

**Written Testimony
of
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**on behalf of the
Edison Electric Institute**

**Before the United States House of Representatives
Committee on Energy and Commerce
Subcommittee on Energy and Environment**

Hearing on Allocation of Emissions Allowances

April 23, 2009

Messrs Chairmen and Members of the Committee and Subcommittee, Thank you for the opportunity to submit a statement before the House Energy and Commerce Committee's Subcommittee on Energy and Environment hearing on allocation of emissions allowances under the American Clean Energy Security Act of 2009. I am Jeff Sterba, past Chairman of the Edison Electric Institute (EEI) and Chairman and CEO of PNM Resources, the parent company of Public Service Company of New Mexico (PNM), Texas-New Mexico Power (TNMP) and First Choice Power.

Headquartered in Albuquerque, New Mexico, PNM Resources is an energy holding company with 2008 consolidated operating revenues from continuing and discontinued operations of \$2.45 billion. Through its utility and energy subsidiaries, PNM, TNMP and First Choice Power, PNM Resources serves electricity to more than 859,000 homes and businesses in New Mexico and Texas. Our generation resources of 2,713 megawatts (MW) reflect a balanced mix of coal, natural gas, nuclear and wind generation. In 2008, our capacity was 35 percent coal, 35 percent natural gas, 15 percent nuclear, 7 percent renewables, and 7 percent long-term contracts, and 49 percent coal, 23 percent nuclear, 12 percent natural gas, 11 percent long-term

contracts and 5 percent renewables on an energy basis. PNM Resources and its subsidiaries market power throughout the Southwest, Texas and the West. In addition, through a joint venture with Cascade Investment, the company has a 50-percent ownership of OptimEnergy LLC, which owns approximately 1,200 MW of coal and natural gas generation in Texas.

I am appearing today on behalf of EEI. EEI is the trade association of U.S. shareholder-owned electric companies and has international affiliate and industry associate members worldwide. EEI's U.S. members serve 95 percent of the ultimate customers in the shareholder-owned segment of the industry and represent about 70 percent of the U.S. electric power industry.

I. Introduction

EEI has endorsed climate change principles intended to help ensure that U.S. climate policy is successful both in reducing greenhouse gas (GHG) emissions and addressing the cost concerns of consumers. This framework calls for an 80-percent reduction in GHG emissions from current levels by 2050, together with a series of actions to mitigate impacts to our customers and the economy. Under any scenario, these reductions will be expensive, but the most cost-effective way to accomplish them in the power sector is through the development and deployment of a full portfolio of climate technologies and measures over the long term. These include: energy efficiency for both supply and demand; renewable energy; advanced coal technologies integrated with carbon capture and storage (CCS); new nuclear power plants; plug-in hybrid electric vehicles (PHEVs); and the smart grid.

Although some of these technologies are currently available—albeit at a higher cost than conventional generation sources—others are not. For example, significant deployment of new nuclear plants is at least 10 years away. CCS technologies are under development but are not

expected to be commercially deployable until 2020 to 2025. Yet these technologies are critical to our dual goals of addressing GHG emissions and maintaining a reliable and affordable electricity supply in a carbon-constrained world.

For any carbon policy to reduce GHG emissions effectively and to protect the U.S. economy, compliance timeframes must correspond to the availability of technologies needed to reduce emissions. Near-term targets will be met primarily by efforts on energy efficiency, current technology for renewable resources and natural gas-based power plants. Medium-term targets should be set in the 10- to 15-year timeframe after enactment, in order to match up with and enable technology development, particularly advanced coal technologies with CCS and new nuclear facilities. The long-term target of an 80-percent reduction below current levels by 2050 will require all of these options, plus other options in other sectors of the economy.

It is important to point out that increased use of electrotechnologies in end uses—such as through increased market penetration of PHEVs—will increase electricity usage and thus GHG emissions in the power sector to some degree, while reducing overall emissions in the U.S. Accordingly, while we strongly support increased use of electrotechnologies, particularly PHEVs, we would also like to see the power sector credited in some way for helping to decrease overall U.S. emissions.

There is widespread agreement that these measures will be costly and will raise electricity prices substantially. Since electricity is used by everyone—residential customers, commercial customers and large industries—this is a matter of national concern. Furthermore, there is widespread agreement that these costs will disproportionately affect low-income families and energy-intensive businesses, particularly those businesses that compete internationally with businesses not subject to a comparable GHG reduction obligation.

The March 31 discussion draft addresses many of the complex issues in a comprehensive way, but leaves unaddressed the issue of disposition of allowances. I will focus on that issue. While there are certainly other key issues, the purpose of my testimony today is to explain, first, why the allocation of emissions allowances to the electric sector is the most effective way to soften cost impacts to electricity consumers during the transition to a decarbonized economy while maintaining the environmental benefit of putting a price on carbon.

Second, EEI's membership has developed a proposal for allocating allowances within the electric sector. I will describe that proposal and explain why it offers the most efficient and fair way to mitigate cost increases to all consumers throughout the nation in a way that avoids the potential for windfall profits.

II. Allocations Of Allowances Are A Proven, Effective And Practical Distribution Method That Protects Customers From Huge Electricity Price Spikes While Maintaining The Environmental Benefit Of Putting A Price On Carbon.

The cap-and-trade system that Congress established for the acid rain program under the Clean Air Act (CAA) is the most successful example of a cap-and-trade program in the world. It is one that the electric industry knows well. Under that program a declining cap on emissions was established and 97 percent of emission allowances were allocated without charge to electric utilities. About 3 percent of allowances were auctioned under the title IV sulfur dioxide (SO₂) emissions trading program. Utilities are required annually to submit to EPA the allowances allocated to them to match their emissions and, under the regulatory supervision of state public utility commissions (PUCs), recover the costs of these allowances net of any gains from allowance trading activity in order to mitigate price increases to their electricity customers. To date, emissions have been reduced more than 50 percent at far less cost than initially estimated, and "windfall profits" do not occur under this PUC regulatory supervision. The direct allocation

of allowances for permitted emissions is an important reason why this program has worked so effectively.

This model demonstrates why allocations are proven, effective and practical. It guides our recommendations on why and how to implement a similar program in a GHG cap-and-trade context and in an industry where the wholesale electricity market is competitive. First, allocations to a regulated local distribution utility company (LDC) ensure that the benefits and costs of those allowances flow directly to end-use consumers. LDCs are the “wires” companies that deliver electricity to all customers. LDCs connect with every electricity customer—residential, commercial and industrial customers. LDCs are best suited to ensure that the customers themselves see any costs or benefits from the value of the allowances. LDCs measure how much power each customer uses and send bills to every customer. Thus, they have a practical, efficient way to flow through the costs and benefits of allowances to all customers. LDCs also have many programs designed to serve and identify low-income customers. They can work with their state PUCs to design programs to benefit low-income customers if policy-makers desire.

Second, LDC rates are regulated by state PUCs. The PUCs have extensive experience making sure utilities flow through cost changes to their customers, and specifically with assuring the flow-through of the costs and benefits of allowances under the CAA allowance program. The utility ratemaking process provides transparency and accountability through a tested, public mechanism. Allocation to LDCs under state PUC supervision addresses any concern that allocations would benefit shareholders, not customers.

Third, allocations to LDCs can take into account regional variations in electricity use, generation and cost. The portion of fossil fuel used for electricity generation varies substantially

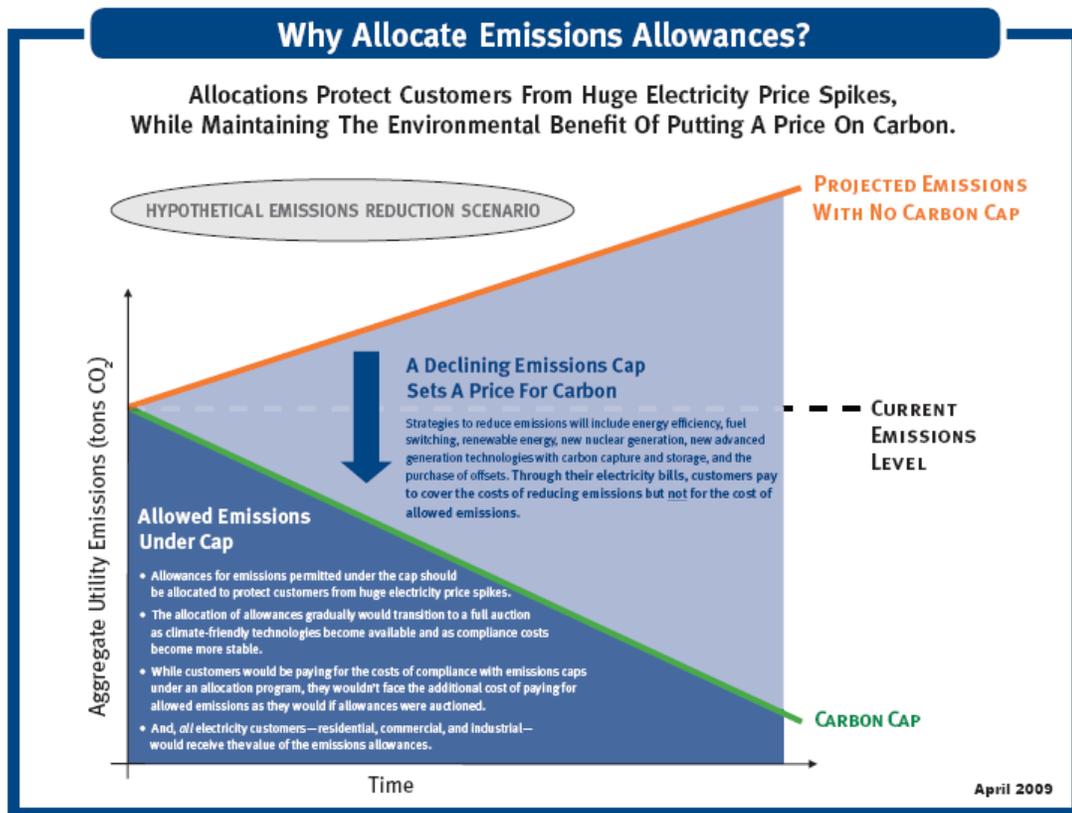
across our nation. Some regions use more coal than others. Average customer demand for electricity also varies by region largely due to factors such as weather and climate—as does the price of electricity. The allocation system that EEI recommends for LDCs has the flexibility to take all of these factors into account. In comparison, a cap-and-rebate approach through the U.S. tax code or a cap-and-dividend approach is fundamentally ill-suited for addressing the disparate impacts that federal climate change policy will have on families and businesses across the country.

Fourth, electricity customers of all types—residential, commercial and industrial—can benefit under an allocation approach. This ability to reach all customers is something that no tax rebate system or cap-and-dividend approach can achieve. Proposals to implement a low-income tax credit or send a payment to all individuals (like the Alaska oil fund payment) would not benefit commercial or industrial users of electricity. In fact, under a cap-and-tax rebate or cap-and-dividend approach, public transit systems like Washington’s Metro, school systems, hospitals and other large users of electricity would receive no benefit. Their increased electricity costs would affect the economy through higher prices for goods and services and higher taxes for governments to cover their costs. An allocation system that benefits all electricity customers helps cushion these cost increases throughout the economy.

Fifth, the average person is not likely to connect a tax rebate, refund or payment with substantial increases in their electricity bills, much less with price increases for goods and services nor jobs lost from businesses that cannot afford the higher energy prices. Our industry’s experience with sudden, large cost increases during the western energy crisis—as well as the public reaction to last year’s large gasoline price rise—shows that customers and voters respond quickly and angrily to large price spikes in essential commodities like electricity. Our allocation

approach helps mitigate these adverse impacts, which could otherwise undermine public support for a carbon-reduction program or even create a public backlash against such policy.

Finally, allocations maintain the environmental benefit of putting a price on carbon and other GHGs. As the following chart shows, our allocation proposal would operate within the emissions cap that is established by the discussion draft. The Environmental Protection Agency (EPA) would allocate allowances only for emissions that are allowed under the cap.



Some claim that allocations give away allowances for “free” and thus are suspect on that account. In truth, allocations only would apply to emissions that utilities are permitted by the cap to emit. As long as the emissions cap remains below expected emissions levels, there still would be an active credit trading market setting a price for allowances based on the marginal cost of staying within the cap. This is precisely how the SO₂ allowance program has worked

with only 3 percent of the allowances up for auction. Also remember that the allowances that are allocated must be turned back to EPA at the end of the year to match the emissions associated with the electricity sold by the LDC.

Under an allocation approach, customers would pay through their electricity rates for the costs of measures to reduce emissions to stay within the cap. But customers would not face the additional cost of paying for allowed emissions as they would if all allowances were auctioned. In comparison, under the auction approach, consumers would pay through their electricity rates both for the costs of reducing emissions and for the costs of purchasing allowances for emissions permitted under the cap. Customers would be much more vulnerable to substantial price spikes if all allowances were auctioned and allowance costs become highly volatile or substantially exceed expectations.

III. Understanding EEI's Allocation Proposal

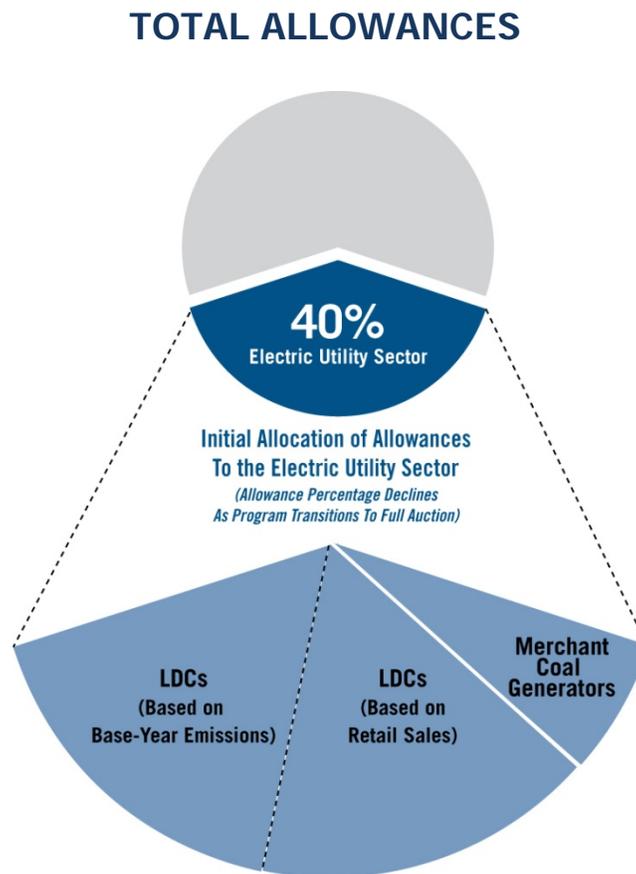
EEI proposes that allowances should be allocated to the electric sector in the early years of a climate program with a gradual transition to a full auction. **The initial allocation to the electric power sector should be 40 percent of all allowances since this is proportionate to our sector's portion of national carbon dioxide (CO₂) emissions.** EEI is not proposing to obtain sufficient allowances to cover all electric sector emissions. As long as the emissions caps are below the level of projected domestic emissions, which is clearly the case under the discussion draft, the electric sector's share of allocated allowances will be less than its total emissions. The electric sector still will need to reduce emissions to stay under the declining cap or purchase additional allowances based on the price of carbon.

This 40-percent allocation share—of a declining quantity of allowances—should remain in place until needed new climate-friendly technologies, such as CCS, are commercially available, with a gradual transition to a full action. Since the cap on emissions

itself declines throughout this period, the actual decline in allowances allocated to the electric sector is much faster.

Within the electric sector, the vast majority of allowances should be allocated to LDCs based on an even split between emissions in the base period (including emissions associated with purchased power) and retail sales.¹ Because the electric sector now includes competitive merchant generators, a portion of allowances should go to merchant coal generators based on their base-period emissions.

The following chart shows the basic proposal for the first year.



¹ In traditional regulated markets, a utility's retail sales are identical to its retail deliveries. However, in competitive retail markets, we would actually measure deliveries by an LDC to retail customers because this is the best measure of output and avoids problems distributing allowance benefits that could be caused if customers switch electricity suppliers.

Let me expand upon the details and explain why this proposal is fair, efficient and feasible.

A. Determining Allocations to LDCs

A federal agency such as the Department of Energy (DOE), working in close coordination with the Environmental Protection Agency (EPA), would calculate each LDC's share of the "LDC allowance pool" using a formula in which 50 percent of the total is allocated based on each LDC's share of average annual electric sector CO₂ emissions during a defined base period and 50 percent of the total is allocated based on each LDC's share of average annual electricity sales during a defined base period.

The determination of each LDC's fossil fuel emissions could be made in the same manner as specified in section 114 of the discussion draft, which creates the Carbon Capture and Sequestration Demonstration and Early Deployment Program. This section incorporates H.R. 1689, which was introduced by Representatives Boucher, Barton and many others on this Subcommittee. Essentially, subsection 114(f) establishes a process that would require DOE, acting in consultation with EPA, to make a best estimate of the fossil fuel electricity emissions attributable to individual LDCs and publish the estimate for comment and public input. This provision provides needed flexibility to adjust the available data on emissions from individual generators to determine emissions at the LDC level in a fair and transparent manner.² And it provides a transparent process for public input into these determinations. DOE could make a similar determination of each LDC's share of total electricity sales in the base period, which is a comparatively easy process. This information would be used by DOE, working with EPA, to

² This section directs DOE to "balance the need to be efficient, reasonably precise and timely, taking into account the nature and cost of data currently available and the nature of markets and regulation in effect in various regions of the country. Different methodologies may be applied in different regions if appropriate to obtain the best balance of such factors."

determine each LDC's share of total utility emissions and total electricity sales for the base period.

Why do we rely upon both sales and emission levels? Frankly, it is a compromise. With the exception perhaps of a few totally hydroelectric-based entities, all LDCs will earn allowances based on both sales and emissions factors. The emissions factor gives weight to concerns of utilities with significant fossil generation that their customers will face higher compliance costs and serves to help offset those costs. The sales factor gives weight to the concerns of other utilities that their customers already face higher prices because those utilities already have invested in non-emitting resources, and their customers have not been compensated for such investments. The 50-50 allocation recognizes the validity of both views.

B. Determining Allocations to Merchant Coal Generators

Merchant coal generators sell electricity in competitive wholesale markets. Because of the nature of such markets, they need to be treated differently from regulated electric utilities. Under EEI's proposal, merchant coal generators would receive allowances based on 50 percent of their base-year emissions. Since in most unregulated markets the market price of electricity is determined by natural gas on the margin, and natural gas emits approximately 50 percent of the carbon from coal, it can be reasonably assumed that merchant coal would be able to recover about 50 percent of its increased costs due to carbon through the increased market price. The 50-percent allocation addresses the portion of their increased costs that is not recovered through market prices (*i.e.*, their net compliance costs). These allowances enable these critical generation facilities, which represent as much as one-third of total U.S. generation in a given year, to continue to operate and avoid a "rush to gas" while the generators are developing new low-carbon electricity generation sources.

Under the EEI proposal, no allowances would be allocated to other competitive generators. Non-emitting generators have no need for allowances, whether nuclear, solar, wind or hydro. And, as indicated above, since natural gas generation typically sets the market price in wholesale markets and the carbon cost will be internalized into this market price, merchant gas generators would not require allocations.

C. Determining the Size of the LDC and Merchant Generator Allowance Pools

Because merchant coal generation’s share of the electric sector allowance pool is based on its emissions profile, this must be calculated first. Then the total of the allowances issued to all merchant coal generators is deducted from the total allowances for the electric sector to determine the total allowances available to LDCs (the LDC allowance pool). The LDC allowance pool then is allocated to individual utilities using the formula set forth above. As the emissions cap declines, and as the share of allowances to the electric sector declines, so will the number of allowances allocated to LDCs and merchant coal generators. The rate of decline that we propose will help to mitigate price spikes to electricity customers.

IV. 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—had several representatives testify yesterday and 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 important way to contain the cost of carbon regulation is by allocating a significant percentage 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 [GHG] emissions.” Likewise, labor groups have called an allowance allocation program “a simple and attractive means to achieve major reductions in [GHG emissions]” that avoids the “uncertainty and potential hidden costs” of an auction.

IV. Conclusion

Climate change presents one of the biggest energy and environmental policy challenges this country has ever faced. An effective federal response will come with an enormous price tag, particularly for electricity customers, which will reverberate throughout the entire economy. In order to mitigate those costs, it is critical that any comprehensive climate legislation have targets and timetables harmonized with the development and deployment of the full portfolio of climate technologies and measures and contain effective cost-containment measures to protect customers. Allocating allowances is critical initially in order to cushion the economic impact of climate change legislation on electricity customers, particularly the low-income families and energy-intensive businesses and industries that will feel these impacts the most.