September 21, 2024

Dear Sir or Madam,

We are pleased to share the accompanying comments to the Washington State Department of Ecology on the proposed Cap-and-Invest linkage rulemaking.

RFF is an independent, nonprofit research institution in Washington, DC. Its mission is to improve environmental, energy, and natural resource decisions through impartial economic research and policy engagement. RFF is committed to being the most widely trusted source of research insights and policy solutions leading to a healthy environment and a thriving economy.

While RFF researchers are encouraged to offer their expertise to inform policy decisions, the views expressed here are those of the individual authors and may differ from those of other RFF experts, its officers, or its directors. RFF does not take positions on specific policy proposals.

If you have any questions or would like additional information, please contact us at the email addresses below. Any references cited are available from the authors.

Sincerely,

Dallas Burtraw (burtraw@rff.org)
Nick Roy (roy@rff.org)
Suzanne Russo (srusso@rff.org)

Comments on the Cap-and-Invest Linkage Rulemaking

Dallas Burtraw, Resources for the Future
Nick Roy, Resources for the Future
Suzanne Russo, Resources for the Future

September 21, 2024

We appreciate the opportunity to provide comments on the proposed Cap-and-Invest linkage rulemaking. Our comments will focus primarily on implementation of the emission containment reserve (ECR) as discussed in section 70A.65.140 of the Climate Commitment Act (CCA).

In its standard implementation, an ECR is a mechanism for automatically adjusting the supply of emission allowances under conditions when the price of allowances is below a specified price situated between the price floor and ceiling. The inclusion of an ECR in the Washington auction would place a tranche of allowances under the annual nominal allowance budget in a reserve that would enter the market only if the auction settlement price is at or above the ECR trigger price. The ECR would be integrated into the auction in a similar way to the existing auction price floor. The ECR acts to accelerate emissions reductions by reducing the supply of emissions allowances when the market price signals that it is inexpensive to do so. An ECR has been active in the Regional Greenhouse Gas Initiative program covering ten mid-Atlantic and northeastern states since 2021.

An ECR offers a rule-based approach to adjusting allowance supply in response to market signals about allowance scarcity. This reduces uncertainty for compliance entities and lowers administrative costs for regulators. In contrast, administrative adjustments to supply implemented by the regulator on an irregular or ad hoc basis can propagate regulatory uncertainty and the expectation that one administrative intervention may foreshadow other additional program interventions, which can serve to destabilize allowance prices and reduce market participation.

As Washington negotiates linking its Cap-and-Invest program with that of California and Quebec, much consideration has been given to potential for reductions in revenues and benefits that flow to Washington—and by extension its communities—from allowance auctions. Linking could lead to increased or decreased revenues, depending on the price that emerges in the linked market compared to the price if Washington were to remain as a separate market. Nonetheless, if revenues were reduced, that would impact the state's timeline and ability to achieve CCA goals by reducing revenue that is available for investments and particularly for reducing environmental burden in overburdened communities.

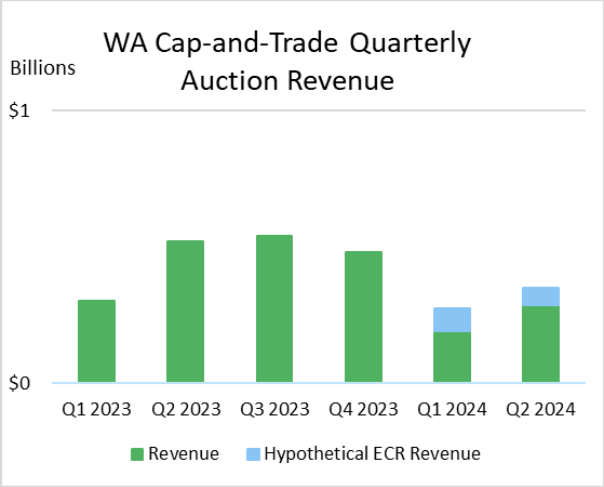
The ECR can decrease uncertainty and support revenue generation in a linked or unlinked market. The ECR is already legislatively a part of Washington's Cap-and-Invest program and only needs to be functionally activated by the Department of Ecology establishing a trigger

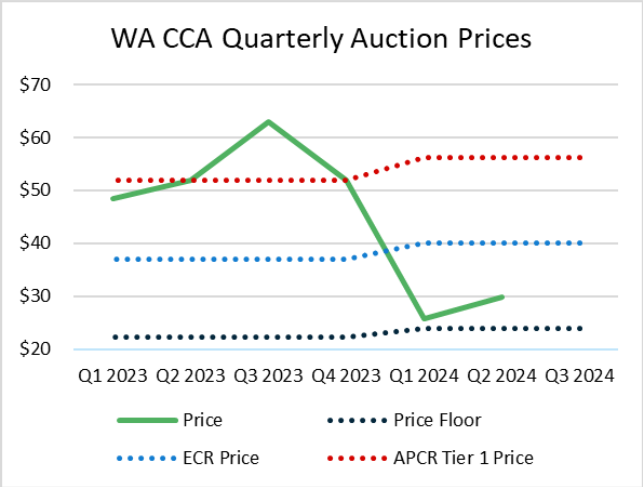
price and reserve quantity. An ECR would support price stabilization and allowance auction prices above the price floor, offering additional price and revenue stability. The ECR could also prevent backsliding when other factors help to reduce the cost of compliance in the allowance market, such as advances in technology. The availability of California's and Quebec's banked allowances in a linked market could become an example of potential backsliding on Washington's goals if they enabled an increase in emissions in Washington. The ECR can mitigate this concern as well as preserve revenues.

Rather than continuing to hibernate the ECR provision contained in the CCA, Washington has an opportunity via linkage to establish a trigger price for its ECR, effectuating this aspect of the market design for Washington and potentially influencing a similar policy outcome in California and Quebec. In a linked market, such a tool could be a critical market-based mechanism that balances opportunities for lower-cost emission reductions enabled by an expanded market with mechanisms to capture more value from auctioned allowances. The ECR would thereby provide an additional revenue assurance for funding the programs and activities described in the CCA, including air quality and health disparity improvements in environmentally overburdened communities.

However, an ECR may not work to the advantage of Washington if it were the only jurisdiction to implement this feature in a linked system, because it could lead to fewer revenues (through fewer auctioned allowances) while supporting the price to the benefit of the other jurisdictions. There might also be difficulties with implementing an ECR in a single joint auction as discussed in the previous workshop. Hence, in a linked system, it only makes sense to reactivate the ECR if it is adopted by all the participating jurisdictions. The ECR has already been recommended by California's Independent Emissions Market Advisory Committee (IEMAC) and Washington's Environmental Justice Advisory Committee (EJAC)

As an illustration of how an ECR could currently benefit Washington, we modeled the two recent allowance auctions (Q1 and Q2 2024), which settled close to the price floor. A natural price level for the ECR might be the midpoint between the price floor and the first allowance price reserve tier, approximately $40/ton. We estimate that if the Q1 and Q2 auctions in 2024 had an ECR active at this level, the auction revenues would have been $60 million and $80 million higher respectively, totaling $140 million more in revenue for CCA-funded programs. We included an allowance price elasticity of approximately 0.15 based upon analysis of California's cap-and-trade market to approximate reduction in allowance demand due to the higher price. See the figures below for a visualization of this behavior.





The ECR is a no-regrets improvement in the design of a carbon market that will improve the Washington market if it continues to stand alone or if it is adopted as a feature of the Washington, California, and Quebec markets as an element of a linked system.

We encourage Ecology to consider implementing its ECR provision ahead of linkage or as a part of the linked market for all participating jurisdictions. In doing so, Washington can continue to provide leadership in centering social benefits and community needs in market design for emission trading systems.