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The 2017-18 Budget: Overview of Governor's Cannabis-Related Trailer Bill Legislation

L E G I S L A T I V E A N A L Y S T ' S O F F I C E

Presented to the following
Senate Budget and Fiscal Review Subcommittees:

Resources, Environmental Protection, Energy, and Transportation
Hon. Bob Wieckowski, Chair

Health and Human Services
Hon. Richard Pan, Chair

State Administration and General Government
Hon. Richard Roth, Chair

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Background

☑ Medical Cannabis Regulation and Safety Act (MCRSA) Passed by Legislature in 2015

- Implemented via Chapters 688, 689, and 719 of 2015 (AB 243, Wood; AB 266, Bonta; and SB 643, McGuire, respectively) and subsequently modified in 2016 by budget trailer legislation, Chapter 32 of 2016 (SB 837, Committee on Budget and Fiscal Review).
- Created a new regulatory structure for the licensing and enforcement of medical cannabis industry, including cultivators, product manufacturers, distributors, testing laboratories, and dispensaries (retailers).
- Assigned regulatory authority to a new bureau within the Department of Consumer Affairs (bureau) and several state departments, including the California Department of Food and Agriculture (CDFA), the Department of Public Health (DPH), and the Board of Equalization.
- The administration released draft regulations on most provisions of MCRSA in late April.

☑ Proposition 64 Passed by Voters in November 2016

- Legalized the use of cannabis for nonmedical purposes by adults age 21 and over.
- Created a new regulatory structure for the licensing and enforcement of nonmedical cannabis similar in many ways to the one created for medical cannabis under MCRSA.

☑ Some Key Differences Exist Between MCRSA and Proposition 64

- ***Vertical Integration.*** MCRSA generally limits a medical cannabis licensee to holding state licenses in no more than two categories. In contrast, Proposition 64 generally allows a nonmedical cannabis licensee to hold licenses in more than two categories.

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Background *(Continued)*

- ***Independent Distribution.*** Distributor licensees under MCRSA generally are required to be independent entities that do not hold licenses in other license categories. In contrast, distributor licensees under Proposition 64 generally can hold licenses in other license categories.
- ***Verification of Local Permits.*** MCRSA requires state license applicants to provide proof of a local permit or other permission to operate. In contrast, Proposition 64 prohibits the state from requiring applicants to provide proof of a local permit or other permission to operate. (However, Proposition 64 prohibits the state from issuing a license if it is in conflict with local ordinances or other laws.)

☑ **Some Changes to Proposition 64 Can Be Made by the Legislature . . .**

- Proposition 64 allows for modifications to the framework of nonmedical cannabis regulation by a majority vote of the Legislature. Modifications to most of Proposition 64's other provisions, such as those related to taxation and criminal offenses, require a two-thirds vote of the Legislature.
- Under the measure, any legislative changes must be consistent with the proposition's stated intent and further its purposes.

☑ **. . . And Others May Require Voter Approval**

- Changes to Proposition 64 not consistent with its stated intent would have to be approved by voters.
- In some cases, it may be unclear whether specific changes to Proposition 64 would be considered consistent with the measure's intent.

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Background *(Continued)*

☑ **Cannabis Continues to Be Illegal Under Federal Law**

- Under federal law, it is illegal to possess or use cannabis, including for medical use.
- In recent years, the U.S. Department of Justice has chosen not to prosecute most cannabis users and businesses that follow state and local cannabis laws if those laws are consistent with federal priorities, such as preventing cannabis from being taken to other states.
- However, this federal policy could change in the future, which might affect the state's ability to effectively implement regulations on cannabis.

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Overview of Governor's Budget Trailer Legislation

☑ Intended to Reconcile Differences Between Proposition 64 and MCRSA

- In April 2017, the Governor released trailer bill legislation (TBL) that creates a single regulatory structure for medical and nonmedical cannabis.
- The legislation generally uses Proposition 64 as its foundation, but includes significant provisions from MCRSA. Also, the legislation makes various other policy choices that were not included in either Proposition 64 or MCRSA.
- Includes provisions related to (1) the structure of the cannabis industry, (2) the local permitting process, (3) administrative flexibility, (4) roles and responsibilities of various state agencies, (5) reporting and oversight, as well as (6) various other policy choices.

☑ LAO Overarching Comments

- In general, we find that the concept of aligning MCRSA and Proposition 64 makes sense. However, the Legislature will want to closely evaluate the specifics of the choices made by the administration to ensure that it has provided clear rationales for these changes and that they are consistent with legislative priorities for the regulation of cannabis.
- The Legislature will also want to consider whether proposed changes to Proposition 64 might require voter approval, as well as keep in mind that cannabis remains illegal under federal law.
- We are still in the process of reviewing this recently released language. On the following pages, we outline some of the key choices included in the language and provide some initial thoughts to help guide the Legislature.

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Structure of the Cannabis Industry

☑ **Proposed TBL Would Affect Industry Structure**

- ***Allows for Vertical Integration, Including Self-Distribution.*** Generally allows for entities to hold multiple license types, with the exception of testing laboratories (consistent with Proposition 64).
- ***Does Not Require California Residency.*** Does not require California residency to obtain or renew a license. (MCRSA did not include a residency requirement. Proposition 64 included a residency requirement through December 31, 2019.)
- ***Prohibits Medical and Nonmedical Activities From Occurring on Same Premises.*** Generally prohibits medical and nonmedical commercial activities from occurring on the same premises (not included in Proposition 64 or MCRSA).
- ***Limits Number of Medium-Sized Cultivation Licenses.*** Tasks CDFA with limiting the number of medium-sized cultivation licenses, defined as (1) canopy size between 10,000 square feet and 22,000 square feet for indoor or mixed-light grows or (2) up to one acre for outdoor grows (consistent with MCRSA).
- ***Defines Ownership.*** Defines an owner as someone with an ownership interest of 20 percent or more or who otherwise participates in the direction, control, and management of the business (consistent with Proposition 64; MCRSA included a lower ownership threshold). Requires disclosure of a complete list of every person with a financial interest in the entity applying for the license (not included in Proposition 64 or MCRSA).
- ***Market Factors.*** Does not include language from Proposition 64 that requires licensing agencies to consider certain factors when making licensing decisions, such as monopoly power, perpetuation of an illegal market, underage use, or excessive concentration (consistent with MCRSA).

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Structure of the Cannabis Industry *(Continued)*

Instead, licensing agencies would be required to submit a report in 2023 that identifies any statutory or regulatory changes necessary to address these factors.

☑ Analyst's Comments

- ***Generally Limit Restrictions on Industry Structures.*** In general, greater restrictions on how industries are structured increases costs and can negatively affect competition. Therefore, we generally favor imposing those restrictions only when there is a compelling reason to do so—for example, for health and safety concerns.

- ***Some Choices on Industry Structure Appear Reasonable . . .*** Some of the administration's key choices related to the structure of the industry appear reasonable to us. For example, we generally do not find a compelling reason to prevent entities from holding multiple license types, such as for cultivation, distribution, and retail sale. Additionally, we do not see a strong rationale for only allowing California residents to apply for licenses, which is generally not the practice for other industries.

- ***. . . But Other Choices Raise Possible Concerns.*** We find that other key choices raise potential concerns. For example, it is not clear to us that the state should prohibit medical and nonmedical activities from occurring on the same premises. The administration indicates that this prohibition would help protect medical licensees from federal enforcement. However, to the extent that licensees are concerned about federal enforcement, they can voluntarily choose to operate only in the medical market or to segregate their medical and nonmedical activities. Additionally, we do not find a compelling reason to limit the number of licenses issued for medium-sized grows, particularly in the long term.

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Local Permitting Process

☑ ***TBL Proposes to Change How State Will Verify Licensee Compliance With Local Laws.*** To address the difference in the verification of local permits discussed above, the administration proposes a multi-prong approach (described below). The proposed changes are different from both MCRSA and Proposition 64.

- ***Creates Incentives for Local Governments to Establish Permit Systems Through California Environmental Quality Act*** (***CEQA).*** Creates a CEQA exemption for local governments that adopt ordinances or regulations related to cannabis regulation under certain circumstances. (CEQA is a state environmental law that requires state and local agencies to analyze and publicly disclose potential environmental impacts resulting from their discretionary decisions and adopt feasible measures to mitigate those impacts.)
- ***Requires License Applicant Compliance With CEQA.*** In cases where local governments do not have permitting systems for cannabis but allow for cannabis activities, requires license applicants to comply with CEQA.
- ***Requires Certain Information From Local Jurisdictions.*** Requires local jurisdictions to provide the state with copies of ordinances related to commercial cannabis activity and local contact information.

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Local Permitting Process *(Continued)*

☑ **Analyst's Comments**

- ***Goal Makes Sense, but Questions on Approach Remain.*** It is important for licensing agencies to have access to the necessary information to determine whether applicants are operating in compliance with local ordinances and other laws. The administration takes an indirect approach to addressing this issue. We still have questions about (1) whether this approach will effectively address the identified issue; (2) how the proposed process will work in practice; and (3) whether the approach is the best way to address this issue or whether another, potentially more direct, approach would be preferable.

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Administrative Flexibility

☑ ***Proposed TBL Would Provide State Agencies Greater Discretion in Some Areas.*** As described below, the TBL would leave some details to be defined in regulations rather than through statute.

- ***Omits Some Language.*** Removes certain language from Proposition 64 such as the definition of volatile solvents (the use of which can raise safety concerns) and requirements that packaging disclose product potency as well as the solvents, pesticides, and fertilizers used in cultivation (MCRSA did not include this language).
- ***Fails to Provide Key Details in Some Areas.*** For example, it does not define premises. (Premises was not defined in either MCRSA or Proposition 64, but is of greater importance under the proposed TBL, which generally prohibits medical and nonmedical activities from occurring on the same premises). Additionally, it provides the bureau with new authority to allow a grace period before contaminant testing is required, but does not specify the length of that grace period.

☑ **Analyst's Comments**

- ***Key Policy Choices Should Be Made Through Legislation Rather Than Regulations.*** Any details that have important policy implications—such as the definition of premises or important labeling requirements—should be defined in statute rather than left to regulations.

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Roles and Responsibilities of Various State Agencies

☑ **TBL Proposes to Modify Various State Agency Responsibilities**

- ***Nonmedical Cannabis Testing Laboratories.*** Transfers authority over these laboratories from DPH to the bureau (consistent with medical cannabis).
- ***Audit Responsibilities.*** Transfers the responsibility for conducting specified performance audits under Proposition 64 from the Bureau of State Audits to the Office of State Audits and Evaluations(OSAE) within the Department of Finance (these audits are not required under MCRSA).
- ***Appeals Process.*** Specifies that appeals of licensing decisions are heard by an appeals panel (consistent with Proposition 64; appeals panel not provided in MCRSA). Also, specifies that appeals of panel decisions be made directly to the Court of Appeals or Supreme Court (rather than trial courts, as envisioned in Proposition 64).
- ***Microbusinesses.*** Adds requirement that CDFA and DPH review microbusiness license applications in addition to the bureau (not included in Proposition 64 or MCRSA). Microbusinesses can engage in cultivation of less than 10,000 square feet, distribution, certain manufacturing, and retailing.
- ***Appellations.*** Requires CDFA to create an appellation program, which allows licencees to market their products as originating from a certain region. (Proposition 64 required the bureau to conduct this function and MCRSA permitted but did not require CDFA to conduct this function.)

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Roles and Responsibilities of Various State Agencies *(Continued)*

☑ **Analyst's Comments**

- ***Some Choices on State Agency Responsibilities Seem Reasonable . . .*** It appears that some of the administration's choices regarding departmental responsibilities make sense. For example, it is reasonable to transfer the authority of nonmedical cannabis testing laboratories from DPH to the bureau, consistent with the Legislature's transfer of authority over medical cannabis testing laboratories in the 2016-17 trailer legislation. Additionally, it may make sense to transfer the authority over appellations from the bureau to CDFA, which has more expertise with agricultural products.

- ***. . . But in Some Cases, Administration Should Provide Clearer Rationale.*** In other cases, the administration should provide a clearer rationale for the proposed choice. For example, the administration has not provided a compelling rationale for transferring the responsibility for performance audits from the Bureau of State Audits to OSAE.

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Reporting and Oversight Provisions

☑ Proposed TBL Would Affect Reporting and Oversight

- ***Annual Reporting.*** Begins required reporting in 2023 and specifies that reporting is required to include certain information such as the amount of funds spent, the number of licenses issued, and the license processing time (date and specifics of reporting generally consistent with MCRSA). Also, specifies that the first report shall identify statutory or regulatory changes to achieve certain goals such as preventing monopoly power, the perpetuation of an illegal market, and underage use (not included in MCRSA or Proposition 64).
- ***Audit Timing.*** Specifies that required performance audits of the bureau shall be conducted on a triennial rather than annual basis, as required by Proposition 64. (MCRSA did not include an auditing requirement.)

☑ Analyst's Comments

- ***Reporting Should Commence No Later Than 2019.*** In our view, the administration should begin reporting key information starting no later than 2019 (covering 2018). Reporting is important in the first several years of implementation when the Legislature and stakeholders will want to closely monitor progress and determine whether changes need to be made to improve aspects of cannabis regulation, particularly given the increased complexity of regulating both medical and nonmedical cannabis

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Various Other Policy Choices

☑ **Proposed TBL Would Implement Various Other Policy Choices**

- ***Modifies Environmental and Other Provisions From 2016-17 Trailer Legislation.*** Includes various environmental-related and other provisions adopted as part of 2016-17 TBL.
- ***Eliminates Medical ID Cards.*** Eliminates the state medical ID program. Makes the medical identification program at the county level optional. (MCRSA and Proposition 64 included a state medical ID program.)

☑ **Analyst's Comments**

- ***Reasonable to Include Provisions in Chapter 32 . . .*** The Legislature made various changes to MCRSA in 2016-17 TBL, such as the addition of various provisions related to the environment. Since the Legislature has recently approved these policy choices for medical cannabis, it appears reasonable to generally apply them to nonmedical cannabis as well.
- ***. . . But Trade-Offs Exist Associated With Eliminating State Medical ID Cards.*** The administration indicates that it is eliminating state medical ID cards because the cards have not been widely used in the past. We note that the elimination of this program would shift the responsibility for issuing medical ID cards from the state to the counties on a voluntary basis. Additionally, the elimination of state medical ID cards could have some potential effects on state and local sales tax revenues. This is because medical cannabis users would be exempted from sales tax by presenting a physician recommendation rather than a medical ID card (which is more difficult to obtain than a physician recommendation).