STATE OF WASHINGTON
DEPARTMENT OF ECOLOGY
PO Box 47600, Olympia, WA 98504-7600 • 360-407-6000

September 21, 2023

The Honorable Shelly Short
State Senate
409 Legislative Building
PO Box 40407
Olympia, WA 98504-0407

Re: Cap and Invest Program Allowance Prices

Dear Senator Short:

This letter is in response to your August 31, 2023, letter concerning the cap-and-invest program and allowance prices. I appreciate your questions and will do my best to provide responses below.

In your letter, you ask about the 2022 independent modelling concerning the cap-and-invest market and potential allowance prices. That modeling examined three different scenarios and determined that allowance prices might range from a high of $68 (in 2022 dollars, not adjusted for inflation) to a low of approximately $41 per allowance, with a mid-range of approximately $58. It is important to remember that in Ecology's final regulatory analysis for the Chapter 173-446 WAC cap-and-invest program rulemaking published September 2022, the primary analysis based on the rule as adopted used an estimated a $58.31 allowance price in 2023[1].

The $41 allowance estimate was based on the market response to the expectation that a linkage agreement between Washington and the California-Québec carbon market would be in place by 2025. If a linkage agreement is in place by 2027, the initial allowance price estimate increases to $49.46. A linkage agreement that is not completed until 2030 would lead to an estimated initial allowance price of $58 [2]. Ecology is currently completing its analysis of the impacts of a potential linkage agreement and anticipates making a recommendation on whether to link Washington's program later this year. If the department decides to pursue linkage, we would work to negotiate a linkage agreement with the other jurisdictions as quickly as possible.

We believe that the final regulatory analysis and the supporting economic analysis conducted for Ecology by Vivid Economics represents the best available understanding of the functioning and impacts of an independent carbon market in Washington State. We are also in the process of contracting for additional modeling as to the potential impact of linkage upon Washington's market

[1] FRA Table 87, Page 212 [Final Regulatory Analyses for Chapter173-446 WAC, Climate Commitment Act Program]
[2] FRA Appendix H, Pages 212-223 [Final Regulatory Analyses for Chapter173-446 WAC, Climate Commitment Act Program]

and allowance prices. As with the 2022 analysis, Ecology will publicly release the results of that modelling.

In your letter, you also ask about the impact of the cap-and-invest program on gas prices. In Ecology's final regulatory analysis, Ecology estimated the cap-and-invest regulations would increase retail transportation fuel prices by 1-3%[3]. Between when the cap-and-invest program began on January 1, 2023, and your letter of August 31, 2023, the average retail price of unleaded gas in Washington rose by about $1.27 per gallon, according to AAA data. In Oregon, which imports 90% of its transportation fuels from Washington refineries, the average retail price for regular unleaded grew by $1.03 over that same period. This data indicates that a large majority of the increase in Washington gas prices in 2023 cannot be attributed to the cap-and-invest program, since prices in Oregon have risen by a similar amount – even though Oregon does not have a comparable carbon cap in place.

The truth is that the exact factors that drive the wild swings we see in fossil fuel prices are often mysterious – international events, seasonal demands, and very local disruptions to production or distribution can all produce major changes in the price we pay at the pump. These factors did not suddenly stop or become less important on January 1, 2023, when the cap-and-invest program took effect: Supply and demand continue to be the most important factors in gas prices.

Nor should the allowance prices we have seen in the first three quarterly auctions in the cap-and-invest program be considered the final word on its ultimate impact on the marketplace: the competitive effects of a market-based program take time to play out. Ultimately, each covered entity will develop their own compliance strategy, including purchasing allowances at auctions, investing in carbon offset programs, and pursuing emission reductions in their own operations. As businesses and other covered organizations implement these strategies, those that identify opportunities to minimize their compliance costs will enjoy a significant competitive advantage over their peers, and this will put downward pressure on retail prices.

Meanwhile, there are also important complementary changes rippling through Washington's economy. So far in 2023, about 17% of new vehicle sales have been battery-powered electric vehicles and plug-in hybrid vehicles. More than 140,000 vehicles statewide now meet zero emission vehicle standards. This zero-emission fleet has permanently reduced statewide demand for gasoline by roughly 2.5% - an impact that is growing every day. Over time, this reduction in demand will reduce price pressures, and should result in lower fuel costs for everyone – both drivers that choose to switch to a zero emission vehicle, and those that continue to fuel their cars and trucks with gas or diesel.

[3] FRA Table 78, Page 210 [Final Regulatory Analyses for Chapter173-446 WAC, Climate Commitment Act Program]

You also had questions about the impact of the cap-and-invest program on the price of natural gas. In the final regulatory analysis, Ecology estimated that the cap-and-invest program would lead to a net decrease in natural gas costs of 1.56%[4] through 2030.

Under the Climate Commitment Act, natural gas utilities are initially awarded 93% of their required emissions allowances at no charge. However, while utilities are given most of their needed allowances at no charge, the law also requires them to consign an increasing number of these allowances for sale in the quarterly auctions and use the proceeds from those sales to benefit their ratepayers, with specific provisions designed to protect low-income natural gas customers. It is the balance between the compliance costs and these allowance sales that drives the estimated reduction in natural gas prices.

Ecology awarded the first round of these no-cost allowances to natural gas utilities in June 2023, and consigned allowances were offered for sale for the first time in the August quarterly auction. Over time, how the proceeds from consigned allowances are utilized, and the impact on ratepayers, will become clearer.

Puget Sound Energy's recent request to the Washington Utilities and Transportation Commission for a rate increase through December 2023 did include an effort to estimate the utilities' compliance costs with anticipated allowance sale revenue. But it is not yet clear what the longer-term distributive impacts of compliance costs and consignment sales will be, or how those impacts will affect average ratepayers.

We continue to believe that the projections in the final regulatory analysis represent the best available understanding of the impacts of the cap-and-invest program on natural gas prices.

I appreciate your continuing interest in tracking the cap-and-invest program's performance. I also will be keeping you, and other members of the legislature, fully informed of my preliminary linkage decision and any subsequent steps that Ecology may make in this regard.

Yours Truly,

Laura Watson
Director

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[4] FRA Table 57, Page 201 [Final Regulatory Analyses for Chapter173-446 WAC, Climate Commitment Act Program]