since its inception.

- 2) *Reauthorization.* When the Legislature passed AB 398 in 2017, it staved off the uncertainty and wildly fluctuating auction results that had plagued the cap-and-trade program as it approached its statutory 2020 end date. That explicit reauthorization expires in 2030, and so the Legislature has been aware (keenly

so, due to recent lower-than-expected auction proceeds) that certainty post-2030 would be needed soon. The behavior of the market before 2030 will explicitly depend on the fate of the program after 2030.

Although no one can predict the future, confidence in a predictable cap-and-trade market through 2045 would be expected to increase demand for allowances today, as market participants attempt to minimize costs for their own future compliance. Higher demand would beget higher prices, and this would be expected to increase cost impacts and auction revenues to GGRF alike. Only time will tell what impacts this reauthorization may have.

Comments

- 1) *Purpose of Bill.* According to the author, “AB 1207 reauthorizes and renames California’s Cap-and-Invest program, one of the strongest, most cost-effective emissions reduction programs in the world, through 2045. AB 1207 also makes changes to maximize the affordability benefit of the California Climate Credit, maintain and improve offsets, restructure industrial allowance allocation to prioritize California’s highest leakage risk industries, increase transparency and accountability for CARB, and align the Cap-and-Invest program with California’s overall climate strategy for achieving net-zero emissions statewide by 2045.”
- 2) *Major provisions.* California’s cap-and-invest program is large, complex, and consequential. This bill takes a relatively modest approach to program reforms compared to some proposals heard this year, and yet there are still a number of significant reforms. The market for cap-and-invest allowances (and the rules governing it) have become hugely important for funding and motivating California’s climate leadership. Among a number of relatively minor changes AB 1207 makes (such as clarifying and updating legislative intent), the bill makes changes to the program touch on all components of the market. There are three primary ways that allowances enter the market: freely allocated to industry (roughly 14% of all compliance instruments), allocated to utilities to be consigned to auction (roughly 37%), or auctioned to fund the Greenhouse Gas Reduction Fund (GGRF) (roughly 46%). The three segments sum to the “cap” of cap-and-trade. The most significant reforms can be categorized broadly and described briefly as follows:
 - a) *Reauthorization and continued review.* Perhaps most importantly, AB 1207 reauthorizes California’s cap-and-trade program (as cap-and-invest) through 2045. This provides greater certainty to covered entities and investors about the longevity of the program, the value of allowances, and California’s commitment to the program.

Although CARB is given significant latitude in how it chooses to implement cap-and-invest, AB 1207 does not write a blank check. A number of oversight and review reforms established by AB 398 are re-upped through 2045 in this bill, such as through Scoping Plan updates, annual review by the Legislative Analyst's Office, and the Independent Emissions Market Advisory Committee (whose members must file Form 700 under AB 1207). This bill also directs CARB to, as part of the periodic Scoping Plan updates, report on progress towards reaching our emission reduction goals, make recommendations regarding necessary statutory changes to the Legislature, and evaluate the cost impacts of cap-and-invest whenever they revise the regulations. CARB will also be required to keep the Legislature apprised of proposed updates to the cap-and-invest regulations (and the economic impacts thereof) and how GGRF money is spent through statutory direction and requirements involving the Joint Legislative Committee on Climate Change Policies.

Ultimately, the Legislature and CARB must strike a delicate balance between oversight and technical expertise. The Legislature cannot implement the cap-and-invest regulations without CARB, but nor should CARB implement cap-and-invest without robust input and accountability to the Legislature. This bill extends and creates some tools, but it is up to the Legislature to effectively and continually wield those tools to ensure cap-and-invest lives up to Californians' expectations.

- b) *Offsets.* The use of compliance offsets (in which, rather than reducing a ton of emissions from a source covered under the program, a covered entity effectively pays an uncovered entity to reduce their emissions by a ton instead) has been a lightning rod for controversy. However, offsets have also provided some cost containment for covered entities and investment opportunities for projects in and outside of California. Pursuant to AB 398, covered entities are currently able to meet 4% of their compliance obligation through the purchase and surrender of offsets, which was set to increase to 6% next year. AB 1207 upholds those limits, and would allow covered entities to meet 6% of their compliance obligation with offsets through 2045.

In their cap-and-invest program, Washington approached the issue of unreliable offset quality by reducing the annual allowance budget by an amount equivalent to offset use.¹ This puts “offsets under the cap,” in the

¹ Washington Department of Ecology, Cap-and-Invest Offsets. <https://ecology.wa.gov/Air-Climate/Climate-Commitment-Act/Cap-and-invest/Offsets>

sense that capped emissions are necessarily reduced by the use of offsets. This mechanism was also offered in previous IEMAC reports as a possible approach to addressing offset concerns in California. Under a hypothetical worst-case scenario where not a single offset corresponded to a real emission reduction, the program would still achieve its emission reduction goals.

Putting offsets under the cap would be expected to increase the cost of offsets (which are currently a significantly less expensive method of compliance than purchasing allowances), which in turn would increase covered entities' cost of compliance. However, it would provide greater confidence in the emission reductions represented in their purchase. Under AB 1207, compliance offsets would be placed under the cap in the same way they are in Washington currently.

Beyond the existing compliance offset protocols, AB 1207 directs CARB to consider developing additional protocols to cover other sectors, including carbon dioxide removal or natural and working lands.

- c) *Price controls.* There are four price controls that apply to cap-and-trade allowances, all of which shape the market. As part of AB 398, CARB established a price ceiling on allowances based on the need to avoid adverse impacts on resident households, businesses, and the state's economy, among other specified considerations. On the low end, the program has had a gradually-rising price floor since inception. There are also two "speed bumps" between the floor and the ceiling: the allowance price containment reserves (APCRs). These are pools of allowances offered at set prices which can be purchased under special circumstances to help address allowance prices, should they increase significantly.

The current price ceiling in 2025 is \$94.92—significantly higher than the \$28.76 settlement price at the latest auction. Notably, AB 398 also required that if that ceiling were to be reached (such as through a significant increase in demand or decrease in supply of allowances), then any number of additional allowances would be sold until all covered entities can achieve their compliance obligations. Under the policy set in place by AB 398, any proceeds from allowances sold at the ceiling would effectively have to be used to buy offsets.

Rather than using the proceeds of the sale of price ceiling allowances to buy offsets, AB 1207 deposits those moneys in the (hereby established) California Climate Mitigation Fund for purposes including but not limited

to, “providing direct rebates and investments to reduce household energy costs, including incentives to transition to zero-emission vehicles and energy efficient housing.” In a situation where prices hit the ceiling, it is not unreasonable to divert revenues to intentionally and directly support Californians facing high costs. Although our cap-and-trade program has never come close to hitting the price ceiling, if it does at any point in the future the outcome would be significantly different under AB 1207 to how it would under AB 398.

Beyond this new mechanism at the ceiling, AB 1207 provides a fairly open-ended directive to CARB to, if they find that the existing ceiling and/or APCR do not “adequately protect California consumers,” consider additional actions such as adjusting the APCR and/or ceiling. This provides additional flexibility for how cap-and-invest’s cost impacts can be managed without requiring further legislation.

- d) *Allocated allowances to industry.* To tailor leakage prevention at the level necessary for each industry, CARB had previously assessed leakage risk, which was a product of their emissions intensity and their trade exposure. Some industries (like oil extraction) were deemed to have a high leakage risk have indeed would have had their “Industry Assistance Factor” (IAF) set to 100%. Others, like automobile manufacturing, were deemed to have low leakage risk, and would have only received at most 50% of their historical freely-allocated allowances starting 2018. No two covered entities are exactly the same, and yet as part of the 2017 reauthorization, major industrial sources of GHG emissions were required by law to receive the same IAF of 100%, which is part of how their freely-allocated allowance amount is calculated. Ultimately, AB 398 set that number to 100% in perpetuity.

Under AB 1207, the 100% IAF will be maintained through 2030, after which CARB will have the discretion to distribute industrial sector allowances in a manner that minimizes emissions leakage risk while cost-effectively achieving our GHG reduction goals. Doing so may involve no longer granting all covered industries a 100% IAF, but it remains to be seen what levels CARB would elect to set.

- e) *Allocated allowances to utilities.* Today, the 37% of allowances that are allocated to electric and natural gas utilities CARB are required to be sold at auction and the proceeds used to benefit ratepayers. To date, about 79% of the auction proceeds have gone to residential ratepayers, with 7% going to industrial ratepayers, 6% to small business ratepayers, and 2% to clean

energy & energy efficiency programs.² The California Climate Credit, administered by the California Public Utilities Commission (CPUC) is by far the largest portion of the utilities' share and a direct way to defray costs to consumers. Being administered by the CPUC, the California Climate Credit is more appropriately within the purview of the Senate Committee on Energy, Utilities, and Communications, but the bill's impacts on the program are considered here for completeness.

For investor-owned utility (IOU) customers, the Credit is applied automatically (typically in April and October) to all customers' bills, regardless of demographics or energy usage. It has generally been in the \$100-160 range per year for most IOU customers.³ Anecdotally, many IOU customers either do not know about the Climate Credit, let alone its connection to cap-and-trade.

In AB 1207, CARB is directed to design the cap-and-invest regulations in a manner that transitions support from gas corporations to electrical distribution utilities. In practice, this could mean that rather than receiving a Climate Credit on one's gas and electric bills, one could receive a larger credit on their electric bill and none on their gas bill. Every gas customer is an electricity customer, but not every electricity customer buys gas. Particularly as state policies continue to push Californians towards electrifying more and more of their home appliances, defraying more of their electric bills with the Climate Credit (and no longer subsidizing their gas bills) could make sense.

The Climate Credit is further adjusted through AB 1207 in that the bill directs utilities to issue the Credit in no more than four high-billed months to maximize affordability (rather than two fixed months with historically lower energy usage).

Although the Climate Credit is where the vast majority of revenues from the sale of utility-allocated consigned allowances go, it is not the only thing. AB 1207 makes further changes to the other allowable uses of these moneys. The same industries that receive allowance allocations as leakage protection also receive the Climate Credit as well; AB 1207 gives CPUC the discretion whether or not to continue that practice. The bill also directs

² Summary of 2013-2023 Electrical Distribution Utility Use of Allocated Allowance Value. CARB.

<https://ww2.arb.ca.gov/sites/default/files/cap-and-trade/allowanceallocation/EDU%202023%20Use%20of%20Allowance%20Value%20Report.pdf>

³ California Climate Credit. CPUC. <https://www.cpuc.ca.gov/industries-and-topics/natural-gas/greenhouse-gas-cap-and-trade-program/california-climate-credit>

5% of the proceeds of consigned allowance sales into a California Transmission Accelerator Revolving Fund.

- f) *Auctioned allowances.* The largest share of allowances issued by the state is those that are auctioned off quarterly, and whose auction proceeds fund the GGRF. In recent years, cap-and-trade auctions have raised between \$2 billion and \$5 billion per year, totaling \$26.4 billion between 2013 and 2023. As a result of several bills over the years, roughly 65% of annual GGRF revenues is now dedicated to statutorily required continuous appropriations.

After accounting for these statutory spending commitments, the remainder of annual GGRF revenues are available for the state to spend on other activities, at its discretion (and pursuant to other statutory requirements). The Legislature typically appropriates GGRF funds as a part of the annual budget process, and spending priorities for these “discretionary” revenues can vary each year.

The majority of decisions made involving GGRF as part of this reauthorization are described in SB 840, which was introduced concurrently with this measure. The only change to appropriations made by AB 1207 is that “nature-based climate solutions” is now included in the list within the intent language directing the Legislature’s annual expenditure plan.

- 3) *Job’s not finished.* Clearly, cap-and-invest is a complex and consequential policy that is deeply embedded in California’s economy and transition away from fossil fuels. Pulling any one policy lever alone will not accomplish our goals, but taken together, the Legislature can chart a course for the program that addresses affordability, reaffirms California’s climate leadership, and invests in California’s climate-ready future.

This bill is a valiant effort in charting that course. It is not a full-scale overhaul of the program, nor is it a clean reauthorization. It is not a blank check to CARB, nor is it an unequivocal endorsement of the first decade-plus of their administration of the program. AB 1207, like cap-and-invest itself, will not (and cannot) please everyone. Nevertheless, passing it will ensure that California’s flagship climate program can proceed with certainty past 2030, which is likely to provide tangible benefits even sooner through restored market certainty and auction revenues.

It is incumbent upon the Legislature to continue to engage with CARB and market participants, to make meaningful use of the oversight tools afforded to

it, and to tackle head-on the hard questions that putting a price on carbon emissions in the world's fourth-largest economy necessitates. Even if no further legislative action is needed to continue the program for nearly two decades, cap-and-invest should continue to be a central feature of how California confronts climate change and continue to evolve alongside our broader strategy accordingly.

SOURCE: Author

SUPPORT:

The Nature Conservancy

OPPOSITION:

Asian Pacific Environmental Network
California Environmental Justice Alliance (CEJA) Action
Center on Race, Poverty & the Environment
Central Valley Air Quality Coalition (CVAQ)
Clean Water Action
Communities for a Better Environment
Leadership Counsel for Justice and Accountability
Physicians for Social Responsibility - Los Angeles

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