Issue Overview:
Use of Allowance Value

On January 15, 2009, the U.S. Climate Action Partnership (USCAP) issued the *Blueprint for Legislative Action* – a detailed framework for legislation to address climate change. This brief discusses the use of allowance value in a cap-and-trade program. It should be considered in the context of the detailed and integrated recommendations in our *Blueprint*.

Background

Under a cap-and-trade system, overall greenhouse gas (GHG) emissions are capped and a supply of emission "allowances" is created up to the level of the cap. Emission sources covered by the cap are required to submit one allowance for each ton of GHGs they emit, or face a penalty substantially higher than the cost of an allowance. Allowances can be made available to covered sources through an auction, free allocation, or some combination of free allocation and auction.

Whether emitters buy all their allowances through an auction or receive allowances through free allocation, they face the same incentive to reduce emissions to the levels required by the cap specified in the legislation. This means that auctioned allowances, free allocation of allowances, or a combination of the two, will all result in the cap being met. Because all allowances can be bought and sold in an allowance trading market, the resulting price of allowances creates the same incentive to reduce emissions, regardless of how the allowances are initially distributed. Covered sources that receive free allocations will seek to reduce emissions so they can be sellers of allowances. Covered sources that have to purchase allowances will seek to reduce emissions to avoid having to buy allowances.

Looking more broadly, emission allowances in an economy-wide cap-and-trade system represent trillions of dollars in value over the life of the program. There may be two components of this value: any GHG allowances that are distributed for free, which represent a financial asset; and the revenue from any auction of allowances. The *Blueprint* calls the sum of these "allowance value." How that value is distributed and invested will have critically important effects on how our nation achieves its climate protection goals. Thus, it is important to establish an effective and equitable framework for allocating this allowance value.

USCAP's Recommendations on Use of Allowance Value

USCAP believes that allowance value should be used to accomplish three broad public purposes:

1. To help consumers and businesses transition to a low-carbon economy;
2. To drive rapid investment in low carbon technology and training of the skilled workforce needed to speed its deployment; and
3. To adapt to the inevitable changes to the climate already occurring.

Building upon these broad public purposes, USCAP recommends that a significant portion of allowance value in the early years of the program should be directed to:

- **End-use energy consumers –** USCAP recommends a significant share of the allowance value should be used to buffer the impacts of increased costs to consumers at the end of the energy supply chain. In the case of electricity and natural gas consumers, USCAP recommends doing so through allocations to state-regulated local distribution companies (LDCs) with the express condition that the full value of these allowances go to electricity and natural gas consumers. State public utility commissions (PUCs) will determine the best means to direct the value to consumers by directly mitigating rate increases, enhanced energy efficiency programs, or other means to buffer the impact of increased energy costs. In the case of transportation consumers, USCAP recommends that some allowance value be used to

buffer transportation-related costs through a combination of cost mitigation and incentives to encourage greater use of public transportation and purchasing more efficient vehicles.

- **Transitional assistance to trade-exposed business** such as energy-intensive manufacturers facing foreign competition from countries without comparable climate programs. Without an initial allocation of allowance value, such manufacturers might lose market share or be forced to relocate production to lower cost areas, causing the "leakage" of emissions and jobs to other counties, undermining the emissions reductions achieved in the U.S.
- **Transitional assistance to competitive large stationary sources** to the extent they cannot recover their allowance costs in their product prices. These initial allocations would be set to facilitate and create incentives for the timely investment in alternative low and no-carbon large stationary technologies, phasing out as it becomes practicable to deploy these technologies.
- **Technology and workforce transformation** that accelerates the development of new low- and zero-GHG emitting technologies and fuels while helping to transition and train the nation's workforce to manufacture, operate, and maintain these new technologies.
- **Adapting to the challenge of climate change in the United States and abroad** including funding the international commitments made by the United States in a global agreement. Central to that effort are programs that increase the resiliency and capacity of ecosystems and human communities to adapt to change.

Consistent with these goals, USCAP recommends that a significant portion of allowances initially be distributed for free. The free distribution of allowances should phase out and an increasing share of allowances should be auctioned over time. Moreover, USCAP recommends that these allocations should not create undue or "windfall" gains for private firms, but should instead support the ability of firms to meet the broad public purposes of the climate protection program.

With regard to USCAP's recommendation that allowances be allocated to state-regulated LDCs, such entities would sell the allowances they receive for use by entities regulated under the cap. The revenues generated from the sale of allowances would be returned to consumers in a manner to be determined by PUCs. The advantages in relying on LDCs for returning allowance value to electricity and natural gas consumers include:

- LDCs are subject to well-established state regulatory oversight, ensuring that the value of the allowance allocation would fairly and transparently benefit consumers.
- LDCs have experience managing consumer benefit programs such as low-income assistance and energy efficiency programs. PUCs might also decide to set prices that are deemed equitable to all classes of consumers. These pre-existing programs and mechanisms provide a means to quickly and effectively deliver allowance value to consumers.
- LDCs and their contractors have established relationships with their customers to service their homes and businesses, conduct energy audits, and meter and bill for consumption each month. These relationships will enable LDCs to identify and deliver allowance value to consumers.

To learn more about the USCAP *Blueprint for Legislation Action*, please visit www.us-cap.org.