Cap and trade policies limiting CO2 can increase value of some electricity generating firms

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A new study in the *Journal of Policy Analysis and Management* explores ways to target the compensation provided by the free allocation of emission allowances under a CO_2 cap and trade policy in order to avoid overcompensation of firms that already are benefiting from the program.

In most prior cap and trade programs, emission allowances have been given away for free to pollution emitting firms as a way to compensate them for the costs imposed by the policy. In the case of a CO_2 cap and trade program affecting the electricity sector, some firms actually profit from the policy and others lose. Consumers as a group will lose in the sense that they will see increases in electricity prices.

A cap and trade policy that limits emissions of CO_2 can increase the value of some electricity generating firms. Free distribution of just 6 percent of the total allowances would be sufficient to compensate shareholders for the loss in market value on an industry-wide basis.

However, granting free allowances to compensate firms for their losses under a cap and trade policy can be costly. It is difficult to compensate losers without also compensating undeserving parties. The researchers find that compensating firms for the last $2.6 billion in losses at the federal level imposes a cost of roughly $25 billion.

"Climate policy promises to be more costly than all prior air pollution policies. The use of a cap and trade approach will help to keep the costs low, but it will impose costs on various sectors of the economy," the authors note. "Information about how to deliver compensation in a cost-effective manner could help to increase the political acceptability of climate policy and help preserve a larger share of allowance value that might be used in ways that lower the costs of compliance with the program and, thereby lower the economic impact of the policy."

Source: Wiley

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