Emissions allowance allocations protect electricity customers

By Tom Kuhn
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As the debate over federal climate change legislation intensifies, policymakers are weighing avenues to help mitigate higher energy costs under a greenhouse gas cap-and-trade program. One of these is the mechanism by which emissions allowances initially are introduced into the market. Allocating a substantial portion of allowances directly to power-sector local distribution companies (LDCs) — rather than selling them through government auction — is the most efficient way to soften economic impacts on electricity customers, while maintaining the environmental benefit of putting a price on carbon.

Among the advantages of this approach is that state public utility commissions (PUCs), which oversee local distribution companies (that is, the “wires” companies that provide local retail service), are close to the customers and best suited to ensure that the customers themselves benefit from the value of the allowances. With this in mind, federal legislation initially should allocate allowances to the LDCs, which would be required to pass along their value to all customers — large and small commercial businesses, industrial users, and residential customers — to help ease the costs of the carbon-reduction program. The PUCs also have extensive experience in administering programs to low-income customers.

Another major benefit of allocating allowances to LDCs is that it provides transparency and public accountability. State PUCs for many years have overseen the use of allowances under the highly successful federal Acid Rain Program, a cap-and-trade program under which utilities have significantly reduced emissions of sulfur dioxide at a much lower cost than initially had been projected — and with no problems of excessive price volatility or claims of “windfall” profits. An auction run by the federal government would not provide the same degree of transparency nor protect customers from potential price shock.

The initial allocation of allowances to the power sector should be proportionate to its level of carbon dioxide emissions (40 percent), with a gradual transition to a full auction. This would help ease the shift to a carbon-constrained economy as all technology options — including energy efficiency, renewables, advanced nuclear generation, advanced coal generation with carbon capture and storage, and plug-in hybrid electric vehicles — become available and as compliance costs become more stable.

Specifically, power sector allowances should be distributed as follows to ensure equitable treatment of the nation’s utility customers: The vast majority should be allocated to LDCs based on an even split between base-year emissions (including emissions associated with purchased power) and retail sales. Remaining allowances would go to merchant coal generators, which would receive allowances equal to 50 percent of their base-year emissions to help defray compliance costs. This approach would allow utility regulators to mitigate the economic impacts of a climate program in a way that takes into account the costs incurred by all customers and their actual energy use, which will differ across the country. In contrast, raising federal revenues by auctioning allowances — and attempting to funnel some of their value to back to individuals in the form of tax rebates — is unlikely to reach all of those who need relief, particularly those who are retired or unemployed. The U.S. tax code is fundamentally ill-suited for addressing the disparate impacts federal climate change policy will have on businesses and families across the country.

There is significant support for an allocation approach. The U.S. Climate Action Partnership — an alliance of major businesses and leading climate and environmental groups — has highlighted the importance of “an allowance value distribution structure (between and within sectors) that cushions the costs to both consumers and business during the transition to a full auction system.” The Pew Center on Global Climate Change has said that one way to contain the cost of carbon regulation is by allocating 90 to 95 percent of emissions allowances during the early years of a cap-and-trade system.

Similarly, the National Association of Regulatory Utility Commissioners has stated that allowance allocations to regulated LDCs comprise “an appropriate transition measure” to ensure electric reliability and climate-friendly technology development, while noting that “emitters would still feel the full effect of pricing [greenhouse gas] emissions.” Likewise, labor groups have called an allowance allocation program “a simple and attractive means to achieve major reductions in [greenhouse gas emissions]” that avoids the “uncertainty and potential hidden costs” of an auction.

Climate change presents one of the biggest environmental policy challenges this country has ever faced. An effective federal response will produce enormous benefits, but also will come with a substantial price tag. Allocating emissions allowances directly to LDCs — not auctioning them off to the highest bidders — is the most effective way to initially protect all electricity customers from a portion of the higher costs they will incur under a federal climate change program.

Kuhn is president of the Edison Electric Institute, the Washington-based association of investor-owned electric utilities in the United States.