



Frequently Asked Questions

October 2009

FAQ: Consumer Benefits of Free CO₂ Allowances for Utilities

The American Clean Energy and Security Act (ACES), as passed by the House in June 2009, seeks to cushion the economic impacts of pricing carbon dioxide (CO₂) emissions by conferring valuable emissions allowances to specific groups of energy users during a transition to an auction-based allocation. Similar provisions are under consideration in the Senate. Under ACES, approximately 30 percent of all allowances would be allocated to regulated electric local distribution companies (LDCs) and another 9 percent to natural gas LDCs, on behalf of the customers of those utilities.

Questions have arisen about how utility consumers will benefit from these no-cost LDC allowances. 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: An LDC is the only utility entity that is universally rate-regulated, regardless of a State's particular industry structure. Since their rates are always regulated, LDCs can receive no-cost allowances on behalf of their retail consumers. Electric LDCs that are part of a fully-regulated vertically-integrated utility will use these 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 of cushioning impacts on all electricity consumers, including residential and business customers, non-profits and governments. Allocation to LDCs would be more equitable than flowing benefits through the tax system or other allocation methods, because LDCs can return the proceeds from these allowances to the very consumers who will be

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.

² Pass-through of LDC proceeds to end-use consumers may entail complications in the ERCOT region of Texas, where LDCs by State law do not have a direct billing relationship with retail customers. Only Retail Electric Providers 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.

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required to pay higher utility bills associated with pricing carbon.

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 some allowance proceeds into clean-energy programs has "the potential to provide the greatest benefit to energy consumers." Thereby, State clean-energy programs provide an essential foundation for a market-based carbon reduction program.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

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, ACES explicitly requires 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 reflect 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 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 and, therefore, will help to compensate merchant generators for their allowance costs.

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.

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



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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 Essentially, free allowances for unregulated generators represent a federal subsidy for polluters. NARUC therefore objects to section 783(c) and (d) of ACES, which provides a portion of the power sector's free allowances to merchant generators that would otherwise benefit the customers of LDCs.¹⁰

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

A: NARUC believes it is appropriate to require that the benefits of the LDCs' allowance allocation go exclusively to 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.

Section 783(b)(3)(B) of ACES 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. 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, ACES contains excessive paperwork requirements for LDCs and regulators that could delay and reduce consumer benefits from the LDC allocation.¹¹

Conclusion

Allocating no-cost allowances to LDCs on behalf of consumers 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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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

¹¹ 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.