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MONTHLY LEGISLATIVE UPDATE

To: Orange County Sanitation District

From Townsend Public Affairs

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STATE UPDATE

California has entered the second year of its two-year legislative session, a pivotal period marked by impending changes in state leadership, including the anticipated transition from Governor Newsom's administration. Following a turbulent 2025 defined by the Los Angeles wildfires, major California Environmental Quality Act (CEQA) reforms, and ongoing tensions with the federal government, the Legislature now turns to a 2026 session that presents just as many challenges. The State faces a growing budget deficit even as policymakers commit to advancing solutions on critical priorities such as housing, affordability, and public health.

DEPARTMENT OF FINANCE DECEMBER 2025 BULLETIN

The California Department of Finance released the December 2025 Finance Bulletin, pointing to generally stable economic conditions accompanied by stronger-than-expected General Fund revenue performance. At the national level, the U.S. unemployment rate increased to 4.6 percent in November, the highest level since September 2021, reflecting slower job growth and continued disruptions tied to the federal government shutdown. Employment gains for the year remain well below 2024 levels, with job growth concentrated largely in private education and health services.

In California, labor market conditions continued to soften as the state's unemployment rate rose to 5.6 percent in September, extending a series of job losses throughout 2025. While several sectors posted modest gains, including education, health services, leisure and hospitality, and government, those increases were offset by continued losses in professional services, manufacturing, and trade-related industries. These trends suggest ongoing pressure in sectors sensitive to higher interest rates and slower consumer demand.

Despite these labor market headwinds, state revenue performance remained resilient. Preliminary General Fund agency cash receipts exceeded the Budget Act forecast by $454 million in November, driven primarily by stronger personal income tax collections. Withholding and estimated payments continued to outperform expectations, while refunds came in below forecast. On a cumulative basis since April, General Fund receipts are $9.1 billion above projections, providing a stronger near-term fiscal position than anticipated at the start of the fiscal year.

Overall, the bulletin indicates that California enters the first half of 2026 with a degree of fiscal cushion, but with economic indicators that warrant continued monitoring. Sustained strength in personal income taxes may help offset labor market softening in the near term, though prolonged employment weakness or further declines in consumer and business activity could place downward pressure on revenues later in the fiscal year.

Budget pressures will have an impact on how the Legislature reacts to various policy proposals as well as on potential opportunities to secure funding for priority projects. These pressures could impact priorities important to OC San.

CAP AND INVEST AUCTION REVENUES

In its December 9 publication, the Legislative Analyst's Office (LAO) reported preliminary results from the November 2025 Cap and Invest quarterly auction, noting that the California Air Resources Board (CARB) expects the state to receive approximately $844 million in revenue, to be deposited into the Greenhouse Gas Reduction Fund (GGRF). This figure is nearly comparable to the August auction results and slightly below the quarterly revenue assumption used in this year's budget, which projected roughly $870 million per quarter. Compared to the auction this time last year, revenues dropped by approximately $150 million. If this trend continues, the LAO indicates that the total 2025-26 GGRF revenues could fall roughly $100 million below budget assumptions, potentially necessitating early or mid-year budget adjustments to discretionary allocations.

The LAO highlights that if auction revenues continue at recent levels, the GGRF could generate around $3.4 billion in auction revenue in 2026-27, with an anticipated $600 million in interest income. Even with both revenue sources, total funds may fall short of the $4.3 billion statutory allocation, potentially creating funding gaps for program commitments. Auctions will resume in February and May of 2026.

Looking ahead to the 2026-27 fiscal year, SB 840 (Limón) modifies the allocation of GGRF revenues, shifting some funding from a percentage-based to a fixed-dollar allocation and altering the funding sequence. Under the new statutory structure, the allocations approved by SB 840 would require roughly $4.3 billion annually to fully fund identified programs, discretionary appropriations, and administrative costs. In addition, statutory legislative intent expressed through SB 840 and AB 102 identifies up to $1.5 billion in potential discretionary uses, including support for fire protection costs, transit passes, climate innovation, and OC San priorities such as innovative biosolids management programs.

GOVERNOR RELEASES 2026-27 BUDGET PROPOSAL

On January 9, Department of Finance Director Joe Stephenshaw presented Governor Newsom's final January Budget Proposal for the 2026-27 Budget, setting the stage for state funding negotiations with the Legislature. Revenue volatility, a modest deficit, federal policy uncertainty, and fiscal prudence were front and center as the Director indicated any major spending changes would be released with the May Revision once the State fully accounts for revenues and spending over the coming months.

During the Governor's State of the State Address on January 8, he provided a preview of his January Budget with an optimistic outlook on progress towards shared goals of his Administration and the Legislature. This preview highlighted funding initiatives in education, workforce development, climate resilience, and a reauthorization of the CalCompetes Tax Credit for innovation and business growth in the state.

Considering potential changes in revenue compared to projections, Director Stephenshaw reiterated that there would be no new adjustments or significant discretionary spending increases. The majority of new expenditures are driven by constitutional requirements due to increased revenue in the budget year. The Director indicated Governor Newsom would present the May Revision, as it would be his final budget presentation during his tenure as Governor and would more accurately reflect the state's fiscal positioning.

Key Themes and Budget Highlights:

Total spending under the Governor's proposed budget is $348.9 billion, including $248.3 billion from the General Fund. Because the budget projects revenues of $42.3 billion above the 2025–26 Budget Act across the 2025–26 and 2026–27 budget window, the State Constitution triggers additional required allocations. These include increased funding under Proposition 98, which establishes minimum funding levels for K–14 education, and contributions under Proposition 2 to the Public School System Stabilization Account, the state's constitutional rainy-day fund for schools and community colleges.

A modest deficit of $2.9 billion is projected for the 2026–27 budget year, driven largely by increases in constitutionally and statutorily required spending. Director Stephenshaw noted that the shortfall is largely addressed by reducing planned deposits to the Budget Stabilization Account in the 2025–26 fiscal year. Last November, the Legislative Analysts Office (LAO) projected a $17.6 billion deficit – a nearly $15 billion contrast to the Governor's estimates. Director Stephenshaw noted the difference is accounted for mostly by the LAO's broader economic outlook, anticipating a sharper decline in stock market performance, driving down state revenues.

To prepare for anticipated future deficits and ongoing revenue volatility, the proposed budget increases total state reserves to $23 billion, including an approximately $3 billion deposit to the rainy-day fund, while suspending a scheduled $2.8 billion deposit in 2025–26. This adjustment accounts for nearly the entire projected deficit. The Director emphasized that the budget solution avoids new taxes or programmatic cuts and generally maintains prior investment levels.

Despite this approach, significant fiscal risks remain as the state moves toward finalizing the budget. Stock market volatility, particularly within the technology sector and emerging artificial intelligence (AI) industries, combined with uncertainty surrounding federal policy, including the potential impacts of tariffs and restrictive monetary policy, could affect revenue performance. This fiscal uncertainty could impact priorities important to OC San.

WATER

As California continues to face increasingly severe weather extremes, including droughts, floods, and rising temperatures, the Administration has sought to build more resilient water systems through targeted climate investments. While overall natural resources funding is significantly reduced in the proposed budget, several adjustments are included to support water resilience statewide:

- $9.5 million in ongoing General Fund support for the Department of Water Resources to maintain 24-hour river forecasting and snow course measurement activities that are critical to water supply forecasting. This funding offsets recent federal reductions in these areas.
- $14 million one-time General Fund for the Department of Water Resources Delta Levees Program to support mitigation activities required for the implementation of levee safety projects in the Delta.

CLIMATE CHANGE

With respect to climate, natural resources, and infrastructure, the Budget maintains prior-year commitments rather than introducing new large-scale initiatives. Since 2019, the state has committed $39.1 billion to climate-related investments, including clean energy, transportation, wildfire resilience, and climate adaptation projects. The Administration emphasizes implementation and delivery of these investments.

This budget continues these commitments and initiatives on the heels of the reauthorization of the Cap-and-Invest program to allocate funds to the Greenhouse Gas Reduction Fund, broken down into three tiers in order of funding priority:

Tier 1: Manufacturing Tax Credit, State Operations, State Responsibility Area Backfill, and the Legislative Counsel Climate Bureau.

Tier 2: $1 billion for High-Speed Rail and $1 billion for discretionary funding. Of the $1 billion in discretionary funding, $250 million is reserved in 2026-27 for various investments identified in SB 840. The remaining $750 million from the $1 billion in discretionary funding supports the CAL FIRE General Fund backfill and could potentially support OC San priorities such as innovative biosolids management programs.

Tier 3: Previous percentage-based continuous appropriations are now capped dollar amounts, with proportionately related allocations that adjust downwards as necessary to ensure Tiers 1 and 2 are fully funded.

Climate Bond

Continuing the rollout of funding from the 2024 Climate Bond, the Governor's Budget proposes to allocate $2.1 billion in 2026-27 for projects that protect communities and natural resources from the impacts of climate change. Out of this amount, $314 million will be dedicated to wildfire and landscape resilience through local fire prevention grants, fire resilience, and risk reduction projects.

The Safe Drinking Water, Drought, Flood, and Water Resilience category receives the largest allocation from the bond to support infrastructure to improve drinking water quality, increase water supply reliability, recharge groundwater, protect against drought, and fortify flood control systems. For wildfire and forest resilience, bond funding is dedicated to reducing wildfire risk and improving forest health, particularly in areas vulnerable to catastrophic fire. Coastal Resilience funding supports projects along California's coast that guard against sea level rise, coastal flooding, and erosion. Grants may be directed toward wetland and dune restoration, shoreline stabilization, and bay shoreline flood management. It also provides resources to support local planning efforts, enabling coastal communities to update their hazard mitigation plans.

Below is a more detailed chart of the Climate Bond Expenditure Plan:

CLIMATE BOND EXPENDITURE PLAN		
Investment Category	**Bond Allocation**	**2026-27 Proposed**
Safe Drinking Water, Drought, Flood & Water Resilience	$3.8 billion	$792 million
Wildfire & Forest Resilience	$1.5 billion	$314 million
Coastal Resilience	$1.2 billion	$107 million
Extreme Heat Mitigation	$450 million	$241 million
Biodiversity & Nature Based Solutions	$1.2 billion	$199 million
Climate Smart Agriculture	$200 million	$89 million
Outdoor Access	$700 million	$35 million
Clean Air & Energy	$850 million	$326 million
Total	**$10 billion**	**$2.1 billion**