



Frequently Asked Questions

May 2010

FAQ: Consumer Benefits of Free CO₂ Allowances via *Regulated* Utilities

One of the challenges of enacting federal climate legislation is to provide an economic impetus to reduce greenhouse gas emissions while minimizing the impact on consumers. The challenge is especially acute in the electricity and natural gas sectors, which are the source of more than half of the nation's carbon dioxide (CO₂), the dominant greenhouse gas.

Climate legislation under consideration in Congress would cushion the economic impacts of pricing CO₂ emissions by giving valuable emissions allowances to consumers of regulated utilities during the transition to a 100% auction-based distribution. Under federal legislation being considered in Congress, emissions allowances would be allocated to regulated electric and/or gas local distribution companies (LDCs), on behalf of the customers of those utilities.

Questions have arisen about how utility consumers will benefit from these no-cost allowances allocated to LDCs. On behalf of the nation's State utility regulators, NARUC offers the following responses:

Q: What is a Local Distribution Company?

A: Local Distribution Companies are *regulated* monopoly utilities that operate “wires” or “pipes” that deliver electricity or natural gas to end-use consumers. While parts of the utility sector have been deregulated in some States, the LDC's retail distribution function always remains regulated with respect to rates charged to consumers – usually by a State public utility commission.¹ Some LDCs provide only distribution services, while others are part of a vertically-integrated utility.

Q: Why give free emissions allowances to regulated LDCs?

A: Because LDCs are subject to price regulation, consumers—not utilities—will benefit from any emissions allowances given to an LDC. An LDC is the only entity in the utility sector that is universally rate-regulated, regardless of a State's particular industry structure. Since their rates are always regulated, LDCs cannot keep allowance proceeds for themselves and are therefore well suited to receive no-cost allowances on behalf of their retail consumers.

LDCs that are part of a fully-regulated vertically-integrated utility may be per-

¹ In States where not-for-profit utilities such as municipals or cooperatives are not subject to State PUCs' rate regulation, their rates are subject to approval by representative boards.

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mitted to use their free allowances in lieu of purchases as they reduce emissions from their own generation. Allowances not used by the LDC could be sold or auctioned under the supervision of regulators, with the proceeds used to benefit consumers.² The allocation of allowances to LDCs, therefore, is an effective means cushioning impacts on all electricity consumers, including residential and business customers, non-profits and governments. In comparison to flowing benefits through the tax system or other distribution methods, allocation to LDCs would more effectively mitigate economic dislocation since proceeds would benefit the very consumers who will be required to pay higher utility bills associated with pricing carbon. Furthermore, given the regional disparities that exist in emission rates and energy prices, an allocation to utility consumers can focus benefits where the economic burden is greatest.

Q: How will the LDCs' allowances be used to benefit consumers?

A: No-cost allowances could benefit end-use consumers in a number of ways. If an LDC is part of a regulated vertically-integrated utility, no-cost allowances could be used for compliance; consumers would benefit since the utility would otherwise have to buy allowances at customers' expense. For other LDCs, allowances would likely be sold, with proceeds being used to benefit consumers under the oversight of State regulators. Regulators could direct allowance proceeds to fund cost-effective energy efficiency programs or other public policy objectives.³ In fact, investing allowance proceeds in clean-energy programs can reinforce the goals of federal climate program while reducing compliance costs.⁴ Regulators could also direct any allowance proceeds toward rate reductions or rebates for end-use consumers, which would offset a portion of the higher energy costs arising from pricing carbon.⁵ These activities would occur under the oversight of State regulators, who could direct that allowance proceeds be used in a manner of greatest benefit to end-use consumers.

Q: Wouldn't a consumer allocation mute price signals to customers and thereby undermine the goals of reducing emissions?

A: Once a price is placed on carbon, all consumers are expected to see higher energy prices regardless of how emissions allowances are distributed. By cushioning the shock of rising energy bills, a consumer allocation could help to minimize potential political backlash. Any dampening of energy prices would be temporary, as free allowances are phased out and the nation moves toward a 100% auction of emissions allowances. Because most distribution costs are fixed, regulators could use allowance proceeds to offset fixed distribution costs instead of reducing unit prices for energy. Furthermore, to the extent that

² Pass-through of LDC proceeds to end-use consumers may entail complications in the ERCOT region of Texas, where only Retail Electric Providers—not LDCs—have a relationship with end-use customers, and there is no authority under State law to require the Retail Electric Providers to pass through potential proceeds to end-use customers.

³ Ten Northeast States comprising the Regional Greenhouse Gas Initiative's cap-and-trade market use proceeds of auctioned allowances to fund customer energy efficiency and other clean energy related programs.

⁴ NARUC Issue Brief No. 4, "State Clean Energy Policies: The Foundation for an Electric-Sector Cap-and-Trade Program," http://www.naruc.org/Publications/ClimateIssueBrief4_Jul2009.pdf

⁵ Significantly, ACES requires that rate reductions be applied first against any fixed charges, before the volumetric portion of the customer's bill is reduced. This is meant to minimize any incentive for consumers to increase their use of energy due to lower prices.

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allowance proceeds are directed toward energy efficiency programs, they will subsidize customer savings rather than rates. In any case, generators will face the full price signal associated with emitting CO₂.

Q: Don't free allowances for LDCs represent a giveaway to polluters?

A: Not at all! While some LDCs own and operate plants that produce carbon emissions, LDCs are always rate-regulated, regardless of industry structure. Furthermore, federal climate legislation can explicitly require that benefits of LDCs' free allowances accrue to retail ratepayers. State PUCs, which have been setting utilities' retail rates for more than 100 years, have a fiduciary obligation to use the receipt of valuable allowances for the benefit of customers. Utilities have been receiving free sulfur dioxide allowances since the 1990s under the federal Acid Rain Program, and PUCs already have mechanisms in place to pass through allowance proceeds to consumers.⁶ "There is a myth out there that this is a giveaway to utilities," according to Center for American Progress's Daniel Weiss. "It's not true."⁷

Q: Why not give free allowances to merchant electricity generators who must reduce pollution?

A: Because merchant generators are not rate-regulated, they have no obligation to pass through benefits to consumers. Operating in a competitive market, merchant generators will likely retain the bulk of the value of free allowances as profits, just as European merchant generators did.⁸ Furthermore, the allocation of allowances to merchant electric generators is unnecessary because power market conditions will reflect allowance prices. The market price of electricity can be expected to increase by an amount that reflects the value of emissions allowances and the emission rates of the marginal generating units that set electricity prices. The resulting increase in prices will help to compensate merchant generators for their allowance costs.

According to a study by Synapse Energy Economics, giving away allowances to unregulated merchant generators instead of LDCs would substantially increase costs for end-use consumers.⁹ NARUC therefore objects to section 783(c) and (d) of the House-passed American Clean Energy and Security Act of 2009, which provides a portion of the power sector's free allowances to merchant generators that would otherwise benefit the customers of LDCs.¹⁰

6 Methods used by State PUCs to pass through the benefits of free SO₂ allowances are described in the Resources For the Future report called, *State-Level Policies and Regulatory Guidance for Compliance in the Early Years of the SO₂ Emission Allowance Trading Program*, May 1998. These include application of fuel-adjustment clauses and deferral to general rate proceedings.

7 New York Times, August 19, 2009

8 Sim, Jos, et al, *The Impact of the EU ETS on Electricity Prices*, Directorate General Environment of the European Commission, December 2008

9 Hausman, Ezra, et al, *Productive and Unproductive Costs of CO₂ Cap-and-Trade: Impacts on Electricity Consumers and Producers*, Synapse Energy Economics, Inc., July 2009

10 Oral statement of Richard E. Morgan before House Subcommittee on Energy and the Environment, on behalf of NARUC, April 23, 2009

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Q: Should federal law restrict the disposition of an LDC's allowance proceeds?

A: NARUC believes it is appropriate to require that the proceeds of the LDCs' allowance allocation benefit consumers, which is consistent with State regulatory principles and practice. Beyond that, public policy would be well served by allowing State utility regulators flexibility to dispose of any allowance proceeds in a manner that best serves the needs of consumers within their jurisdiction.

The fine print in some federal climate bills unnecessarily ties the hands of utility regulators by requiring that the value of LDCs' free allowances be distributed "ratably" among customer classes and "equitably" within classes.¹¹ This restrictive federal formula would discourage creative solutions to address each State's unique circumstances. Energy efficiency programs, for example, would be severely constrained by the requirement that all classes and customers receive the same proportional benefits. Furthermore, some federal climate bills contain excessive paperwork requirements for LDCs and regulators that could delay and reduce consumer benefits from allocations to LDCs.¹²

Conclusion

Allocating no-cost allowances to consumers through regulated LDCs during the transition to a 100% auction is an effective means of cushioning consumers and mitigating potential economic dislocations associated with pricing carbon. Rather than apply a single federal formula for disposition of any LDCs' allowance proceeds, Congress should allow flexibility to State regulators in order to encourage creative solutions that address each jurisdiction's individual circumstances.

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¹¹ For example, ACES section 783(b)(3)(B).

¹² For example, section 783(b)(4) of ACES requires regulators to hold recurring regulatory proceedings on each LDC's plans for the disposition of its no-cost allowances and to report the results to EPA. NARUC does not see the value of this cumbersome provision, given that LDCs are also required to report annually on the actual disposition of their free allowances.