



**Statement of Stephen A. Smith, DVM
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**Submitted to the
U.S. House of Representatives Committee on Ways and Means
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Mr. Chairman, Ranking Member, and Members of the Committee:

My name is Stephen Smith. I am the Executive Director of the Southern Alliance for Clean Energy (SACE). Since 1985, SACE has been working on behalf of citizens in the Southeast to promote responsible energy choices that create global warming solutions and ensure clean, safe and healthy communities throughout the Southeast.

SACE applauds the work you have done to promote effective climate change legislation and pledges to work with you and your staff to ensure the bill ultimately adopted by Congress embraces the most effective and responsible approach to reducing greenhouse gas emissions.

In this testimony, I would like to focus on one particular and critical aspect of a well-designed cap and trade program for carbon emissions – the need to auction 100 percent of the credits immediately. As this testimony will demonstrate, auctioning all the credits is a critical predicate to ensuring the environmental, economic and political success of a carbon cap-and-trade program.

Unprecedented Resources at Stake

The science of pollution mitigation has advanced significantly since Congress enacted the first cap-and-trade program to address the problem of acid rain back in 1990.

In the 18 years that followed, study after economic study lends critical support to the idea that a properly constructed cap-and-trade program must auction 100 percent of the carbon credits. Anything less than 100 percent auctions would needlessly increase the cost of the program to the economy and consumers, while potentially resulting in windfall profits for shareholders and executives of electric utility companies and other industries.

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. These credits will be extremely valuable – eventually generating hundreds of billions of dollars in revenue each year – and they represent an important resource in our nation’s efforts to address global warming.

As CBO Director Orszag testified in April 2008 before the Senate Finance Committee:

On the basis of a review of the existing literature and the range of CO2 policies now being debated, CBO estimated that by 2020, the value of those allowances could total between \$50 billion and \$300 billion annually (in 2006 dollars). The actual value would depend on various factors, including the stringency of the cap (which would need to grow tighter over the years to keep CO2 from continuing to accumulate), the possibility of offsetting CO2 emissions through carbon sequestration or international allowance trading, and other features of the specific policy that was selected. On April 10, 2008, CBO estimated that the value of the allowances created under S.2191 (America's Climate Security Act) would be roughly \$145 billion once the proposed program took effect in 2012; in subsequent years, the aggregate value of the allowances would be even greater.

The cumulative value of these credits over the life of the program is simply unprecedented and any decision on the allocation these resources should be made only after extensive examination of their potential utility. Properly structured, these revenues could be used to help 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, the legislation the Senate considered earlier this summer -- America's Climate Security Act -- would auction just 26.5 percent of the credits at the start of the program. Many of the remaining 73.5 percent of credits would be allocated for free to industries with a history of emitting greenhouse gases. Later in the program's lifetime, this legislation would still allocate more than a quarter of the credits for free. Other major climate change bills in Congress allocate credits in a similar fashion.

We caution the Committee from adopting this approach. It will needlessly increase the economic cost of reducing our greenhouse gas emissions and undermine the ability of future Congresses to assist low-income families and other vulnerable 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. For example, in testimony before the Senate Environment and Public Works Committee on June 28, 2007, Jim Rogers, the Chairman of Duke Energy, stated:

Consumers should not be penalized for fuel choices that were made 40-plus years ago. Areas of the country facing the largest increases in electricity rates due to climate change policy also represent the nation's industrial heartland. How allowances are allocated will directly impact the cost of electricity and the prices these consumers pay.

This argument is simply inaccurate. Gifting billions of dollars in pollution credits to utilities will not lower energy bills for ratepayers 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 Congressional Budget Office observed in their testimony before the Senate Energy and Natural Resources Committee in May:

By attaching a cost to CO2 emissions, a cap-and-trade program would thus lead to price increases for energy and energy-intensive goods and services. Such price increases would stem from the restriction on emissions and would occur regardless of whether the government sold emission allowances or gave them away. Indeed, the price increases would be essential to the success of a cap-and-trade program because

they would by the most important mechanism through which businesses and households were encouraged to make investments and change their behavior to reduce CO₂ emissions.

Further, the CBO notes:

Giving all or most of the allowances to energy producers to offset the potential losses of investors in those industries – as was done in the cap-and-trade program for sulfur dioxide emissions – would also exacerbate the regressivity of the price increases. On average, the value of the CO₂ allowances that producers received would more than compensate them for any decline in profits caused by a drop in demand for energy and energy-intensive goods and services. As a result, the companies that received allowances could experience windfall profits.

Harvard Economist Greg Mankiw accurately points out that freely allocating carbon credits to polluting industries is nothing more than corporate welfare.

To understand why this is the case, consider a utility that is given credits equal to its historic level of carbon emissions, as many utilities have suggested should happen. How will that allocation affect the utility's behavior? Very little, as it turns out.

If the utility has a history of emitting 100 tons of carbon dioxide or equivalent per year and is given 100 credits that can be used to emit one ton of carbon each. The utility considers options for reducing its carbon emissions and determines that the cost of reducing its emissions from 100 to 99 tons is \$10. If each credit is worth \$15 dollars, then the utility will spend the \$10 to reduce its carbon emissions by one ton, sell the credit, making its shareholders \$5 in the transaction. The utility will continue to reduce its emissions and sell its credits until the cost of reducing another ton of carbon emissions is equal to the market 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 is given zero credits, and has to buy them 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 important 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 like everybody else. In both cases, the utility produces the same amount of electricity as well as carbon. And ratepayers will face similar costs.

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 a carbon cap and trade program. 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, found the regulatory regime of a cap and trade program without auctions could increase the opportunity for profits by affected industries. As Resources for the Future noted in a 2002 study:

By compelling fossil fuel suppliers to restrict their outputs, the government effectively causes firms to behave like a cartel, leading to higher prices and the potential for excess profit. To the extent that the environmental policy enables firms to retain these rents – such is the case under CO₂ policy involving freely offered tradable permits – the firms can make considerably higher profit under regulation than in its absence.

Wall Street apparently agrees. The Wall Street Investment firm of 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” – reflects its findings that implementing a cap-and-trade program could increase profits for some utilities. As the report notes:

If the U.S., in implementing its own cap-and-trade regime for GHG emissions, also allocates allowances for free, we can expect unregulated power generators in this country to behave similarly, passing through the value of allowances consumed to wholesale power prices. And as these generators will bear no offsetting cost, their earnings can be expected to increase materially.

Whatever the costs or benefits to industry, the more pertinent question to ask is simply this: If a cap-and-trade program affects everyone – 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 vulnerable to changes in energy prices. The answer to this question, again, is to auction the credits and use the revenues raised to reduce the program's overall cost to the economy.

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.

Further, the CBO noted in their June 17th letter to Senate Energy and Natural Resources Committee Chairman Bingaman that lawmakers have several options for assisting those most effected by increased energy costs, including collecting the resources from the auction of carbon credits and issuing rebate checks to households across the United States. The CBO noted that:

Lawmakers could choose to offset the price increases experienced by low- and moderate-income households by providing for the sale of some of all of the CO₂ emission allowances and using a portion of the revenues to compensate such households. For example, the Congressional Budget Office (CBO) found that lower-income households could be financially better off as a result of a cap-and-trade program (compared with no program – and without consideration of any benefit in terms of reduced risk of damage from climate change) if the government chose to sell

the allowances and used the revenues to pay an equal lump-sum rebate to each household in the United States. In that case, the size of the rebate would be larger than the average increase in low-income households' spending on energy-intensive goods.

Different studies may suggest different optimal options, but they are universal in finding that the free allocation of credits to industry produces 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 credits under a cap and trade program and use those resources to assist ratepayers with their energy costs while investing in the development of critical technologies necessary to speed the future reduction of greenhouse gas emissions.

Such an approach represents 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 climate change.

I thank the Committee for holding this hearing and for advocating solutions to global warming. SACE looks forward to working with the Committee to produce the most effective climate change legislation possible.

Southern Alliance for Clean Energy (SACE) is a nonprofit, nonpartisan organization that promotes responsible energy choices that create global warming solutions and ensure clean, safe and healthy communities throughout the Southeast.

Since 1985 SACE has been working on behalf of citizens in the Southeast to provide independent analysis of the energy supply system in the region, help state utility commissions evaluate proposed energy projects, work with state and local governments to develop new programs to improve the energy efficiency of government facilities and vehicles, and support the siting and development of clean, renewable energy sources in our region.

SACE has been a leading voice for energy reform protecting our communities and our region's natural resources for more than 20 years with offices and staff throughout the Southeast.