



**Task Force on  
Climate Policy  
May 2009**

National Association  
of Regulatory Utility  
Commissioners

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# Climate Issue Brief

Climate Issue Brief #2

## Allocation and Use of Allowances in a GHG Cap-and-Trade Program

NARUC supports the use of market mechanisms to reduce greenhouse gas (GHG) emissions in an economy-wide effort through a well-designed federal policy. A cap-and-trade program is one option for achieving this goal. This issue paper lays out NARUC's position on the key questions of how CO<sub>2</sub> allowances should be allocated and how allowance value should be used if a cap-and-trade system were to be adopted for GHG reduction.

### Auction vs. Free Allocation

NARUC believes an auction is the most efficient means of distributing emissions allowances, but we support free allocation of some allowances during a transition period. In particular, we support a transitional allocation of allowances at no cost to the electric sector in order to provide a funding source for energy efficiency programs and to allow some cushioning of economic disruption caused by increased costs of meeting GHG limits.

### Allocation of CO<sub>2</sub> Allowances to the Electric Sector: Who Should Receive Them?

In order to prevent windfall profits, any no-cost allowances for the electric sector should be allocated exclusively to regulated Local Distribution Companies (LDCs) on behalf of consumers, rather than to generation owners or load-serving entities (LSEs). State public utility commissions are obligated to account for the receipt of valuable allowances as utility income. Only allocation to LDCs ensures that allowance value will be used for public purposes rather than to enhance the profits of some generation owners or LSEs, which may operate in unregulated markets. Furthermore, only allocation to LDCs brings about equitable treatment of electricity consumers in States with different regulatory structures.

### Windfall Profits

In States where the wholesale price of electricity is determined by an organized market process, generation owners will be able to pass on climate-related costs to end use customers. If generation owners receive emissions allowances at no cost, this would create windfall profits. These profits would go to utility investors, and not to public investment in energy efficiency programs or to restraining customer electricity rates.



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## Equity

In States where public utility commissions determine wholesale prices based on generation cost and a reasonable return on equity, commission regulation can ensure that allowance value does not simply add to investor profits, regardless of whether allowances are given to generation owners or LDCs. In States where price is determined in competitive wholesale markets, windfall profits will result when allocations are made to generators.

Allowances allocated to LDCs are subject to price regulation in all 50 States and the District of Columbia, so commissions have the same ability and authority to determine how rates and public programs are affected by allowance prices in all jurisdictions. This creates a much more equitable result among States with different regulatory structures. In receiving free allowances, LDCs would serve as a proxy for end-use customers and would not be permitted to keep the value of these allowances for their shareholders.

## Allocation to LDCs: How Should Allowance Value be Used?

There are three distinct uses of allowance value in the electric sector that all meet the test of contributing to the public interest: funding energy efficiency programs, limiting price increases, and targeted assistance to vulnerable consumers and businesses. NARUC supports giving States latitude to determine the optimal balance of these uses, but we believe that funding energy conservation programs in particular should be a top priority for States to efficiently and effectively reduce GHG emissions.

*Funding State-managed energy efficiency programs* – NARUC strongly supports state-level programs in energy conservation and alternative energy development as the foundation of cost-effective GHG reduction. Allowance value is an important source of funding for such programs. How much of available allowance value is used for this purpose depends on other available funding sources and the level of new programs that different States can implement and evaluate efficiently.

*Limiting price increases* – Some portion of the value of free allowances could go to defray the total costs of electricity provision that LDCs must recover from end users. Thus, during the transition to auctioning of allowances, consumers would pay lower electricity rates than if the full cost of allowances were included. For consumers and businesses vulnerable to price increases, such a result could provide valuable time to adjust to new energy realities without undue economic hardship.

*Targeted assistance to vulnerable consumers and businesses* – Some part of the value of allowances could go to lowering rates for low-income consumers and/or electricity-dependent industries. Allowance value could also be used to fund a LIHEAP-type program of direct financial assistance that does not affect electricity rates.

## Conclusion

The allocation of transitional no-cost allowances to regulated LDCs therefore offers a potential mechanism for returning some of the revenues associated with pricing greenhouse gases directly to the very consumers who will be required to pay resulting higher energy prices. This approach could help minimize any potential economic dislocation for consumers during the transition to 100-percent auctioning of allowances, while generation decisions would still be influenced by the full effects of pricing GHG emissions.