

CALIFORNIA DEPARTMENT OF FOOD AND AGRICULTURE
Title 3 of the California Code of Regulations

**Notice of Proposed Rulemaking
45-Day Notice**

NOTICE IS HEREBY GIVEN that the Department of Food and Agriculture (Department or CDFA) intends to adopt Division 8, Chapter 1, sections 8000 to 8608, within Title 3 of the California Code of Regulations pertaining to its Cannabis Cultivation Program. With this rulemaking, the Department will propose permanent regulations after the consideration of all comments, objections, and recommendations regarding the proposed action.

The Department is issuing this notice to meet requirements set forth in Government Code section 11346.5.

PUBLIC HEARINGS

The Department will hold public hearings at the dates, times, and locations listed below at which time any interested person may present statements or arguments orally or in writing relevant to the proposed action.

Tuesday, July 24, 2018 1 PM to 3 PM

Adorni Center
1011 Waterfront Drive
Eureka, CA 95501

Thursday, July 26, 2018 1 PM to 3 PM

Mission Inn Hotel and Spa
3649 Mission Inn Avenue
Riverside, CA 92501

Tuesday, July 31, 2018 1 PM to 3 PM

Hilton Santa Barbara Beachfront Resort
633 E Cabrillo Boulevard
Santa Barbara, CA 93103

Tuesday, August 28, 2018 1 PM to 3 PM

California Department of Food & Agriculture Auditorium
1220 N St
Sacramento, CA 95814

Services, such as translation between English and other languages, may be provided upon request. To ensure availability of these services, please make your request no

later than ten (10) working days prior to the hearing by calling the staff person referenced in this notice.

Servicios, como traducción, de Ingles a otros idiomas, pueden hacerse disponibles si usted los pide en avance. Para asegurar la disponibilidad de éstos servicios, por favor haga su petición al minimo de diez (10) dias laborables antes de la reunion, llamando a la persona del personal mencionada en este aviso.

WRITTEN COMMENT PERIOD

Any interested person, or his or her authorized representative, may submit written comments relevant to the proposed regulatory action to the Department. Comments may be submitted by mail or by email to:

Amanda Brown
California Department of Food and Agriculture
CalCannabis Cultivation Licensing Division
P.O. Box 942871
Sacramento, CA 94271
CalCannabisRegs@cdfa.ca.gov
Phone: (916) 263-0801

The written comment period closes at 5:00 pm on August 27, 2018. The Department will consider only comments received by that time and via the delivery methods designated above.

AUTHORITY AND REFERENCE

The Department is proposing to adopt sections 8000 – 8608 of Title 3 of the California Code of Regulations.

Business and Professions Code sections 26000, 26001, 26012, 26013, 26050.1, 26053, 26055, 26060.1 and Health and Safety Code section 11362.768 authorize the Department to prescribe, adopt, and enforce the proposed regulations governing the licensing of commercial cannabis cultivation. The proposed regulations will implement, interpret, make specific or reference sections 12027, 12210, 12212, 12700, 26001, 26010, 26012, 26013, 26015, 26031, 26038, 26050, 26050.1, 26051, 26051.5, 26053, 26054, 26054.2, 26055, 26057, 26058, 26060, 26060.1, 26061, 26063, 26066, 26067, 26069, 26070, 26110, 26120, 26121, 26160, 26180, and 26201 of the Business and Professions Code, sections 1602 and 1617 of the Fish and Game Code, section 12754.5 of the Food and Agricultural Code, section 1140 of the Labor Code, sections 40141 and 42649.8 of the Public Resources Code, and sections 5101, 13149, 13575, and 13751 of the Water Code.

INFORMATIVE DIGEST / POLICY STATEMENT

Existing Law:

Proposition 215 (1996), also known as the Compassionate Use Act of 1996, was passed by California voters and made it legal for patients and their designated primary caregivers to possess and cultivate marijuana for their personal medical use given the recommendation or approval of a California-licensed physician.

Senate Bill 420 (Vasconcellos, Chapter 875, Statutes of 2003), also known as the Medical Marijuana Program Act, required the establishment of a program for the issuance of identification cards to qualified patients so that they may lawfully use cannabis for medical purposes, and required the establishment of guidelines, including limits, for the lawful cultivation of cannabis grown for medical use.

Assembly Bill 243 (Wood, Chapter 688, Statutes of 2015), Assembly Bill 266 (Bonta, Chapter 689, Statutes of 2015), and Senate Bill 643 (McGuire, Chapter 719, Statutes of 2015), established a regulatory program for the cultivation of medical cannabis as part of the Medical Cannabis Regulation and Safety Act (MCRSA). The MCRSA mandated the Department to establish the Medical Cannabis Cultivation Program (MCCP) to regulate, implement, and enforce the MCRSA as it pertains to the cultivation of commercial medical cannabis. The legislation mandated regulation to encourage environmental protection measures by the cultivator to prevent further pollution of water, degradation of the natural environment, wildlife endangerment, and to protect public peace, health, and safety. MCRSA required the Department to develop and enforce regulations for statewide commercial medical cannabis cultivation activities occurring at nurseries and indoor, outdoor, and mixed-light cultivation sites. The MCRSA also obligated the Department to create and implement a track-and-trace system to monitor commercial medical cannabis from cultivation through the distribution chain, to be the lead agency in implementing California Environmental Quality Act requirements for the statewide cultivation program, and ensure that weighing or measuring devices used for the sale or distribution of medical cannabis are required to meet standards equivalent to Division 5 of the Business and Professions Code (commencing with section 12001). Fees associated with cultivation are required to be scaled and must cover the Department's costs of implementing and enforcing the commercial cultivation licensing program and subsequent regulations. The MCRSA has since been repealed, but all of the Department's obligations listed above have been incorporated in the Medicinal and Adult-Use Cannabis Regulation and Safety Act of 2017.

Proposition 64 (2016), also known as the Adult Use of Marijuana Act or AUMA, was passed by California voters and legalized the consumption and cultivation of cannabis for adult-use and specifies conditions under which cannabis may be cultivated, processed, and sold for commercial purposes in California.

Senate Bill 94 (Committee on Budget and Fiscal Review, Chapter 94, Statutes of 2017), also known as the Medicinal and Adult-Use Cannabis Regulation and Safety Act or MAUCRSA, repealed the MCRSA and integrated the regulation of the medical and adult recreational markets into one regulatory framework that prioritizes consumer and public safety, environmental protection, and tax compliance for commercial cannabis cultivation. This law created agricultural cooperatives for small cannabis cultivators, a method for collecting and remitting taxes, a process for testing and packaging, and a process for collecting data related to driving under the influence.

Assembly Bill 133 (Committee on Budget, Chapter 253, Statutes of 2017) made technical changes to MAUCRSA on cannabis related issues necessary to implement the 2017 Budget Act. This new law further clarified the intent of the legislature regarding MAUCRSA.

Environmental Information and California Environmental Quality Act Compliance:

One of the largest effects of unregulated cannabis cultivation has been serious adverse impacts to the environment. The State Water Resources Control Board, the North Coast Regional Water Quality Control Board, and the Department of Fish and Wildlife have documented an increase in the number of unregulated cannabis cultivation sites and corresponding increases in impacts to water supply and water quality, including the discharge of sediments, pesticides, fertilizers, petroleum hydrocarbons, trash, and human waste.

The Department prepared the Programmatic Environmental Impact Report (PEIR) in accordance with the provisions of the California Environmental Quality Act. Certified on November 13, 2017, the PEIR provides stakeholders, including the public, responsible agencies, and cannabis cultivators with information about the potential significant environmental impacts associated with the adoption and implementation of these statewide regulations and mitigations to address significant environmental impacts at cannabis cultivation sites in California.

The PEIR is available for viewing at: <https://www.cdffa.ca.gov/CalCannabis/PEIR.html>

Objectives and Anticipated Benefits from this Regulatory Action:

Existing law obligates the Department to license and regulate all commercial cannabis cultivators in California, but allows for discretion with regard to the promulgation and maintenance of regulations to achieve this goal. The primary goal of these regulations is to establish practical and implementable licensing, enforcement, and track-and-trace programs to fulfill the Department's responsibilities under the MAUCRSA, as well as provide a framework for implementation.

Because regulations are intended to transition California cannabis cultivation to a legitimate industry, cultivators will be provided the opportunity to operate in compliance

with state laws and regulations applicable specifically to cannabis and California business requirements in general. For the first time, California cannabis cultivators will have the opportunity to become licensed by the state and openly operate within their communities.

The availability of state licensing for cannabis cultivators allows local and state law enforcement to clearly differentiate legal and illegal cannabis cultivation operations. This clear differentiation allows law enforcement to focus their efforts on eliminating cultivation sites that elect to grow cannabis without a state license. Over time, this prioritization will reduce the number of illegal cannabis cultivators in California and in turn reduce illegal cannabis cultivation activity impacts on California's environment and public health.

Regulations will also outline specific requirements included to protect the environment. Licensed cultivators will be subject to verification of compliance with these requirements and may face fines and penalties if found to be noncompliant. Under the state licensing program, cultivators will face potential consequences for noncompliance that did not exist under the unregulated marketplace. As an effect, the Department expects that state licensed cannabis cultivators will be motivated to comply resulting in protection of the environment at licensed cultivation sites.

Anticipated cumulative benefits of these regulations action include:

- Safeguarding of the environment through implementation of environmental protection measures and enforcement of existing environmental protection laws;
- Promotion of a fair and equitable marketplace for licensed cultivators;
- Creation of legitimate businesses and tax revenue sources;
- Increased worker safety through enforcement of existing employee protection laws.

Regulations are expected to create jobs through the introduction of new cultivation businesses and from industries that will support the emerging legitimate market such as accounting and legal services.

Inconsistency with Federal Regulations or Statutes:

The United States Drug Enforcement Administration, under the Controlled Substances Act, lists cannabis as a Schedule I drug. Schedule I drugs are defined as having a high potential for abuse, having no currently accepted medical use in treatment in the United States, and a lack of accepted safety for use of the drug under medical supervision (21 U.S.C. § 812).

Controlled Substances Act, Title 21 – Food and Drugs, Chapter 13 – Drug Abuse and Prevention Control, Subchapter 1 – Control and Enforcement, Part B – Authority to Control; Standards and Schedules:

<https://www.dea diversion.usdoj.gov/21cfr/21usc/812.htm>

Consistency with Existing State Regulations:

As required by Government Code section 11346.5(a)(3)(D), the Department has conducted an evaluation of these regulations and has determined that they are not inconsistent or incompatible with existing state regulations.

PLAIN ENGLISH REQUIREMENT

The Department staff prepared the proposed regulations pursuant to the standard of clarity provided in Government Code section 11349 and the plain English requirements of Government Code sections 11342.580 and 11346.2, subdivision (a)(1). The proposed regulations are written to be easily understood by the persons that will use them.

DISCLOSURES REGARDING THE PROPOSED ACTION

The Department has made the following initial determinations:

LOCAL MANDATE: There will be no local mandate. Business and Professions Code section 26200 provides local jurisdictions the ultimate authority to adopt and enforce local ordinances related to cannabis business licensure as well as the ability to completely prohibit the establishment or operation of such businesses within its jurisdiction.

COST OR SAVINGS TO STATE AGENCIES (FISCAL IMPACT):

The Department is tasked with issuing medicinal and adult-use cannabis cultivation licenses and administering all aspects of the cannabis cultivation regulations. The total annual agency budget equals approximately \$32 million (medicinal and adult-use cannabis) for the current Fiscal Year (2017-18), including \$6.3 million in external consulting services. The program cost will be recovered through one-time application fees and annual license fees, which will need to be adjusted as the market modifies over time.

The Department is tasked with ensuring that licensed cultivators are complying with cultivation regulations. This includes site inspections and ensuring compliance with all licensing requirements, including the track-and-track system. Department enforcement staff will also be responsible for referring complaints about unlicensed operations to appropriate state and local law enforcement.

It is likely that more illegal grow sites will be reported and local agencies will need to allocate more resources to eradication under MAUCRSA. These additional costs are not caused by Department regulations. By licensing cultivators, these regulations will make it easier for local agencies to identify unlicensed grow sites and the cost per eradication

will likely decrease. The Department assumes that the total compliance cost will increase, but the effectiveness of enforcement per dollar spent will also increase. The Department's Standardized Regulatory Impact Analysis used a mid-point cost of eradication equal to \$3 per plant, which is assumed to be inclusive of all incremental eradication/enforcement costs. It is additionally assumed that eradications increase by 15 percent over 2015 levels (2.6 million plants) under MAUCRSA. The total increase in enforcement costs to local agencies equals \$1.189 million.

The Department's regulations do not cause any increase in costs to other state agencies. The State Water Resources Control Board, Department of Pesticide Regulation, Department of Consumer Affairs, and other agencies are required to take actions under MAUCRSA, but any costs are separate from the Department's regulations. Similar to local agency fees, taxes, and regulations, the Department's regulations require cultivators to comply with other state agency regulations, but do not require any agency to take specific actions. As such, other state agencies do not incur costs as a result of these proposed regulations.

COST TO ANY LOCAL AGENCY OR SCHOOL DISTRICT WHICH MUST BE REIMBURSED IN ACCORDANCE WITH GOVERNMENT CODE SECTIONS 17500 THROUGH 17630:

None.

OTHER NON-DISCRETIONARY COST OR SAVINGS IMPOSED ON LOCAL AGENCIES:

The Department's regulations do not require additional expenditures by local governments. However, local agencies can set fees, taxes, and other rules independent of what the Department does (or what is required in MAUCRSA) under medicinal and adult use cannabis regulations. The Department will require cultivators to comply with all local regulations, and as such, the cost of complying with these local regulations is included in the economic impact analysis. In short, there are no fiscal impacts to local agencies as part of the medicinal and adult use cultivation regulations, but the economic impact analysis does include local fees/costs that cultivators must pay to obtain a cannabis license because these costs affect cannabis production costs across the state.

COST OR SAVINGS IN FEDERAL FUNDING TO STATE:

None.

DETERMINATION OF ANTICIPATED BUSINESS IMPACT:

The proposed regulations are intended to encourage what are currently illegal cannabis cultivation businesses to become legal (at the state level) and regulated. There may be some new businesses that did not pay taxes before these proposed regulations, and therefore are "new" as far as the California Department of Tax and Fee Administration is concerned. California is known worldwide for its cultivated cannabis, so it is likely that

the new businesses are simply current operators that decide to join the regulated market. These proposed regulations will increase the number of legal cannabis cultivation businesses paying taxes in California.

Businesses will be required to submit an application to obtain a license from the Department. The proposed regulations include applicant requirements and the fees required to obtain a license. Businesses will also need to comply with the environmental protection measures set in the proposed regulations. The proposed regulations establish a track-and-trace system that the businesses will need to follow, including uniquely identifying plants and products and recordkeeping.

According to the Department's Standardized Regulatory Impact Analysis, the net effect of these proposed regulations is an increase of 1,673 jobs statewide. Most of the increase comes from additional labor for local and state government and related programs.

The Department has made an initial determination that the adoption of this regulation may have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states. The Department has considered proposed alternatives that would lessen any adverse economic impacts on business and invites you to submit proposals. Submissions may include the following considerations:

- (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to businesses.
- (ii) Consolidation or simplification of compliance and reporting requirements for businesses.
- (iii) The use of performance standards rather than prescriptive standards.
- (iv) Exemption or partial exemption from the regulatory requirements for businesses.

COST IMPACTS ON A REPRESENTATIVE PRIVATE PERSON OR BUSINESS:

The Department regulations will have an uncertain impact on individuals. Regulations will increase cannabis product safety (e.g. limited pesticides), but this has uncertain effects on consumer health outcomes. Public safety may improve through better regulation, enforcement, and compliance (licensing), but there is limited evidence to analyze this effect. There is no evidence of adverse health or public safety outcomes.

Direct benefits to individuals include an increase in employee wages. Labor income increases with the exception of cultivator proprietor income, with different effects by industry sector. The net impact on wage income equals an increase of \$128 million statewide annually. This is driven by the significant decrease in proprietor income to cultivators that are offset by increased wages in other sectors of the economy that

support cannabis cultivation. Effectively, Department regulations reduce cultivator margins by increasing licensing, application, and direct regulatory compliance fees. This results in a decrease in proprietor income and statewide labor income.

HOUSING COSTS:

None.

SMALL BUSINESS IMPACT:

Most cannabis businesses are small businesses therefore the impacts listed above would affect these businesses.

BUSINESS REPORTING REQUIREMENT:

It is necessary for the health, safety, or general welfare of the people of the state that this regulation which requires a report apply to businesses.

RESULTS OF THE STANDARDIZED REGULATORY IMPACT ANALYSIS (SRIA):

(A) The creation or elimination of jobs within the state.

The net effect of the Department's regulations analyzed in its economic impact study is an increase of 1,673 jobs statewide, as shown in Table 32 of the SRIA. Also in Table 32, the total number of jobs created equals 2,795, and the total number of jobs destroyed equals 1,122 (net = 1,673). Most of the increase comes from additional labor for local and state (in addition to the Department) government and related programs. Labor income increases with the exception of cultivator proprietor income, with different effects by industry sector. The net impact on wage income equals an increase of \$128 million statewide annually. This is driven by the significant decrease in proprietor income to cultivators that are offset by increased wages in other sectors of the economy that support cannabis cultivation. Effectively, the Department's regulations reduce cultivator margins by increasing licensing, application, and direct regulatory compliance fees. This results in a decrease in proprietor income and increase statewide labor income.

(B) The creation of new businesses or the elimination of existing businesses within the state.

The combined effect of the Department's regulations and increased effectiveness of enforcement for unlicensed cultivation (not directly part of these regulations) will result in new businesses entering the regulated industry. Most of the businesses that enter the regulated market will shift over from the existing unregulated market. There will be some "new businesses" (e.g. do not currently grow cannabis in California), but these new businesses will likely be a small share of the market and will be offset by unregulated cultivators (who are currently producing cannabis in California) leaving the market in response to more effective enforcement. In short, the proposed regulations will cause an increase in the number of licensed cannabis cultivation businesses paying taxes in California. The net increase over current conditions is the difference between the combined medicinal and adult use market after statutory and regulatory adjustments

and the current medicinal market. The net increase as defined using SRIA guidelines is the difference between the combined medicinal and adult use market after statutory and regulatory adjustments and the SRIA baseline (combined adult use and medicinal market after statutory adjustments only).

The total number of licensed cannabis cultivation businesses depends on the average license size of the businesses that enter the market. In general, 2,000 – 7,500 licenses can supply the estimated market size. The regulations would also create a new business sector, processors, that would handle cannabis trimming, drying, and packaging activities. This analysis has assumed that these businesses could be 20 percent of total medicinal cannabis harvest, based on comparable fresh fruit and berry industries.

As stated under Section 6.1 of the SRIA, it will take some time for the market to reach equilibrium. There is a multiplicity of rules being promulgated by state and local agencies and this will continue for the next several years. The economic impact analysis presented in the SRIA reflects the best information available, and demonstrates impacts relative to a market in equilibrium. Market adjustments should be monitored closely as the industry adjusts over the next several years.

The investment in California's gross state product is the value added contribution for each industry, shown in Table 32 of the SRIA. The net effect on total value added is positive, but varies by sector. The net impact on statewide value-added equals \$140.9 million dollars annually, which is significant but is still a small share of the total economy. Most of the change in value added is due to increased local and state government expenditures (permit fees excluding taxes), and decreases in cultivator proprietor income.

(C) The competitive advantages or disadvantages for businesses currently doing business within the state.

California has an established cannabis production industry and it is likely that this will continue into the foreseeable future. Regulating and standardizing the industry may improve quality and reliability. This could be beneficial and further solidify a competitive advantage for California cannabis producers. It is not possible to quantify these effects at this time.

(D) The increase or decrease of investment in the state.

The Department's regulations are likely to spur investment by cultivators, other California cannabis businesses, and related sectors of the economy. The SRIA analysis clearly shows that regulations require significant investment in cottage, specialty, small, and medium cultivation (and nursery and processing) businesses in California. In the longer run as the industry adjusts it is likely that there will be spillover benefits and additional investment from the conventional agricultural industries. For example, recent trends in high tech agriculture (e.g. irrigation monitoring, farm data management, smart input management, etc.) may have similar application for cannabis cultivation.

The economic market analysis estimates that the total size of the medicinal and adult use cannabis market (farm-gate value) equals approximately \$2.1 billion (after accounting for statutory changes and the impact of these proposed regulations). At 8.84% average corporate tax rate, this results in \$180 million dollars in tax revenues. Additional cultivation taxes equal approximately \$152.20 per pound (inclusive of flower and trim taxes) and thus would generate an additional \$201 million annually.

(E) The incentives for innovation in products, materials, or process.

The Department's regulations are likely to spur private business innovation for cannabis cultivation. Much like conventional agriculture, cannabis is dependent on land, water, and labor resource inputs. All are in short supply in California and there is a clear incentive to develop technologies to more efficiently manage limited resources. For example, cannabis production is labor intensive during the harvest/trimming process. This requires skilled labor inputs, but there is potential for innovation of new mechanical harvesting approaches similar to the wine grape industry. Other areas for innovation might include identifying and labeling particular strains of cannabis with desirable qualities. This type of research is currently being conducted informally by cultivators. In general, the cannabis cultivation industry is young, evolving, and likely to innovate.

(F) The benefits of the regulations, including, but not limited to, benefits to the health, safety, and welfare of California residents, worker safety, and the state's environment and quality of life, among any other benefits identified by the agency.

The overall purpose of the Department's Program is to establish a regulatory licensing program that would ensure that medicinal and adult use cannabis cultivation operations would be performed in a manner that protects the environment, cannabis cultivation workers, and the general public from the individual and cumulative effects of these operations, and fully complies with all applicable laws.

One of the largest impacts of unregulated cannabis cultivation has been serious adverse impacts to the environment. The State Water Resources Control Board, the North Coast Regional Water Quality Control Board, and the California Department of Fish and Wildlife (FGC 12029 Findings) have documented a dramatic increase in the number of cannabis cultivation sites, corresponding increases in impacts to water supply and water quality, including the discharge of sediments, pesticides, fertilizers, petroleum hydrocarbons, trash, and human waste. These impacts result from the widespread unpermitted, unmitigated, and unregulated impacts of land grading, road development, vegetation removal, timber clearance, erosion of disturbed surfaces and stream banks, stream diversion for irrigation, and temporary human occupancy without proper sanitary or waste disposal facilities which threaten the survival of endangered fish species as well as public safety. In addition, the actions of some cannabis cultivators, either directly or through irresponsible practices, result in the killing of wildlife, including the endangered Pacific Fisher.

In the absence of a formal regulatory framework the negative impacts associated with cannabis cultivation are expected to increase, resulting in an unregulated, unstudied,

and potentially permanent negative impact on the environment and upon the peace, health, and safety of Californians.

As indicated on page 3 of this Notice, the Department prepared the Programmatic Environmental Impact Report (PEIR) in accordance with the provisions of the California Environmental Quality Act. Certified on November 13, 2017, the PEIR provides stakeholders, including the public, responsible agencies, and cannabis cultivators with information about the potential significant environmental impacts associated with the adoption and implementation of these statewide regulations and mitigations to address significant environmental impacts at cannabis cultivation sites in California.

The potential improvements in public health, safety, and environmental outcomes were not quantified in the Department's SRIA analysis. Quantified benefits—in terms of change in related industry purchases—are summarized in Table 32 of the SRIA. These benefits result from direct regulatory cost to cultivators, which in turn increase purchases and generate economic activity in other industries. The net increase in terms of output value equals \$140 million, as shown in Table 32 of the SRIA.

SUMMARY OF DEPARTMENT OF FINANCE COMMENTS AND CDFA RESPONSES:

The Department of Finance (Finance) provided five comments to the Department's Standardized Regulatory Impact Assessment (SRIA), which generally address two action items: state and local costs and industry projections. A summary of the comments and the Department's responses are below:

Finance Comment #1: “[T]he total regulatory costs should include both state and local costs. Even though departments do not have control over local costs, the regulations require that state-licensed entities comply with local requirements. Thus entities have no choice about paying the local costs. However, we recommend discussing all three numbers together when identifying regulatory costs (the total, the state component, and the local component), as this makes it clear to the public what they should be commenting on and to whom.”

Finance Comment #2: “[T]he SRIAs should use likely local costs in the modeling, not straight averages. Some local jurisdictions have chosen very high fees and taxes to discourage cannabis businesses, and including these will make it seem as though the regulated industry is not viable. However, if entities have a choice in where to locate, they will choose lower-cost jurisdictions, and the likely local cost should make the regulated industry viable. This could also help locals figure out if they have chosen their fees appropriately as well.”

These first two comments are important, and related, and the Department has addressed them as follows. First, the Department has revised the tradeoff analysis to demonstrate the effect of regulatory cost only, regulatory cost plus state and local taxes, and regulatory cost plus state taxes only. This allows the reader to see the effect of local taxes and fees on the illustrative tradeoff analysis presented in the SRIA. The

Department also clarified that the tradeoff analysis is comparing the risk premium to the regulator costs (and regulatory risk premium) and does not show the net income to the grower (e.g. risk preferences are an important consideration). The conclusion is consistent with the comments above: namely, high local taxes discourage cultivators from locating in those areas, but other areas will have lower taxes and the market will succeed.

The Department also added two points of clarification regarding the tradeoff analysis. First, we note that the local taxes shown represent the average of the counties that currently have taxes in place only, and that many counties do not have taxes (or may be considering lower taxes). Second, the Department clarified that the tradeoff analysis does not consider cultivator risk preferences. In practice, many cultivators that decide to participate in the legal market are likely to be risk averse, which all else equal, would encourage participation in the market (the risk premium would be understated as presented in the analysis).

Finally, the Department adjusted the local costs (fees/permits and taxes) and included them as a regulatory cost in two ways. Local fees and permits were already included in the regulatory cost in the draft cultivation SRIA. The Department moved the local taxes into the regulatory compliance costs. Next, the Department adjusted the total combined local fees and taxes to acknowledge that many of these fees and taxes are uncertain at the local level, and it is likely that many local taxes and fees will be set lower than the current average reported in the SRIA. In addition, cultivators are more likely to locate in counties with lower fees and taxes, thus the averages presented in the SRIA would be expected to decrease for this reason as well. Since the Department has no basis for estimating local fees and taxes in counties that have not yet reported what they might be, it adjusted the local regulatory costs by setting the local taxes to zero in the economic impact analysis. That is, the local fees and permitting costs are included and set equal to the average in the sample counties (which is biased upward), and the taxes are set to zero. Using this approach the Department is able to avoid overstating local fees and taxes while still demonstrating the multiplier effects the additional local revenues will have in local economies. This is a reasonable approximation—given the complete dearth of information—to adjust for the upward bias in the local fees and permit costs and acknowledge that combined fees and taxes are likely to be lower in counties where cultivators actually choose to locate.

Additional discussion along these lines were added to the SRIA to clarify: (i) local costs shown in the SRIA are biased upward, (ii) local taxes are set to zero in the economic impact analysis to adjust for this bias, (iii) high local fees/taxes will push cultivators to other counties with lower fees and taxes, and (iv) the SRIA shows the combined net effect of local fees and taxes as required. The net result is that the economic impact numbers do not change (local fees were also included), but the Department moved local taxes over to regulatory compliance costs and clearly stated that local taxes and fees are included, and adjusted for the upward bias in the sample average local fees and

taxes, as requested. This makes the point that local taxes and fees can be burdensome on the regulated industry and have unintended consequences.

Finance Comment #3: “[T]he SRIAs should make it clear what is likely to happen to the industry over time, rather just in equilibrium after everyone adjusts to being regulated. We know from other states that the first year of a regulated industry has higher prices, tighter supply, and a great deal of entry and exit for businesses. After that, entities seem to have figured out how to comply. Prices should fall, supply should expand, and there should be more stability. Since it can be difficult to model that first year, it might be best to model the eventual equilibrium, disclose that getting there will take some time, and discuss the dynamics of how the market gets there qualitatively. This should help set expectations for the public and ease worries that the industry will figure it out.”

The Department included an additional subsection in the SRIA under the “SRIA Baseline” discussion to clearly state that we are modeling an industry in equilibrium, but it will take several years to adjust this equilibrium. The economic story is consistent with everything described above - namely, there will be downward price pressure as supply expands with cultivators entering the market.

Finance Comment #4: “I should also mention that our official comment letters will make it clear that these cannabis SRIAs have a unique baseline. Usually baselines cannot include the effects of policies that are not legally binding yet, even if they are expected to be binding at the time of implementation. For these SRIAs, since they are tied together, the impacts only makes sense by assuming the other regulations are in place.”

The Department welcomes this additional clarification and agree that this is an unusual situation.

Finance Comment #5: “Finally, since we were discussing state and local costs, we checked with our budget analysts for your departments. It appears that the SRIAs assume revenues for departments that are inconsistent with the latest information the budget side has. Please check with your departments to ensure that nothing has changed that should be reflected in the modeling.”

The Department clarified the agency budget for the current fiscal year (as specified in the SRIA), and updated 3 year projections based on the information contained in this current SRIA. We understand that the last BCP provided to Finance was based on the MCCP licensing costs. These were derived for a different market size and set of regulations. The current projections are consistent with the current harmonized SRIA.

CONSIDERATION OF ALTERNATIVES

In accordance with Government Code section 11346.5(a)(13), the Department must determine that no reasonable alternative considered by the Department or that has otherwise been identified and brought to the attention of the Department would be more effective in carrying out the purpose for which this action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or

would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provisions of law.

Two alternative Department regulations were considered in the economic analysis and ultimately rejected: (i) flat cultivation licensing fees, and (ii) higher fines for cultivators that are found to be out of compliance with the Department regulations.

The first alternative considers a revised fee structure where the application and license cost is the same for all license types. It is rejected because it increases regulatory costs to small cultivators and outdoor cultivators, putting them at a disadvantage relative to larger, higher productivity cultivators. The market impacts show this alternative would result in fewer statewide economic benefits than the preferred alternative as large mixed-light and indoor cultivators push out small cultivators. Small and outdoor cultivators already shoulder a larger share of Department regulatory costs.

The second alternative considers fines that are triple the level proposed in the preferred alternative. This effectively increases the regulatory risk premium (which is modeled as a direct increase in cost to cultivators), and corresponding incentives to participate in the regulated market. It is rejected because it results in lower market participation across all cultivation license types. The market impacts show this alternative would result in fewer statewide economic benefits than the preferred alternative as fewer cultivators enter the industry and stay in the unregulated market.

CONTACT PERSON

Inquiries concerning the proposed action may be directed to:

Amanda Brown
California Department of Food and Agriculture
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P.O. Box 942871
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The backup contact person for these inquiries is:

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Email: CalCannabisRegs@cdfa.ca.gov

AVAILABILITY OF STATEMENT OF REASONS AND TEXT OF REGULATIONS

The Department has prepared and has available for public review an initial statement of reasons for the proposed regulations, all the information upon which the proposed regulations are based, and the express terms of the proposed regulations. A copy of the initial statement of reasons and the proposed regulations in underline may be obtained upon request. The location of the information on which the proposal is based may also be obtained upon request. Requests should be directed to Ms. Amanda Brown at the mailing or email address specified above.

AVAILABILITY OF CHANGED OR MODIFIED TEXT

After holding the hearings and considering all timely and relevant comments received, the Department may adopt the proposed regulations substantially as described in this notice. If the Department makes modifications which are sufficiently related to the originally proposed text, it will make the modified text (with the changes clearly indicated) available to the public for at least 15 days before the Department adopts the revised regulations. Any person interested may obtain a copy of any modified regulations prior to the date of adoption by contacting Ms. Amanda Brown at the mailing or email address specified above.

AVAILABILITY OF THE FINAL STATEMENT OF REASONS

Upon its completion, copies of the Final Statement of Reasons may be obtained by contacting Ms. Amanda Brown at the mailing or email address specified above.

INTERNET ACCESS

The Department has posted the information regarding this proposed regulatory action on its Internet Web site (<http://calcannabis.cdfa.ca.gov/>).

