



Southern Alliance for Clean Energy

January 23, 2008

Representative Edward Markey
Chairman, Select Committee on Energy Independence and Global Warming
B243 Longworth House Office Building
Washington DC 20515

Dear Mr. Chairman:

As the Executive Director of the Southern Alliance for Clean Energy (SACE), I applaud your work to ensure the climate change bill ultimately adopted by Congress embraces the most effective cap and trade approach to reducing greenhouse gas emissions.

The science of pollution mitigation has come a long way since Congress enacted the first cap-and-trade program to address acid rain back in 1990. Since then, study after economic study, including the recent testimony by Congressional Budget Office Director Peter Orszag, lends critical support to the idea that a properly constructed cap-and-trade program must include a 100 percent auction of the carbon credits. Anything less would needlessly increase the cost of the program to the economy and consumers alike.

Under a cap-and-trade program, a carbon credit authorizes the holder to emit one metric ton of carbon dioxide, or its equivalent, per year. The cumulative value of these credits over the life of the program is simply unprecedented. Any decision on the allocation of these resources should be made only after extensive examination of their potential. Properly structured, these revenues could be used to reduce the overall cost of the program to the economy, to help low-income families with their energy bills, and to speed the development of important renewable energy and energy efficiency technologies.

Many of the leading climate change bills before Congress, however, would give a majority of the carbon credits away. For example, America's Climate Security Act of 2007 (S.2191) would auction just 24 percent of the credits at the start of the program. Many of the remaining 76 percent of credits would be allocated for free to industries with a history of emitting greenhouse gases. Other major climate change bills in Congress allocate credits in a similar fashion.

We caution the Committee that adopting this approach will increase the cost of reducing our greenhouse gas emissions and undermine the ability of future Congresses to assist low-income families and other at-risk communities.

No Windfalls for Polluting Industries

Utilities and other greenhouse gas emitting industries argue that Congress should allocate some or all of the credits to them for free to minimize the energy costs they pass on to their ratepayers. This argument is simply inaccurate. Gifting credits to industry will not help ratepayers lower their energy

bills because the marginal cost of abating a unit of greenhouse gas is the same regardless of whether a firm buys the permits or is allocated the permit for free. As the CBO observed:

A common misconception is that freely distributing emission allowances to producers would prevent consumer prices from rising. Although producers would not bear out-of-pocket costs for allowances they were given, using those allowances would create an “opportunity cost” because it would mean foregoing the income that they could earn by selling the allowances. Producers would pass that opportunity cost on to their customers in the same way they would pass along actual expenses.

Consider a utility that has a history of emitting 100 tons of carbon dioxide per year and is given 100 credits that can be used to emit one ton of carbon each. The utility determines that the cost of reducing its emissions from 100 to 99 tons is \$10. If each credit is worth \$15 dollars, the utility will spend the \$10 to reduce its carbon emissions by one ton, sell the credit, and make its shareholders \$5 in the transaction. The utility will continue to reduce emissions and sell credits until the cost of reducing another ton of emissions equals the value of the credit. If the cost of reducing emissions from 60 to 59 tons is equal to \$15, then the utility will stop there. In the end, it uses 60 credits and sells 40.

Now consider the case where the utility has to buy credits in order to continue operations. Once again, the utility will have to balance the cost of credits versus the cost of reducing its carbon emissions. In this case, the utility will buy credits until the \$15 cost of buying a credit is equal to the cost of reducing the next ton of carbon emissions. Here, the utility buys 60 credits, and invests in mitigation technologies to reduce the other 40 tons of carbon.

The point here is that the firm’s behavior is the same regardless of whether it is given the credits or it has to buy them. In both cases, the utility produces the same amount of electricity as well as carbon. More importantly, costs to the utility’s ratepayers are the same under either scenario.

What about Costs to Industry?

In recent years, considerable research has gone into assessing what level of credit allocation is necessary to “compensate” the owners of utilities and other industries for losses associated with the a carbon cap-and-trade program. For example, one study found that allocating between 9 and 21 percent of the credits under the Kyoto Protocol would be sufficient to offset the agreement’s costs to energy and electricity producers.

Other studies, however, find the regulatory regime of a cap-and-trade program could increase the opportunity for profits by affected industries. Wall Street agrees. Bernstein Research reported earlier this year its analysis of the potential impact of a cap-and-trade program on utility industry financials. The title of the report – “U.S. Utilities: Unregulated Generators' Profits Could Surge under Senate Bills to Cap CO2 Emissions” -- reflected its findings that implementation of a cap-and-trade program could result in increased profits for some utilities.

Whatever the costs or benefits to industry, we believe the more pertinent question to ask is simply: If a cap-and-trade program affects the entire economy -- energy consumers and producers alike -- why should polluting industries alone get compensated?

Global warming affects everyone. No industry should be given special status and protected from the responsibilities that the rest of us will face.

Economic Efficiency and Low-Income Families

Effectively addressing climate change will impose a certain level of costs on the economy. The question before Congress is how to best structure a cap-and-trade program to minimize the impact to the economy while helping low-income families and other energy consumers most at risk of changes in energy prices. The answer to this question, again, is to auction the credits and use the revenues raised to reduce the overall cost of the program to the economy.

For example, in 2007 the CBO estimated that giving away credits under a cap-and-trade program would cost nearly twice as much than if the credits were auctioned and the revenues used to cut taxes. Who would bear the additional costs of giving away credits to polluting industries?

Of the four allowance-allocation and revenue recycling scenarios that CBO analyzed, the share of policy costs borne by households in the lowest income quintile would be largest if the government gave allowances away and used the revenue received... to reduce corporate taxes.

Different studies may suggest different optimal options, but they are universal in finding that the free allocation of credits to industry ensures the worst outcome, both for the economy as a whole and for at-risk populations. Freely allocating credits needlessly surrenders resources that could be used to ensure the best outcome for the economy and low-income families.

Auction, Not Allocation

Congress should auction all the credits under a cap-and-trade program and use those resources to assist ratepayers with their energy costs while facilitating the development of critical technologies necessary to speed the future reduction of greenhouse gas emissions.

Such an approach is the surest means of meeting emission targets in the most equitable and economically efficient manner. Anything less is simply corporate welfare to those industries that have contributed the most to our climate change challenge.

I thank the Chairman for his work advocating solutions to global warming, and SACE looks forward to working with the Committee to produce the most effective climate change legislation possible.

Sincerely,



Stephen A. Smith
Executive Director, Southern Alliance for Clean Energy

Southern Alliance for Clean Energy
www.cleanenergy.org