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CHANGING CLIMATE BILL TO GIVE MORE ALLOWANCES TO ELECTRIC UTILITIES WOULD LIKELY HURT, NOT HELP, CONSUMERS

By Chad Stone and Hannah Shaw

In a July 6 letter to Majority Leader Harry Reid, the Edison Electric Institute (EEI) called for an even larger allocation of free allowances to the electricity sector than the substantial share it would receive under the House climate bill, as well as a more protracted phase-out of these allowances. In advancing these requests, the EEI letter makes a number of dubious claims.

The Senate should look skeptically at these claims as it drafts climate legislation and should resist requests to increase the allocation to electricity utilities or to delay its phase-out. Although EEI claims that its request would benefit consumers, the opposite is more likely to be the case.

On policy grounds, relying on utilities as the main vehicle for consumer relief is problematic, but the allocation to local distribution companies (LDCs) was part of a political compromise that was necessary to pass the climate bill in the House. The problems this approach poses would be made significantly more serious, however, if EEI's new requests are accepted. Consumers would likely be harmed, rather than helped, by granting EEI's requests.

KEY FINDINGS

- In a July 6 letter to Majority Leader Harry Reid, the Edison Electric Institute (EEI) proposed that the utility sector receive an even larger allocation of free allowances than under the House climate bill and that the phase-out of these allowances be stretched out. This, however, would more likely harm consumers than help them.
- EEI describes the allowances allocated to electricity local distribution companies under the House bill as "important consumer protection." But the majority of these resources would likely go to increase business profits rather than to protect consumers.
- EEI argues that its recommendation would "reduce the costs of any cap-and-trade program to energy consumers and the American economy." Yet local utilities are not the best means of delivering consumer relief. Moreover, utility-based relief would likely increase the overall cost to the economy of reducing carbon emissions by undercutting incentives for energy conservation and energy efficiency investments.
- EEI claims that the House bill's plan to phase out the allocation of free allowances to utilities "will lead to abruptly higher energy prices for consumers." But under the House bill these resources would be converted into direct consumer relief. This would give households both the financial resources and the economic incentives to make sound choices about energy conservation and energy efficiency investments.
- Instead of expanding the free allocation of allowances to utilities, the Senate should scale back the relief going to utilities' business customers and use the freed-up allowances to extend and expand direct consumer relief.

The Limitations of Free Allocations to Utilities

Utility-based consumer relief has a number of inherent limitations:

- It does not offset the bulk of the increased costs that households will face as a result of capping certain emissions. The majority of the increase in costs that households will bear will be for items *other than* home utilities, including higher prices for gasoline and the broad array of goods and services that use energy in their production or transportation to market.
- Assuring that utility-based relief works as intended requires relying on state public utility commissions, and state utility regulation is uneven across the country.
- Utility-based relief that keeps customers from perceiving the true cost of electricity and natural gas blunts the "price signal" that is integral to the effectiveness of a cap-and-trade system, thereby undercutting incentives for energy conservation and energy efficiency investments. It also *increases* the cost to the U.S. economy of meeting the cap.
- Well-intentioned efforts to preserve the price signal by encouraging utilities to provide relief on the fixed part of their customers' bills (as the House bill does) are likely to be ineffective in the residential sector, and to increase profits rather than protect consumers when applied to businesses' utility bills.

A better policy direction would be to scale back the LDC relief provided to business customers and channel the savings into expanding the *direct* consumer relief that the House bill provides to low-income households so that it also reaches households somewhat farther up the income scale. To *increase* the LDC relief instead, as EEI proposes — and to delay the point when the LDC allocations begin to be phased down and converted to direct consumer relief — would move the legislation in precisely the wrong direction.

The remainder of this paper evaluates the claims in the EEI letter in more detail.

Would free allocations to electricity LDCs provide "important consumer protection," as EEI claims?

EEI's July 6 letter describes the allowances allocated to electricity local distribution companies under the House bill as "important consumer protection." This ignores two key facts:

- **The majority of the resources allocated to electric utilities would likely go to increased profits for businesses rather than to protect consumers.** The House legislation requires that LDCs use the allowances to benefit all retail ratepayers, which, as EEI notes, "include[s] residential, commercial and industrial customers." The Congressional Budget Office has pointed out that fewer than 40 percent of the free allocation to LDCs would go to LDCs' residential customers;[1] more than 60 percent would go to the utilities' business customers. CBO has also concluded that businesses that receive relief as a fixed rebate on their bill would

[1] See Chad Stone and Hannah Shaw, "Senate Can Strengthen Climate Legislation by Reducing Corporate Welfare and Boosting True Consumer Relief," Center on Budget and Policy Priorities, July 10, 2009.

retain that relief as *added profit*, rather than pass it on to their own customers in the form of lower prices for their products.[2]

- **The higher profits that businesses enjoy from lower utility bills would primarily benefit the high-income households who own or hold stock in the firm.** CBO estimates that 63 percent of the allowance value given to utilities to benefit their business customers would ultimately accrue to the 20 percent of households with the highest incomes (i.e., the top income quintile) because that is the part of the income scale in which the owners and shareholders of those businesses are concentrated.

Does utility relief "reduce the cost of cap and trade to consumers and the economy"?

The EEI letter urges the Senate to "reduce the costs of any cap-and-trade program to energy consumers and the American economy." Yet providing consumer relief through LDCs is not the best way to compensate consumers for their increased costs, and it is likely to *increase* the costs to the U.S. economy of reducing carbon emissions.[3] There are three main reasons why:

- **Utility relief wouldn't address the full range of higher consumer costs.** As noted, more than half of the "hit" to consumers' budgets from climate legislation will come in areas other than home utility bills. Utility-based relief would not address these other factors that will reduce consumers' purchasing power.

- **CBO and leading economists have found that utility relief undercuts incentives to reduce fossil-fuel consumption, increasing the cost to the economy of meeting the emissions cap.** Dallas Burtraw, Senior Fellow at Resources for the Future and one of the nation's leading experts on these issues, recently testified before the Senate Finance Committee that:

  > It is broadly accepted that the free allocation to local distribution companies raises the overall cost of the program. This occurs because by reducing energy costs for consumers, the policy would also reduce the price incentive for households and businesses to change the way they use energy. Detailed modeling results show that on average, households are made worse off by the effort to protect them from electricity price changes because it will lead to greater electricity consumption. Consequently, greater emissions reductions will be necessary, at higher cost, in other parts of the economy.[4]

  The Environmental Protection Agency makes a similar point in its analysis of the House bill:

  > Returning the allowance value to consumers of electricity via local distribution companies in a non-lump sum fashion prevents electricity prices from rising but makes the cap-and-trade policy more costly overall . . . since greater emission reductions have to be achieved by other

[2] Congressional Budget Office, "The Estimated Costs to Households from the Cap-and-Trade Provisions of H.R. 2454," letter to the Honorable Dave Camp, June 19, 2009.

[3] See Chad Stone, "Holding Down Increases in Utility Bills Is a Flawed Way to Protect Consumers While Fighting Global Warming," Center on Budget and Policy Priorities, June 3, 2009.

[4] Dallas Burtraw, testimony before the Senate Finance Committee, August 4, 2009, p.3.

sectors of the economy. Resulting changes in prices of other energy-intensive goods also influence the overall distributional impacts of the policy.[5]

In short, providing consumer relief through LDCs leads to excessive electricity consumption and raises the cost of reducing emissions. As a consequence, the average cost to households from higher prices (net of all consumer relief they receive) is *higher* than it would be if financial relief were provided directly to consumers rather than as relief on utility bills. Direct payments or refunds to consumers protect their purchasing power without blunting the price signal that promotes reduced fossil-fuel use.

- **The regulation of utilities is uneven.** The House bill relies on state utility regulators to ensure that local utility companies use the subsidies to produce well-targeted and effective consumer relief. Unfortunately, the quality of state regulation of utilities is uneven across the country. In the abovementioned testimony, Burtraw stated: "State public utility commissions will play the determining role in how households are affected, not Congress, and this will be done in 50 different ways. In fact, there is great uncertainty about how the allowance value directed to local distribution companies will flow back to consumers."

Would significantly extending the period during which LDCs receive free permits on a large scale "help protect consumers"?

The EEI letter asks for a longer phase-out of the allocation of free allowances to electricity LDCs, claiming that the current "swift phase-out will lead to abruptly higher energy prices for consumers." But it fails to mention that under the House bill, the phase-out (would not begin until 2026) and then would entail redirecting these allowances to the Climate Change Consumer Refund Fund, where they would be *returned as a tax refund to all households on a per-capita basis.* In other words, the free allocation to LDCs would be converted to direct, more efficient consumer relief that does not interfere with the price signal.[6]

- **The economic costs of cap-and-trade will be *lower* once utility relief is phased out.** As explained above, allocating allowances to LDCs to provide relief to their customers is more expensive than auctioning the equivalent amount of allowances and returning the proceeds on a per-capita basis.

- **Direct consumer relief from the Climate Change Consumer Refund should be more equitable than LDC consumer relief.** When an increasing proportion of the allowance value goes to direct consumer relief rather than relief for LDC business customers, households in general — rather than the narrow, more affluent slice of Americans who are business owners and shareholders — will be the main beneficiaries.

- **After the phase-out, consumers will face the right incentives to reduce fossil-fuel energy**

[5] United States Environmental Protection Agency, "EPA Analysis of the American Clean Energy and Security Act of 2009 H.R. 2454 in the 111th Congress, 6/23/09," p. 49.

[6] In 2030, about 50 percent of the total permit value would be used for these per-capita payments to households. That percentage would continue to rise as the free allocation to trade-impacted industries was phased out.

> **use and have the financial resources to make the right choices.** Unlike giving utilities funds to keep their customers' bills from rising, providing direct consumer relief through the Climate Change Consumer Refund would show consumers the true costs of continuing to use carbon-based energy and give them the economic incentives — and the financial resources — to make sound choices about energy conservation and energy efficiency.

RFF's Burtraw testified to the Senate Finance Committee that the duration of the free allocation to LDCs under the House bill is already "too long to provide incentives for changes in consumer behavior." He explained that "to provide households with an incentive to purchase more efficient appliances, etc., it is essential that they anticipate they will see increasing prices in the near future."

Burtraw argued that rather than extending the phase-out of free allocation of allowances to electricity LDCs, Congress should begin the phase-out sooner, at the outset of the program, and complete the phase-out by 2020 rather than the House bill's 2030.

Conclusion

The Senate should not accept EEI's request for more free allowances and a longer phase-out of these allowances. A better approach would be to scale back the allocation to LDC business customers and use the freed-up allowance value to extend well-targeted direct consumer relief to moderate-income families and for other important climate policy measures.