LAO

The 2026-27 Budget:

Cap-and-Invest Expenditure Plan

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SUMMARY

2026-27 Greenhouse Gas Reduction Fund (GGRF) Expenditure Plan Implements New Allocation Methodology. The Governor's 2026-27 budget proposal is the first since the passage of Chapter 117 (AB 1207, Irwin) and Chapter 121 (SB 840, Limón). Together, these bills extended the cap-and-invest program and modified the methodology for allocating the associated GGRF revenues, including creating new allocation "tiers."

Expenditure Plan Allocates Discretionary Revenues to Various Activities. In its 2026-27 GGRF expenditure plan, the administration proposes to allocate a total of over $1.6 billion to discretionary activities, including: (1) $1.25 billion to backfill California Department of Forestry and Fire Protection (CalFire) costs that otherwise would be paid by the General Fund, (2) $250 million for activities specified in intent language in SB 840, and (3) $115 million to create a new light-duty zero-emission vehicle (ZEV) incentive program. The administration does not anticipate GGRF will have adequate revenues to support the full amounts identified in SB 840 for certain programs.

Proposed Activities Generally Reflect Recent Agreements, With Addition of New ZEV Program. We find that the administration's proposal to support the CalFire backfill and SB 840 intent items is consistent with recent legislative guidance. Notably, however, the administration chooses not to support any of the programs that were anticipated to receive out-year monies in the 2024-25 GGRF expenditure plan, including some funds that the state has already awarded to local transit agencies. Failing to provide these transit funds could have negative implications, such as on agencies' financial positions and ability to draw down federal grant funds. Instead, the Governor prioritizes providing GGRF to support the creation of an entirely new ZEV program.

Given General Fund Condition, Recommend Directing GGRF to Highest Priorities Across Budget. In a typical year, trying to maintain existing funding commitments makes sense. However, in light of the state's alarming multiyear budget deficits, we recommend the Legislature use GGRF as an important tool to help it fund its highest funding priorities across the entire state budget. This will necessitate reexamining existing GGRF commitments—both discretionary and statutory—to make sure they continue to reflect the Legislature's highest priorities, and making modifications accordingly. This could include consideration of whether to fund at least some portion of previous transit commitments, given the potential implications of not providing that support. We also recommend the Legislature apply a very high bar to its review of new spending proposals, whether from the General Fund or GGRF. Consistent with this guidance, we recommend rejecting the Governor's proposal to fund a new ZEV incentive program.

Consider Whether Proposed Statutory Changes Are Consistent With Legislative Intent. The administration proposes budget trailer legislation to codify its view that the SB 840 allocation methodology is only intended to apply to auction revenues (not interest income or any entering fund balance). The choice of which funds to include in the SB 840 methodology has important implications for the level of support programs receive under this new structure. Accordingly, we recommend the Legislature consider whether the proposed statutory changes conform to its intent.

Background

Cap-and-Invest Is a Key Program Aimed at Limiting Greenhouse Gas Emissions (GHGs). Since the cap-and-invest program was created through the passage of Chapter 488 of 2006 (AB 32, Núñez), it has served as one of the state's core policies intended to help it achieve its ambitious GHG reduction goals. In 2017, Chapter 135 (AB 398, Garcia) extended the statutory authorization for the program from 2020 to 2030. In September 2025, the Legislature adopted AB 1207 and SB 840, which authorized a second extension of the program (from 2030 to 2045) and made some important changes to it. (We discuss these changes in our December 2025 publication, *Overview of New Updates to the Cap-and-Invest Program*.)

Cap-and-Invest Revenues Are Deposited Into GGRF. Under the cap-and-invest program, the California Air Resources Board (CARB) issues a limited number of allowances each year. (An allowance is essentially a permit to emit one ton of carbon dioxide equivalent.) Under current regulations, the state gives away about half of these allowances for free to industrial facilities, electric utilities, and natural gas suppliers. CARB sells the remaining half of allowances at quarterly auctions and the revenues are deposited into GGRF. Historically, GGRF revenues have been used to support a wide range of programs, many of which are aimed at reducing GHG emissions. However, from a legal perspective, GGRF funds are considered akin to tax revenues, so they can be used for any purpose.

GGRF Monies Typically Allocated by Statute and Annual Budget Process. The Legislature has approached appropriating GGRF revenues through two main methods. First, the Legislature has set aside a portion of ongoing GGRF funding each year for certain programs or projects articulated in legislation (often referred to as "statutory allocations"). Second, the Legislature has allocated other available revenues through the annual budget act, typically for one year at a time (often referred to as "discretionary" allocations). In addition to these two main allocation methods, the state has also funded some ongoing state administrative costs—such as related to implementing GGRF-funded programs—from the fund. Once approved, GGRF funding for state administrative costs generally has been included in departments' base budgets in annual budget acts. (The administration sometimes refers to these as GGRF "state operations" costs.)

The 2024-25 Budget Agreement Included Out-Year Funding for Various Programs. The 2024-25 budget agreement took an atypical approach to allocating discretionary revenues, as it not only appropriated GGRF to discretionary programs for that budget year but also included plans to dedicate a large share of out-year discretionary GGRF revenues for specific purposes. The bulk of the agreed-upon planned GGRF spending was slated to backfill reductions to expenditures that were previously planned to be made from the General Fund for a wide variety of activities. Some of the planned spending was also related to fulfilling statutory agreements. For example, the 2024-25 GGRF expenditure plan included funding to support: (1) public transit, consistent with Chapter 54 of 2023 (SB 125, Committee on Budget and Fiscal Review) and (2) the Clean Energy Reliability Investment Plan (CERIP), consistent with Chapter 239 of 2022 (SB 846, Dodd). (For more details on the 2024-25 budget agreement's multiyear spending plan, please see our September 2024 publication, *The 2024-25 California Spending Plan: Natural Resources and Environmental Protection*.)

The 2025-26 Budget Package Directed Most Discretionary GGRF Spending to Support General Fund and Motor Vehicle Account (MVA). The 2025-26 budget agreement allocated all the GGRF that the administration projected to be available as of the budget act, thus leaving no projected fund balance. The agreement included funding for the statutorily required expenditures, as well as $1.7 billion in discretionary spending. Most of the latter allocation—$1 billion—was provided for a CalFire fund shift, replacing a like amount of General Fund support for the department to help address a budget shortfall. Additionally, to help make up for a projected deficit in the MVA in 2025-26, the budget included $81 million from GGRF to pay for costs that otherwise would have to be paid by that account. Other discretionary allocations represented some, but not all, of the funding that was originally planned for 2025-26 as part of the 2024-25 multiyear GGRF expenditure plan discussed above. (Please see our October 2025 publication, *The 2025-26 California Spending Plan: Natural Resources and Environmental Protection*, for a summary of which programs received GGRF in 2025-26.)

Starting in 2026-27, Allocation of Revenues Is Guided by New Legislation. Senate Bill 840 not only made changes to the cap-and-invest program itself, but also made various modifications to the allocation of GGRF revenues starting in 2026-27. For example, SB 840 changed some statutory allocations from being set percentages of annual GGRF revenues to fixed dollar amounts. Senate Bill 840 also modified the order in which certain allocations are made, including setting aside $1 billion for discretionary allocations earlier in the prioritization process. (We discuss SB 840's changes to the statutory allocations of GGRF in greater detail in our recent report, *Overview of New Updates to the Cap-and-Invest Program*.)

In Figure 1, we summarize the GGRF allocations under SB 840.

Recent Legislation Expressed Intent for Use of Funds in 2026-27. In addition to the statutory allocations shown in the figure, the Legislature enacted statutory language expressing its intent to use discretionary GGRF monies to support certain other activities in 2026-27 and future years. Specifically, SB 840 expressed the Legislature's intent to provide a total of $250 million to fund the following specific activities from the $1 billion discretionary GGRF set aside in 2026-27:

- $125 million for transit passes.
- $85 million for climate-focused technological innovation.
- $25 million for seed funding for a University of California Climate Research Center.
- $15 million to rebuild Topanga Park (which sustained damage in the Palisades fire).

Figure 1

Statutorily Required GGRF Appropriations Pursuant to SB 840

Program	Department	Annual Amounts
Tier 1: Starting in 2026-27, auction revenues will be allocated first to the following programs:		
Manufacturing tax exemption	N/A	• Roughly $160 million
State operations[a]	Various	• Roughly $120 million
State Responsibility Area fee backfill	CalFire	• Roughly $90 million
Legislative Counsel Climate Bureau	Legislative Counsel	• $3 million
Tier 2: Then second to the following programs:		
High-speed rail project	HSRA	• $1 billion
Unspecified programs subject to appropriation[b]	Various	• $1 billion
Tier 3: Then third, if funding is available, to the following programs[c]:		
Affordable Housing and Sustainable Communities Program[d]	SGC	• $800 million
TIRCP	CalSTA	• $400 million
Community Air Protection Program—AB 617	CARB	• $250 million
Low Carbon Transit Operations Program	Caltrans	• $200 million
Wildfire and forest resilience—SB 901	CalFire	• $200 million
Safe and Affordable Drinking Water Program	SWRCB	• $130 million
Tier 4: Then fourth, remaining funding is subject to legislative appropriation for discretionary purposes.		

[a] SB 840 does not explicitly mention state operations as part of Tier 1, but references funding them prior to allocating Tier 3. The administration proposes budget trailer legislation to clarify that they are considered part of Tier 1.

[b] SB 840 included intent language for spending some of this funding in 2026-27.

[c] SB 840 requires the Department of Finance to proportionately reduce the amounts for these programs if funding is insufficient to fully support them.

[d] The Governor proposes budget trailer legislation to divide the Affordable Housing and Sustainable Communities funding into two separate programs.

GGRF = Greenhouse Gas Reduction Fund; SB 840 = Chapter 121 of 2025 (SB 840, Limón); CalFire = California Department of Forestry and Fire Protection; HSRA = High Speed Rail Authority; SGC = Strategic Growth Council; TIRCP = Transit and Intercity Rail Capital Program; CalSTA = California State Transportation Agency; AB 617 = Chapter 136 of 2017 (AB 617, C. Garcia); CARB = California Air Rescources Board; Caltrans = California Department of Transportation; SB 901 = Chapter 626 of 2018 (SB 901, Dodd); and SWRCB = State Water Resources Control Board.

Additionally, Chapter 5 of 2025 (AB 102, Gabriel) expressed the Legislature's intent to provide GGRF in 2026-27 and potentially future years to support some CalFire activities that otherwise would be funded from the General Fund. Specifically, if the General Fund continued to experience deficits in 2026-27, AB 102 expressed the Legislature's intent that GGRF cover $1.25 billion of CalFire's costs in 2026-27, $500 million in 2027-28, and $500 million in 2028-29. (If the General Fund was not projected to be in a deficit in 2026-27, GGRF would only cover $500 million for CalFire in that year.)

Allowance Prices Have Been Relatively Stable Since Passage of New Legislation. The passage of AB 1207 and SB 840 provided additional clarity regarding the future of the cap-and-invest program. As such, some expected that their passage could put upward pressure on allowance prices and potentially result in higher GGRF auction revenues compared to recent trends. As of the preparation of this report, only one auction—in November 2025—has been conducted since the passage of the two bills. However, the resulting revenues were roughly equivalent to the amount the state received from the August 2025 auction, as both allowance prices and the number of allowances sold were similar across the two auctions. In both August and November, allowances sold for roughly $28 each, which is much closer to the program's price floor ($26) than its price ceiling ($95). (We discuss the recent auction results in greater detail in our December 2025 publication, *Cap-and-Invest: November 2025 Auction Update and 2026-27 Budget Context*.)

Governor's Proposal

Proposes SB 840-Related Budget Trailer Legislation. The administration proposes budget trailer legislation to make various changes to SB 840. Some of the main proposed changes would memorialize its interpretation of the intent of SB 840 by clarifying that: (1) the SB 840 allocation methodology applies to auction revenues, not interest earnings or the entering fund balance, and (2) state operations costs should be considered as part of Tier 1. Other notable proposed changes include (1) dividing the Affordable Housing and Sustainable Communities (AHSC) Program into two allocations, (2) enhancing flexibility across two portions of wildfire resilience funding, and (3) expanding the eligible uses for the High-Speed Rail Authority's GGRF allocation to include its administrative and state operations costs. (We plan to discuss the AHSC portion of the budget trailer legislation in greater detail in a forthcoming publication, *The 2026-27 Budget: Streamlining California's Affordable Housing Funding System*.)

Allocates $3.8 Billion in Projected GGRF Auction Revenues Through SB 840 Methodology. The Department of Finance (DOF) forecasts cap-and-invest auction proceeds of $3.8 billion in 2026-27. As shown in **Figure 2**, DOF applies its interpretation of the new SB 840 methodology to these auction proceeds. Notably, the Governor proposes to allocate the $1 billion discretionary set aside within Tier 2 for two purposes: (1) $250 million for the legislative intent items identified in SB 840 and (2) $750 million to partially support the planned CalFire General Fund backfill.

Funds New State Operations Expenditures Within Tier 1. The Governor proposes to support a few new activities from the state operations portion of GGRF, which it would fund in Tier 1, as mentioned above. These consist of:

- ***Climate Change Assessment.*** Proposes $9.9 million over five years (including $355,000 in 2026-27) for various departments to support the development of the state's Sixth California Climate Change Assessment and associated research.
- ***AB 1207 and SB 840 Implementation.*** Proposes $2.1 million ongoing and seven positions for the California Public Utilities Commission (CPUC) and $871,000 ongoing (as well as additional funding from the Cost of Implementation Account) and ten positions for CARB to undertake new activities associated with implementing AB 1207 and SB 840 requirements. Such activities include implementing changes to the "California Climate Credit" rebates funded by free allowances provided to utilities and updating the rules governing the eligibility and quantification of offsets under the program.

Figure 2

Governor's Cap-and-Invest Expenditure Plan for 2026-27

(In Millions)

SB 840 Formula	
Estimated Auction Proceeds	**$3,770**
Tier 1	
Manufacturing tax exemption	$159
State operations	120
State Responsibility Area fee backfill	88
Legislative Counsel Climate Bureau	3
Subtotal Tier 1	($370)
Tier 2	
High-speed rail project	$1,000
CalFire General Fund backfill	750
SB 840 intent language items	250
Subtotal Tier 2	($2,000)
Tier 3[a]	
Affordable housing[b]	$396
Transit and Intercity Rail Capital Program	283
Community Air Protection Program—AB 617	177
Sustainable communities and agricultural land conservation[b]	170
Low Carbon Transit Operations Program	141
Wildfire and forest resilience—SB 901	141
Safe and Affordable Drinking Water Program	92
Subtotal Tier 3	($1,401)
Remaining Balance Available for Priority 4 Discretionary Activities	**—**
Total Projected Expenditures	**$3,770**
Outside of SB 840 Formula	
Estimated Non-SB 840 Funding	**$750**
Entering fund balance[c]	$250
Interest earnings	500
Proposed Non-SB 840 Expenditures	**$615**
CalFire General Fund backfill	$500
Zero-emission vehicle incentive program	115
Projected Remaining Fund Balance and End of 2026-27	**$135**

[a] Tier 3 amounts reflect proportional reductions to statutorily-defined amounts based on projected revenues, pursuant to the SB 840 methodology.

[b] The Governor proposes budget trailer legislation to divide the Affordable Housing and Sustainable Communities funding into two separate programs.

[c] A portion of the anticipated entering fund balance results from the administration's proposal to undo the $81 million transfer to the Motor Vehicle Account that was approved in the 2025-26 budget.

CalFire = California Department of Forestry and Fire Protection; SB 840 = Chapter 121 of 2025 (SB 840, Limón); AB 617 = Chapter 136 of 2017 (AB 617, C. Garcia); and SB 901 = Chapter 626 of 2018 (SB 901, Dodd).

- ***AB 617 Implementation.*** Proposes $1.6 million ongoing and 5.2 positions for CARB to implement Chapter 118 of 2025 (SB 352, Reyes) related to the Community Air Protection Program established by Chapter 136 of 2017 (AB 617, C. Garcia).

- ***CARB Consolidated Administration.*** Proposes $82,000 ongoing (as well as additional funding from other sources) and six positions to support various human resources and information technology-related functions at CARB.

Under DOF's Projections, Revenues Would Not be Sufficient to Fully Fund Tier 3 Programs in 2026-27 and Out-Years. Based on its auction projections and interpretation of SB 840, DOF does not anticipate GGRF will have adequate revenues in 2026-27 to support the full amounts identified for the Tier 3 programs in SB 840. Instead, DOF projects that the Tier 3 programs will be subject to proportional reductions in 2026-27 pursuant to the statutory methodology, receiving roughly 70 percent of the amounts specified in statute. The projected allocations are displayed in Figure 2. Notably, DOF also projects that Tier 3 programs may be subject to proportional reductions in the out-years as well, as shown in Figure 3 on the next page.

Allocates $615 Million Outside SB 840 Spending Framework for Rest of CalFire Backfill and ZEV Incentive Program. The administration assumes about $750 million in GGRF monies will be available in 2026-27 that are not from budget-year auction revenues and thus not subject to the SB 840 allocation process under its statutory interpretation. This includes an expected entering fund balance ($250 million), as well as projected GGRF interest income ($500 million). The estimated GGRF entering

Figure 3

Administration's Greenhouse Gas Reduction Fund Revenue and SB 840 Expenditure Projections

(In Millions)

	2026-27	2027-28	2028-29	2029-30
DOF GGRF Revenue Estimates[a]	**$3,770**	**$3,915**	**$4,066**	**$4,221**
Tier 1				
Manufacturing tax exemption	$159	$163	$168	$174
State operations	120	124	127	131
State Responsibility Area fee backfill	88	88	88	88
Legislative Counsel Climate Bureau	3	3	3	3
Subtotal Tier 1	($370)	($378)	($386)	($396)
Tier 2				
High-speed rail project	$1,000	$1,000	$1,000	$1,000
CalFire General Fund backfill	750	500	500	—
SB 840 intent items	250	—	—	—
Remaining discretionary set aside	—	500	500	1,000
Subtotal Tier 2	($2,000)	($2,000)	($2,000)	($2,000)
Tier 3[b]				
Affordable housing[c]	$396	$435	475	$516
Transit and Intercity Rail Capital Program	283	311	339	369
Community Air Protection Program—AB 617	177	194	212	231
Sustainable communities and agricultural land conservation[c]	170	186	204	221
Low Carbon Transit Operations Program	141	155	170	184
Wildfire and forest resilience—SB 901	141	155	170	184
Safe and Affordable Drinking Water Program	92	101	110	120
Subtotal Tier 3	($1,401)	($1,537)	($1,680)	($1,825)
Projected SB 840 Expenditures	**$3,770**	**$3,915**	**$4,066**	**$4,221**

[a] Revenue estimates assume allowances will sell at the same average premium above the price floor as has been the case for the last four quarters with fully subscribed auctions. DOF notes that this scenario is presented as an example and should not be considered as a market price forecast.

[b] Tier 3 amounts reflect proportional reductions to statutorily-defined amounts based on projected revenues, pursuant to the SB 840 methodology.

[c] The Governor proposes budget trailer legislation to divide the Affordable Housing and Sustainable Communities funding into two separate programs.

GGRF = Greenhouse Gas Reduction Fund; DOF = Department of Finance; CalFire = California Department of Forestry and Fire Protection; SB 840 = Chapter 121 of 2025 (SB 840, Limón); AB 617 = Chapter 136 of 2017 (AB 617, C. Garcia); and SB 901 = Chapter 626 of 2018 (SB 901, Dodd).

fund balance is higher than previously anticipated for a couple of reasons, including (1) a new proposal to undo the $81 million MVA transfer that was approved in the 2025-26 budget agreement, as the administration projects that account will not need it to remain solvent through 2026-27, and (2) lower-than-budgeted expenditures on some activities. As displayed in Figure 2, the administration proposes to use $615 million of the $750 million in additional revenues to support the following activities, thus leaving a projected GGRF fund balance of $135 million at the end of 2026-27:

- ***CalFire Backfill.*** Proposes $500 million to support the remainder of the planned $1.25 billion CalFire backfill.
- ***ZEV Incentive Program.*** Proposes $115 million to create a new light-duty ZEV incentive program. (The Governor also proposes providing $85 million from the Air Pollution Control Fund—similarly freed up from undoing the previously-approved MVA fund transfer—to support this new ZEV program, for a total of $200 million.)

Assessment

Administration's Revenue Estimates Appear Reasonable, but GGRF Revenues Remain Difficult to Predict. Based on currently available information, DOF's 2026-27 GGRF revenue forecast appears reasonable. However, GGRF revenues are inherently somewhat unpredictable. Moreover, while one key near-term source of program uncertainty was resolved with its statutory extension, some remaining factors could potentially still create a heightened level of revenue unpredictability in the next couple of years. For example, CARB recently released draft regulations that propose to make various changes to the program—including to the total number of allowances issued and the allocation of those allowances across various purposes (such as GGRF and free allowances to utilities and industry)—that could affect GGRF revenues. Additionally, CARB still is considering linking California's cap-and-invest program with the program in Washington state. Such a linkage could affect allowance prices in both states as they come into alignment. Moreover, the current federal administration has been critical of California's cap-and-invest program, including in a April 2025 executive order. Should the federal government threaten action against the state's program, allowance prices could be affected.

Proposal Generally Reflects Recent Agreements, with Addition of New ZEV Program. The administration's proposal to provide $1.25 billion for a CalFire backfill and $250 million for SB 840 intent items is consistent with the guidance included in recent legislation. Notably, however, the administration does not propose to fund any of the programs that were anticipated to receive out-year monies in the 2024-25 GGRF expenditure plan, such as CERIP or transit, in either 2026-27 or future years. Instead of funding the programs envisioned in the 2024-25 GGRF plan, the Governor prioritizes providing GGRF to support the creation of an entirely new ZEV incentive program.

Neglecting to Provide Planned Transit Funding Could Lead to Disruptions for Local Capital Projects. The amounts planned in the 2024-25 GGRF package that are no longer included in the administration's multiyear spending plan (or in SB 840 intent language) include a total of $710 million that would have supported local transit agencies across the state. This includes $20 million for the Transit and Intercity Rail Capital Program planned for 2026-27, and $230 million in 2026-27 and $460 million in 2027-28 for the Zero Emission Transit Capital Program. In part because some of these funds had originally been scheduled to be provided in previous years but then were delayed due to the state budget condition, some local transit agencies already have committed portions of this funding to specific local projects. For example, the Metropolitan Transportation Commission in the Bay Area indicates that, consistent with the SB 125 plan it submitted to the Legislature, it programmed about $250 million of the anticipated funds which the Legislature has not yet appropriated for two Bay Area Rapid Transit expansion capital projects in order to help leverage billions of dollars in forthcoming federal support from the Capital Investment Grant Program. It states that failure to receive the anticipated funds could jeopardize local transit agencies' ability to draw down significant federal funding, and that agencies have entered into construction contracts based on state commitments. Accordingly, not providing this funding could be disruptive to affected local agencies. Additionally, some transit agencies planned to use some of this funding to offset operational funding shortfalls. The Legislature may want to learn more about potential consequences that could ensue from the administration's proposal to not fund these planned amounts and consider them as it develops its final GGRF spending package.

Given General Fund Condition, Directing GGRF to Support Core State Priorities Is an Important Budget Tool. In our view, it typically makes sense to try to maintain existing funding commitments. However, as we discuss in our January 2026 publication, *The 2026-27 Budget: Overview of the Governor's Budget*, the state faces alarming multiyear budget deficits, ranging from $20 billion to $35 billion annually. We expect that the Legislature will need to make very difficult decisions to address these deficits. Within this context, we think the Legislature should use GGRF as an important tool to help it fund its highest funding priorities across the entire state budget. This could include helping to support existing core services currently paid for by the General Fund. We note that, given the legal flexibility of GGRF, its funds could be used not only to support existing core environmental-related activities—such as parks and fire protection—but also other activities, such as in the areas of health and human services.

Since Much of GGRF Is Committed, This Approach Would Involve Revisiting Existing Commitments. As discussed above, the Legislature has already committed large portions of GGRF for specific activities in 2026-27 and out-years. Thus, using GGRF as a budget tool will necessitate reexamining existing commitments—both discretionary and statutory—to make sure they continue to reflect the Legislature's highest priorities. If any of these commitments represent lower-priority activities than programs at risk of being defunded, reallocating funding so it is instead directed to the highest-priority activities across the budget would make sense. (This could also include allocating funding consistent with earlier GGRF plans, such as to public transit.)

Very High Bar for Approving New Proposals Under Current Budget Conditions. We also believe the Legislature should apply a very high bar to its review of new spending proposals, whether from the General Fund or GGRF. This is because, in the context of a budget deficit, funding any new proposals will necessitate making commensurate reductions elsewhere within the budget. As we discuss in our companion report, *The 2026-27 Budget: Framework for Approaching the Natural Resources, Environmental Protection, and Agriculture Budget*, we do not think the Governor's proposal to provide GGRF to establish a new ZEV incentive program meets this threshold. (We also plan to discuss the ZEV proposal in more depth in a forthcoming publication, *The 2026-27 Budget: Proposed Zero-Emission Vehicle Incentive Program*.)

Does Administration's Interpretation of SB 840 Methodology Align With Legislative Intent? DOF indicates that its proposed budget trailer legislation clarifies its interpretation of the intent of SB 840 related to (1) the funds subject to the SB 840 methodology and (2) the treatment of state operations costs. A key question for the Legislature is whether it is comfortable that the proposed statutory modifications do indeed reflect its intent, as they have important implications for which programs receive funding under this new structure. Specifically:

- ***Considering Interest Income and Entering Fund Balance Discretionary and Outside of SB 840.*** The practical implication of the administration considering revenues from interest income and the entering fund balance outside of the SB 840 allocation process is that more than $1 billion annually will be set aside as available for discretionary purposes prior to computing allotments for Tier 3 programs. The precise amount of such available discretionary funding will vary by year depending on the entering fund balance and interest income. In 2026-27, for example, under this approach roughly $1.75 billion is available for discretionary purposes prior to funding Tier 3 programs, of which the administration proposes to spend about $1.6 billion. We note that the language of SB 840 indicates that the methodology applies to "moneys in the fund" and thus does not clearly limit it exclusively to auction revenues. However, the administration indicates that the intent of SB 840 was to apply the methodology only to auction revenues, consistent with historical practice.
- ***Providing State Operations Costs First Priority.*** By including funding for state operations in Tier 1, they are taken "off the top" before allocations are computed for nearly all other activities. The main implication of this approach is that any activities that are added to this category essentially result in less funding available to support programs in other tiers and a greater likelihood that Tier 3 programs may not receive their full statutory allotments. We note that SB 840 is not explicit about the allocation tier within which these activities should be covered. Instead, the statute references setting aside funding for them prior to computing allotments for Tier 3 funding.

Funding Proposals From State Operations Has Implications for Money Left Available for Other Tiers. Under the administration's interpretation of the SB 840 methodology (which would be codified in the proposed budget trailer legislation), activities that are funded as part of GGRF state operations are prioritized above nearly all other programs and activities. The administration indicates that because these funds typically support ongoing state staff, ensuring more certainty that they will be available is important so as not to risk staff layoffs if GGRF revenues come in below expectations. While this rationale is reasonable, this approach is not without trade-offs. Most notably, because including state operations expenditures as part of Tier 1 means they receive first priority for available GGRF, adding new activities to this category can have the effect of gradually "crowding out" other GGRF-funded programs and activities. In light of this, we think the Legislature should carefully consider what types of activities it would like to include in this category—and potentially provide this guidance to the administration in statute, as appropriate—recognizing that this year's decisions could serve as a precedent going forward. For example, the administration's proposal to support the Sixth California Climate Change Assessment serves as a somewhat nontraditional example of a GGRF state operations category activity, in that it is not directly linked to implementing cap-and-invest or GGRF-funded programs and would support *one-time* activities rather than *ongoing* state staff. (We provide additional analysis of this proposal in our companion report, *The 2026-27 Budget: Framework for Approaching the Natural Resources, Environmental Protection, and Agriculture Budget*. We also plan to discuss CPUC's AB 1207 implementation proposal—also funded from the GGRF state operations category—in a forthcoming publication, *The 2026-27 Budget: California Public Utilities Commission's Implementation of AB 1207*.)

Recommendations

Direct GGRF to Highest Legislative Priorities, Including for Supporting Core Activities Traditionally Funded With General Fund. We recommend the Legislature dedicate GGRF to its highest budget priorities across the entire state budget, not just within climate- or environment-related programs. To effectuate this, we recommend the Legislature review prior plans and commitments for spending GGRF—including discretionary and statutory allocations, as well as state operations expenditures—to make sure they continue to reflect the Legislature's highest priorities across the broader budget, and then make modifications accordingly. This could include consideration of whether to fund at least some portion of previous transit commitments, given the potential implications of not providing that funding. Additionally, we recommend the Legislature reject new discretionary GGRF proposals unless they meet an exceptionally high bar, as they both come at the expense of previous unmet GGRF planned commitments and mean forgoing the ability to use that amount of GGRF to help address the General Fund shortfall. Consistent with this guidance, we recommend rejecting the Governor's proposal to fund a new ZEV incentive program.

Review Proposed SB 840 Implementation Approach and Statutory Changes to Ensure Consistency With Legislative Intent. We recommend the Legislature carefully review the administration's proposed approach to implementing SB 840 to ensure that it is consistent with legislative intent and preferences, and make any associated statutory modifications, as relevant. This could include adopting the administration's proposed budget trailer legislation clarifying the funds subject to SB 840 and the prioritization of state operations costs, if those changes accurately reflect legislative intent. It could also include memorializing in statute the Legislature's preferred guiding principles for which types of activities the administration should include as GGRF state operations proposals going forward, as those activities would receive first priority for funding and thus can crowd out other GGRF-funded programs and activities.

Monitor Auctions and Adopt Spending Levels That Reflect Evolving Revenue Trends. Given the continued uncertainty around cap-and-invest revenues, we recommend the Legislature closely monitor upcoming quarterly auctions—in February and May 2026—to assess how revenues are materializing. We recommend the Legislature be prepared to modify its GGRF expenditure plan accordingly, should revenues from these auctions come in at higher or lower levels than currently anticipated.

LAO PUBLICATIONS

This report was prepared by Helen Kerstein, and reviewed by Rachel Ehlers and Ross Brown. The Legislative Analyst's Office (LAO) is a nonpartisan office that provides fiscal and policy information and advice to the Legislature.

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