



**Statement of Stephen A. Smith, DVM
Executive Director
Southern Alliance for Clean Energy
WWW.CleanEnergy.Org**

**Submitted to the
U.S. Senate Committee on Environment and Public Works
“Legislative Hearing on America’s Climate Security Act of 2007”
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Madam Chairwoman, 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 come a long way since Congress enacted the first cap and trade program to address the problem of acid rain back in 1990.

In the 17 years since, study after economic study, including the excellent testimony offered just last week by the Director of the Congressional Budget Office (CBO), 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 than 100 percent auctions 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. These credits will be extremely valuable – eventually generating hundreds of billions of dollars in revenue each year –

and represent an important resource in the battle to fight global warming. As CBO Director Orszag testified last week:

Under a cap-and-trade program, a key decision for policymakers is whether to sell emission allowances or to give them away. The value of those allowances would probably be substantial: Under the range of cap-and-trade policies now being considered by the Congress, the annual value of emission allowances would be roughly \$50 billion to \$300 billion by 2020 (measured in 2006 dollars). More-stringent caps would result in higher total allowance values.

The cumulative value of these credits over the life of the program is simply unprecedented and 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 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, the legislation under consideration by this Committee -- 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. 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 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. For example, in testimony before this Committee on June 28, 2007, James Rogers, the Chairman of Duke Energy warned:

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 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 as a result of the cap. 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.

A 2002 article in the Tax Journal makes a similar point:

The impact of these higher prices on households (that is, households' share of the allowance cost) is determined by their purchasing patterns; it is independent of the government's decision whether to distribute allowances freely or through an auction.

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 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 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. 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.

Apparently, Wall Street 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" -- reflected its findings that implementation of a cap-and-trade program could result in increased 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, we believe the more pertinent question to ask is simply: If a cap-and-trade program affects everyone -- energy consumers and producers alike -- why should polluting industries alone get compensated?

Certainly, 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 Committee for holding this hearing and for advocating solutions to global warming, and 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. Questions regarding this testimony should be directed to Jennifer Rennicks in the SACE Asheville office: (828)254-6776.