

AN ACID RAIN "ECONOMY": COPING IN A NONINFLATIONARY WORLD

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The recently enacted acid rain provisions of the Clean Air Act¹ constitute a dramatic shift in the focus of federal air quality regulation from traditional "command and control" strategies to a "market-based" approach to allocating and enforcing an acid rain reduction program."² Under the provisions of Title IV, regulated (or affected)³ fossil fuel-fired steam electric utilities⁴ will be permitted to emit sulfur dioxide (SO₂), one of the primary precursors of acid rain,⁵ only to the extent that they hold "allowances" originally issued by the Environmental Protection Agency (EPA or the Agency).⁶ Allowances will be freely trade-

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1. Clean Air Amendments of 1990, Pub. L. No. 101-549, 104 Stat. 2399 (1990) (codified as amended at 42 U.S.C.A. §§ 7651-7651o (Supp. 1991)).

2. HOUSE COMM. ON ENERGY AND COMMERCE, CLEAN AIR ACT AMENDMENTS OF 1990: REPORT ON H.R. 3103, H.R. REP. NO. 450, 101st Cong., 1st Sess., pt. 1, at 365 (1990) [hereinafter HOUSE REPORT].

3. Utility units become "affected" units (*i.e.*, subject to the requirements of Title IV) in two "phases." 42 U.S.C.A. § 7651a(2). In Phase I, beginning January 1, 1995, specific units listed in Table A to 42 U.S.C.A. § 7651c are affected units. In Phase II, beginning January 1, 2000, all other existing and new utility units, as defined in Title IV, are affected units. 42 U.S.C.A. §§ 7651c(a), 7651d.

4. A "unit" is "a fossil fuel-fired combustion device." 42 U.S.C.A. § 7651a(15). The term "utility unit" includes, with certain exceptions, units that either serve a generator that produces, or during 1985 served a generator that produced, electricity for sale in one of the 48 contiguous states or the District of Columbia. The most significant exception is for a cogeneration unit that does not supply "more than one-third of its potential electric output capacity [or] . . . more than 25 megawatts electrical output to any utility power distribution system for sale." 42 U.S.C.A. § 7651a(17). Additionally, "units which serve a generator with a nameplate capacity of 25 [megawatts] or less" are not "existing units" which may be affected units. 42 U.S.C.A. § 7651a(8).

5. Title IV also regulates emissions of nitrogen oxides (NO_x) from affected coal-fired units. 42 U.S.C.A. § 7651f. SO₂ is emitted during the burning of fossil fuels, which contain sulfur. Once in the atmosphere, SO₂ combines with oxygen to form sulfate (SO₄). SO₄ attracts water, which converts it into sulfuric acid, H₂SO₄. Similarly, nitrogen in fossil fuels combines with oxygen during burning to form oxides of nitrogen. These may combine with water to produce nitric acid, HNO₃. SENATE COMM. ON ENVTL. AND PUBLIC WORKS, CLEAN AIR ACT AMENDMENTS: REPORT ON S. 1630, S. REP. NO. 228, 101st Cong., 1st Sess. 261-262, reprinted in 1990 U.S.C.A.N. 3645, 3646 [hereinafter SENATE REPORT].

6. An allowance is "an authorization, allocated to an affected unit by the

able,⁷ with the total number of allowances permanently capped at 8.9 million tons of emissions annually from the regulated community.⁸

Basically, the goal of the new program is to convert reductions in SO₂ emissions into a valuable commodity. As such, the mechanisms of a free market would provide incentives to achieve the most cost-effective emissions reductions while simultaneously providing opportunities for new capacity expansion.⁹ This ambitious goal can be achieved only if the "allowance trading market," contemplated in the statutory provisions,¹⁰ is both broad in geographic scope and substantial in volume. EPA recognizes this critical point:

Administrator [of the EPA] under this title [Title IV], to emit, during or after a specified calendar year, one ton of sulfur dioxide." 42 U.S.C.A. § 7651a.

7. 42 U.S.C.A. § 7651b ("Allowances . . . may be transferred among designated representatives of the owners or operators of affected sources . . . and any other person . . ."); see also SENATE REPORT, *supra* note 5, at 320, 1990 U.S.C.C.A.N. at 3703 ("In fact, ownership of allowances by brokers, investors and other market makers will maintain fluidity in the allowance market, link ultimate buyers with original sellers and facilitate rational price-finding.").

On July 17, 1991, the Board of Directors of the Chicago Board of Trade approved contract specifications for clean air allowance futures. CHICAGO BD. OF TRADE, NEWS RELEASE (July 17, 1991). If approved, the contract will be traded in units of 25 one-ton sulfur dioxide emission allowances. *Id.* Minimum price fluctuations will be in multiples of \$1 per allowance. Under this plan, the exchange will begin trading "cash forward" contracts in 1993. Peter Passell, *A New Commodity to be Traded: Government Permits for Pollution*, N.Y. TIMES, July 17, 1991, at A1. These contracts are merely simple agreements to deliver allowances after they are issued in 1995. *Id.* The exchange will also ask the Commodity Futures Trading Commission for permission to establish a continuing "futures" market, permitting anyone to gamble on emissions rights in standardized 25-ton allotments up to three years in advance. *Id.*

8. 42 U.S.C.A. § 7651b. *But see id.* § 7651d(a)(3), (adding 50,000 additional Phase II allowances to the allocations of certain Phase I units). Additional allowances may also be created by industrial sources that choose to opt into the program under *id.* § 7651i. This provision might allow an industrial cogenerator, for example, to take credit for shutting down an existing steam boiler and apply a portion of the emission allowances thereby created to the cogeneration facility. Note, however, that there are certain limitations on the banking of allowances generated by reduced utilization or shutdown of opt-in units. *Id.* § 7651i.

9. The Senate Environment and Public Works Committee clearly stated how a market-based mechanism would result in lower cost emission reductions:

[T]hrough a system of marketable allowances, the reduction programs established by the title maximize the range of choices sources have for complying with their emissions limitation requirements. An individual source may emit more than required if another source emits less than it, the latter, is permitted to emit. Through this flexibility, the bill minimizes costs and maximizes flexibility and efficiency.

SENATE REPORT, *supra* note 5, at 303, 1990 U.S.C.C.A.N. at 3686.

10. The "allowance trading market" will also be defined in EPA regulations.

[W]e believe that the definition of success of this program must go beyond its ability to achieve mandated reductions. A successful program must also facilitate the addition of new sources and must achieve the reductions in compliance costs that we believe can result from the use of this market-based approach. As robust allowance trading is necessary if we are to accomplish these goals, we must collaborate to demonstrate both the feasibility and desirability of allowance trading.¹¹

As contemplated by the new law, allowances will be, in effect, "a new currency."¹² Significantly, this new currency will never be subject to inflation, because EPA can never issue more than 8.9 million allowances annually,¹³ though the electric utility industry is expected to continue to grow.¹⁴ In the short-term, there is no necessary conflict between industry growth and reductions in emissions. National emissions of SO₂ have decreased substantially from 1975 to 1988, because, for at least the last fifteen years, United States utilities have shifted to cleaner fuels and more effective pollution control technologies.¹⁵ Thus, it is likely that allowances will be available to new and expanding utilities, when the law becomes fully effective, in the year 2000.¹⁶ The reason these allowances will be available is due, at least in part, to the fact that EPA will make a limited number of allowances available through controlled sales.¹⁷

However, as the demand for electricity continues to grow, the permanent cap on the number of allowances will inevitably generate forces that have the potential to distort the market. Further, factors such as (1) the need for public utilities and state regulators to make long-range decisions about new capacity, (2) the project financing needs of new nonpublic utility steam generating facilities, and (3) possible inconsistencies in state and fed-

11. EPA, ACID RAIN PROGRAM VISION STATEMENT, 3 (December 7, 1990) (draft).

12. HOUSE REPORT, *supra* note 2, at 365. The Amendments clarify, however, that an allowance does not constitute a property right. 42 U.S.C.A. § 7651b(f).

13. See 42 U.S.C.A. § 7651b(a).

14. See U.S. DEP'T OF ENERGY, ENERGY SECURITY: A REPORT TO THE PRESIDENT OF THE U.S. 136-41 (1987) (nearly 100 gigawatts of new construction will be needed by the turn of the century). *Id.* at 139.

15. See NATIONAL ACID PRECIPITATION ASSESSMENT PROGRAM, 1989 ANN. REP. TO THE PRESIDENT AND CONGRESS F-47 (1990). See generally *Hearing on S. 879 Before the Comm. on Energy and Natural Resources*, 100th Cong., 1st Sess. (1987) (encouraging the deployment of clean coal technologies).

16. 42 U.S.C.A. § 7651c(e); see also *id.* § 7651d(a).

17. See *infra* notes 42-44 and accompanying text.

eral treatment of allowances under utility rate regulations, are likely to accelerate these distorting forces.

This article will first analyze each of the above factors. As will be shown, the nature of the utility industry and the noninflationary aspect of the allowance "currency" necessarily require coordination between EPA and state and federal utility regulators. This coordination is not provided for in the new law to the extent necessary to avoid market failure.¹⁸ Although EPA may promulgate regulations to govern the trading of allowances,¹⁹ it does not possess sole regulatory authority over allowance trading. The prices, facilities and other assets of the affected sources have been extensively regulated for many years at both the state and federal levels.²⁰ Notably, these existing regulatory jurisdictions are not diminished by the enactment of acid rain controls.²¹ The noninflationary nature of allowances will require the relevant agencies to develop an integrated approach to regulating allowance trading. The failure to develop such an approach will pose a significant threat to the ultimate success of a true marketplace in allowance trading. Accordingly, this article concludes with a proposal to facilitate such an approach.

I. THE NEW ACID RAIN PROGRAM

Title IV of the new Clean Air Act Amendments combines a number of approaches to form the nation's first major market-based environmental regulatory program.²² If successful, the acid rain program may serve as a model for other environmental regulations.²³ The crucial elements of the program are: (1) the requirement of steep reductions in existing emission rates of SO₂,

18. The legislative history of the Amendments provide some indication that EPA might be authorized to take drastic action, conceivably including preempting State Public Service Commission decisions and overriding conflicting decisions, "if the Administrator finds that owners and operators are engaging in, or are likely to engage in, extreme practices that would defeat the environmental protection or economic efficiency objectives of [Title IV]" See SENATE REPORT, *supra* note 5, at 321, 1990 U.S.C.C.A.N. at 3704. As described in the text, in the case of severe market failure, corrective action by the EPA, even if authorized by Title IV, would likely be too disruptive of other regulatory systems to merit serious consideration.

19. 42 U.S.C.A. § 7651b(b).

20. See *id.* § 7651b(f), (h), (i), (j) (stating that the Amendments do not impair certain existing rights and obligations).

21. See *id.*

22. See, e.g., HOUSE REPORT, *supra* note 2, at 365.

23. *Id.*; see also EPA, ACID RAIN PROGRAM VISION STATEMENT, 1 (December 7, 1990) (draft).

(2) the nationwide bulk emissions cap (the requirement, once the cap is reached, that new or expanded affected units may emit additional bulk SO₂ only to the extent that existing units have made corresponding emissions reductions), and (3) the creation of a bulk emissions trading market to encourage flexibility and innovation in and among units.²⁴

The "centerpiece" of the new law is the nationwide SO₂ cap and the emissions trading system.²⁵ When the law becomes fully effective in the year 2000, bulk SO₂ emissions from fossil fuel-fired steam electric generating units will be permanently capped at 8.9 million tons a year, an almost fifty percent reduction from 1980.²⁶ Currently, electric utilities contribute nearly seventy percent of total United States SO₂ emissions from anthropogenic sources,²⁷ with over ninety percent of utility emissions resulting from coal combustion.²⁸

Under the emissions trading system, each ton of SO₂ will be represented by an allowance, defined as an authorization to emit one ton of SO₂ during or after a specified calendar year.²⁹ Affected units will be legally allowed to emit only those amounts of SO₂ for which they hold allowances,³⁰ with the number of allowances the unit holds automatically incorporated into its operating permit.³¹ Unused allowances may be traded or banked and carried forward, but they may not be carried backward.³² Annual emissions in excess of the number of allowances held will subject the unit to fines and other penalties.³³

The primary source of allowances will be annual distributions, which EPA is directed to make free of charge, to units in commercial operation before November 15, 1990.³⁴ The number of allowances allocated for each unit will remain the same begin-

24. SENATE REPORT, *supra* note 5, at 322-23, 1990 U.S.C.C.A.N. at 3705-06.

25. HOUSE REPORT, *supra* note 2, at 364.

26. *Id.* at 355.

27. NATIONAL ACID PRECIPITATION ASSESSMENT PROGRAM, 1989 ANN. REP. TO THE PRESIDENT AND CONGRESS F-41 (1990). "Anthropogenic sources" is the term used to describe all man made SO₂ emitting sources.

28. *Id.*

29. 42 U.S.C.A. § 7651a.

30. *Id.* §§ 7651c(a)(1), 7651d(a)(1), 7651j(a).

31. *Id.* § 7651b.

32. See *id.* § 7651b(b), (d); see also H.R. CONF. REP. NO. 952, 101st Cong., 2d Sess. 343 (1990), reprinted in 1991 U.S.C.C.A.N. 3875.

33. 42 U.S.C.A. § 7651j.

34. November 15, 1990 is the enactment date of the Clean Air Act Amendments. See *id.* § 7651a(8) (definition of "existing unit").

ning in the year 2000,³⁵ and will be calculated using a formula provided in the statute.³⁶ With limited exceptions, owners and operators of existing units will receive annual distributions in perpetuity, even after the unit ceases operation.³⁷ New units will not receive an allocation of allowances from EPA.³⁸ In order to emit any SO₂ at all, they will have to obtain allowances from other sources.³⁹ If the market works as desired, new units will obtain allowances directly from existing plants that have received a free allocation of allowances and reduced their SO₂ emissions below the number of allowances they need to operate.⁴⁰ The primary source of excess allowances is initially expected to be 110 existing high-emitting plants that are specifically listed in the statute.⁴¹

Additionally, the law creates a number of EPA administered allowance "reserves," which are designed to meet certain contingencies and to keep the market fluid.⁴² From the most significant of these reserves, EPA is required to offer for sale up to 50,000 allowances a year on a first-come, first-served basis, for 1,500 dollars each, and to offer additional allowances at an auction.⁴³ In the event emissions trading does not evolve organically, sales from these reserves will enable EPA to "jump-start" the market.⁴⁴

As contemplated, the allowance trading system is designed to turn SO₂ emissions control into an economic commodity or

35. *Id.* § 7651d.

36. Generally speaking, allowances will be allocated based on a formula: $(X \text{ lbs/mmBtu}) \times (Y \text{ mmBtu})$ 2000, where X is an emission rate (either numerical, e.g., 1.2, or descriptive, e.g., the lesser of actual or allowable (permitted) emissions for 1985), and Y represents fuel use, in millions of British thermal units, for a given year or a yearly average for a specified period. Division of the product by 2000 adjusts pounds to tons. The specific formula applicable to a unit will vary depending on numerous factors, including the unit's size, previous emissions rate, previous emissions limitation in permits, and type of fuel. Other factors may include special formulas for clean states and various bonus allocations. In all, there are 29 categories of allowance allocations in the Amendments. *EPA Acid Rain Advisory Committee Meeting* (December 7, 1990) (statement of Brian McClean, Deputy Director, EPA office of Atmospheric and Indoor Air Programs).

37. 42 U.S.C.A. § 7651b(a).

38. *Id.*

39. *Id.*

40. See SENATE REPORT, *supra* note 5, at 318, 1990 U.S.C.C.A.N. at 3701.

41. 42 U.S.C.A. § 7651c tbl. A.

42. See SENATE REPORT, *supra* note 5, at 325, 1990 U.S.C.C.A.N. at 3708.

43. 42 U.S.C.A. § 7651o(c), (d). The price the EPA must charge for direct sales of allowances must reflect any increase in the Consumer Price Index (base year 1990). *Id.* § 7651o(c).

44. HOUSE REPORT, *supra* note 2, at 366.

currency for which a rational market will provide the measure of value.⁴⁵ The system ideally provides compliance flexibility for the regulated community⁴⁶ because "high-emitting plants [will] . . . be able to make more cost-effective reductions than required and sell the resulting unused allowances to plants whose on-site reduction costs would be higher than the purchase price of allowances."⁴⁷

As noted above, however, the allowance market will be subject to the strict prohibition against inflation. The Senate Report on the Clean Air Act Amendments explains at length:

The value of . . . allowances will be determined in large part by the cost of reducing or avoiding the emissions against which they are applied. If some sources, in this case new ones, are permitted to add emissions and increase the total emissions from utilities rather than being mandated to offset their emissions, the value of allowances retained by other sources will be diminished since the new sources' emissions avoidance cost will be reduced to zero. Allowances are intended to function like a currency that is sufficiently valuable to stimulate efforts to acquire it through innovative and aggressive efforts to reduce emissions more than required. If the addition of new unit emissions creates inflation in the currency then the market incentives to earn allowances—that is, to reduce pollution—will be seriously weakened.⁴⁸

Because of the demand for allowances in the regulated community, the noninflationary allowance market eventually will require constant regulatory oversight and adjustment.

II. POTENTIAL SOURCES OF DISRUPTION IN THE ALLOWANCE MARKET

A. *The Electric Utility Industry*

New utilities, as well as existing utilities that hope to expand, will require many years of allowances (*i.e.*, allowance streams) in order to ensure that they have an opportunity to obtain returns on investments in new facilities. This presents a potentially major obstacle to the liquidity of the allowance market. To illustrate, existing utilities that presently hold surplus

45. See HOUSE REPORT, *supra* note 2, at 365.

46. See SENATE REPORT, *supra* note 5, at 323, 1990 U.S.C.C.A.N. at 3706.

47. *Id.* at 318. Due to their economic nature, antitrust, commercial, and other laws will apply to allowances.

48. SENATE REPORT, *supra* note 5, at 324, 1990 U.S.C.C.A.N. at 3707.

allowances may be unwilling to sell an allowance stream that extends far into the future. As well, new utilities that require project financing may be unable to obtain such financing without a guaranteed stream of allowances.

Under applicable state laws, regulated electric public utilities must provide service, in their franchised territory, to those who request it.⁴⁹ Similarly, they must engage in long-range planning to meet projected growth.⁵⁰ These mandates are enforced by state public utility commissions.⁵¹ While public utilities may once have been virtually impervious to economic trends, this is clearly no longer the case. In the last two decades, public utilities have suffered billions of dollars in write-offs for plant capacity that was not needed or was constructed over budget.⁵² Other losses have resulted from investments in nuclear facilities that either never went on-line or were never able to operate at full power.⁵³

For public utilities that expect to expand in the next twenty to thirty years, the question of selling streams of allowances is likely to be critical to their plans. Regardless of whether the holder of allowances intends to build a new source, or buy from another source, the availability of allowances will be the key to expansion. Viewed in this light, surplus allowances can take on an economic significance far beyond that of merely financing pollution control on existing units. Indeed, the cost of not selling such allowances may fade into insignificance when compared with the cost of not having a stream of allowances when one is needed.

Proposed independent power production facilities seeking project financing will see the obverse side of this problem. Such facilities are often smaller units that are unaffiliated with the franchised public utilities to which they sell electricity wholesale.⁵⁴ Independent power production facilities are expected to

49. [1990] 1 *Energy Law and Transactions* (MB) §§ 2.01-2.02.

50. *See id.* § 2.01(2).

51. *Id.* § 4.01.

52. *See* IV Fed. Energy Reg. Comm'n. Statutes & Regulations (CCH) ¶ 32,456, at 32,105 (March 16, 1988) [hereinafter *FERC Statutes*].

53. In fact, according to the U.S. Department of Energy, since 1973, every nuclear power plant on which construction was commenced has ultimately been canceled. U.S. DEPT OF ENERGY, *ENERGY SECURITY: A REPORT TO THE PRESIDENT OF THE U. S.* 189 (March 1987). The completed, but never utilized, Shoreham plant on Long Island, New York is perhaps the most notorious example of a multi-billion dollar investment that had to be largely written off by its owner, the Long Island Lighting Co.

54. As defined by the Federal Energy Regulatory Commission (FERC), independent

provide a large share of the nation's new utility capacity.⁵⁵ Typically, independent facilities are "project financed."⁵⁶ In this type of financing, the lender relies on the projected revenue of the project, rather than on the credit-worthiness of the developer, to assure debt service. Lenders, therefore, are likely to be reluctant to finance projects that do not have a commitment to obtain a stream of allowances for the life of the project.⁵⁷

Finally, it is important to note that the allowance allocation system also sets up a scenario that is rife with antitrust implications. Title IV grants existing public utilities, with their enormous assets and market power, control of assets that their potential competitors, aspiring independent power producers, must purchase in order to compete against them. Independent producers typically do not possess large assets and by definition have little market power.⁵⁸ Congress, cognizant of the anticom-

power producers are unaffiliated with franchised utilities in their market area (*i.e.*, independent power producers do not sell power in any retail service area which they or an affiliate have a franchise), do not possess transmission facilities, and lack significant market power in the area in which they are selling as independent producers. See FERC Statutes, *supra* note 52, at 32,103-3. Sales of electricity by independent producers are not regulated on a cost-of-service basis (*i.e.*, sales are not regulated to ensure investors a reasonable return on their investments), as are retail sales of regulated public utilities. See FERC Statutes, *supra* note 52 at 32,110. "Independent power production facility" is defined somewhat similarly in 42 U.S.C.A. § 7651o(a)(2) of the Amendments, with the added requirement that the facility be "a new unit required to hold allowances." Additionally, the facility must sell at least 80% of the electrical energy generated at wholesale rates in order to qualify as an independent power producer. 42 U.S.C.A. § 7651o(a)(2)(A).

55. It is now estimated that approximately 40 to 50% of the United States' new generating capacity in the next 10 years will be provided by competitive independent power producers. See SENATE REPORT, *supra* note 5, at 325, 1990 U.S.C.C.A.N. at 3708.

56. The Amendments required the Secretary of Energy to define the term "nonrecourse project-financed" by February 15, 1991. 42 U.S.C.A. § 7651o(a)(B)(2). A proposed definition was published in the *Federal Register* on February 15, 1991. 56 Fed. Reg. 6,319, 6,320 (1991) (to be codified at 10 C.F.R. pt. 715).

57. The Amendments provide that independent power producers have the right to purchase allowances from the EPA subaccount for direct sales before other purchasers. 42 U.S.C.A. § 7651o(c). This subaccount is limited to 50,000 allowances per year, with 25,000 to be sold for immediate use, and 25,000 to be sold for use in or after the seventh year after the year in which they are offered for sale. *Id.* § 7651o, tbl. 1. EPA will also offer up to 200,000 allowances at auction after the year 2000, half for immediate use and half for use in or after the seventh year after they are sold. *Id.* § 7651o, tbl. 2. While EPA sales and auctions may meet immediate needs, it is likely that the demand for allowances will soon far exceed the EPA supply. See Shenandoah Nat'l Park, 55 Fed. Reg. 38,403, 38,406 (1990) (prelim. notice of adverse impact) (identifying recently proposed or permitted, but not yet operating, electric generating stations in Virginia, which will contribute over 20,000 tons per year in SO₂ emissions).

58. See FERC Statutes, *supra* note 52, at 32, 105 (independent power producers by definition have little "market power"); see also 42 U.S.C.A. § 7651o(a)(2)(B) (defining an "independent power production facility" in part as a facility that is "nonrecourse project-

petitive potential inherent in this situation, specifically provided that the Amendments do not affect the applicability of the anti-trust laws or the authority of the Federal Energy Regulatory Commission (FERC or the Commission) with respect to anticompetitive acts or practices.⁵⁹ Arguably, within the structure of the allowance market, existing public utilities can accomplish anticompetitive ends without having any anticompetitive intent, simply by following rational planning policies with respect to surplus allowances.⁶⁰

B. State and Federal Regulators

States exercise plenary jurisdiction over the structure and activities of electric utilities, pursuant to state statutes and precedents that incorporate the traditional public utility theory of regulation.⁶¹ This jurisdiction includes, among other things, power to review and approve or disapprove rates charged for electricity, as well as power to oversee the acquisition and disposition of assets which are useful to the rendering of such service.⁶²

Title IV creates an asset, an SO₂ allowance, which will be legally necessary to the rendering of electric service by fossil fuel plants to consumers. This allowance will be subject to the regulatory oversight of state commissions. The mere presence of this oversight, however, cuts against the congressional intent that utilities acquire, utilize, or dispose of allowances solely according to their economic self-interest.⁶³ For example, a utility that is considering selling allowances it does not presently need may be deterred from making such sales by the possibility that the

financed"). "Market power" is the ability of a business unit or enterprise to affect the price which will prevail on the market in which the enterprise trades. The basis for analyzing the strength of an enterprise's ability to affect the price of a good depends on the reaction of buyers to price changes initiated by the seller, which are in turn related to the availability of substitutes for the seller's product. LAWRENCE A. SULLIVAN, *HANDBOOK OF THE LAW OF ANTITRUST* 30-32 (1977).

59. 42 U.S.C.A. § 7651b(i). Federal antitrust law applies to regulated public utilities. *Otter Tail Power Co. v. United States*, 410 U.S. 366, 374-75 (1973).

60. Under the Sherman Act, two elements are necessary to establish an antitrust violation: (1) monopoly power (market power), and (2) anticompetitive intent. Anticompetitive intent is generally inferred from conduct which is deemed predatory, coercive, or calculated to heighten the entry barrier into a given market. However, conduct which tends to reduce competition will generally suffice to show the requisite intent, as long as it is not a mere by-product of industry-wide changes. SULLIVAN, *supra* note 58, at 29-30, 135-38.

61. See [1990] 1 Energy Law and Transactions (MB) §§ 4.01, 4.02.

62. *Id.*

63. See SENATE REPORT, *supra* note 5, at 322-24, 1990 U.S.C.C.A.N. at 3705-07.

state public service commission may later adjudge the sale imprudent (because the allowances should have been "banked" for later use, or the price obtained was not the best price available) and decide to penalize the utility. The penalty could take the form of requiring the entire sum of proceeds to be deducted from the rate charged to the customer or even of imposing a fine on the utility.

Promulgation of policies by one or more states prohibiting the sale of allowances may have a more inhibiting effect on the development of an allowance trading market. Congress was aware of this threat:

During hearings, the term "hoarding" was used to describe the possibility that a utility, of its own accord or in conjunction with a state regulatory authority, might elect to keep tradeable allowances to itself rather than use them or sell them in the open market. It was generally conceded that excessive hoarding, although probably legal,⁶⁴ could hinder the effectiveness of a national trading system.⁶⁵

In lieu of second guessing utility decisionmaking on allowance trading, or an outright preclusion of trading, states may adopt policies that indirectly discourage utility dealings in allowances. When a utility makes sales of surplus allowances, the proceeds of the sales will be subject to its state commission's rate policies. The question, which then arises, is: Will the net proceeds be retained, in whole or in part, by utility shareholders, or will they flow through to rate-payers? The FERC has encountered a similar question in the context of short term sales of power from one utility to another: who keeps the gain from the sale, the shareholder or the rate-payer, or is the gain shared?⁶⁶ The answer to this question reflects a policy choice. Should the investors in the utility be rewarded by good performance as an incentive to produce similar results in the future, or should the rate-payers be rewarded by a reduction in their electric bills? With respect to allowances, if a given state adopts a flow-through policy, it may remove a potentially powerful incen-

64. There may be an issue as to whether a state prohibition on allowance trading would violate the Commerce Clause of the U.S. Constitution. U.S. CONST. art. 1, § 9, cl. 3.

65. HOUSE REPORT *supra* note 2, at 366 (footnote added).

66. See Public Service Co. of N.M., [1983] 25 Fed. Energy Reg. Comm'n Rep. (CCH) ¶ 61,469, at 62,055 (Dec. 30, 1983) (allowing a portion of the proceeds of the utility's sales to go to shareholders). However, because state rate policies usually differ from those of the FERC, this decision is not a precedent for states that might address an analogous issue.

tive for the utility to search for trading opportunities (e.g., the possibility of increasing dividends for shareholders). If the state commission refuses to allow utility shareholders to share in the proceeds of allowance sales, the utility's only incentive to seek sales opportunities would be the effect upon rates resulting from such sales; arguably not a significant incentive for a quasi-monopolist. This summary description of the potential impact of state rate-making authority over allowances indicates that there will be significant opportunities for states to either encourage or discourage utility dealings in allowances.

On the federal level, the rate treatment of allowances will almost certainly become an issue in proceedings before the FERC and will thereby bring that agency into conflict with the states. The FERC has jurisdiction over the resale of electricity in interstate commerce, as well as over the assets dedicated to such transactions.⁶⁷ Pursuant to this jurisdiction, the FERC reviews and approves rates for sales of electricity from utilities to other utilities.⁶⁸

At the outset, it must be noted that the FERC may not be in the same position vis-à-vis allowances as the state commissions. A significant difference between federal and state regulation over electric utilities stems from the fact that sales at the wholesale level are essentially voluntary. There is no generally recognized "obligation to serve" flowing from a utility seller to a utility purchaser.⁶⁹ Thus, the FERC may not view allowances with the same parochial concern as do state regulators, who have the duty, and the power, to ensure that utilities adequately serve the consumers in their franchised service territories.⁷⁰

Suppose, for example, the FERC were to take action with regard to utilities' acquisition and disposal of allowances. Because the FERC would likely view these allowances as useful or necessary to making wholesale sales,⁷¹ the Commission would

67. 16 U.S.C. § 824(b)(a) (1988).

68. *Id.* § 824(a), (d), (e).

69. *But see* [1990] 1 Energy Law and Transactions (MB) § 52.03(3) (an "obligation to serve" can be created by contract); *cf.* Gainesville Utilities Dep't v. Florida Power Corp., 402 U.S. 515 (1971) (pursuant to § 262(b) of the Federal Power Act, the Federal Power Commission directed the interconnection of a small municipality-owned utility and a large private electric utility after a finding that the interconnection would be in the public interest, would not unduly burden the private utility, and would benefit both parties).

70. *See* [1990] 1 Energy Law and Transactions (MB) §§ 4.01, 4.02.

71. An example of such an action is a ruling that constrains how or in what manner utilities which have contracts to supply power to other utilities may sell their own allowances. Many utilities have opted to join "power pools," in which the power facilities

probably create a conflict with the policies of state regulators, who view the same allowances as useful or necessary to serving customers at retail. The possible result would be that different regulators could impose conflicting requirements on utilities regarding the same allowances. Unfortunately, however, the new Clean Air Act Amendments provide no guidance on how to determine whether an allowance is properly subject to either state rate authority or federal rate authority, or both. Thus, a substantial degree of regulatory uncertainty exists. For utilities, such uncertainty would not encourage active trading of allowances, as regulated companies usually tend to be risk averse.

Nonpublic utility power (independent power production) sales is another area where the FERC and state regulators may clash over allowances.⁷² The Commission has sought to encourage the development of power generation by independent power producers (IPPs), pursuant to the subsidies provided for certain nonpublic utility generators (qualifying facilities or QFs) under the Public Utility Regulatory Policies Act (PURPA) of 1978,⁷³ and pursuant to the Commission's own interpretation of the Federal Power Act⁷⁴ for nonpublic utility generators who do not qualify for PURPA benefits.⁷⁵ Nonpublic utility generation is still an emerging industry, however, and much future capacity will not be entitled to an allocation of allowances from EPA.

of the utility participants are dispatched on a coordinated basis (called central dispatching) in order to achieve short and long term efficiency gains. Short term efficiencies are made possible by the utilization of the least costly power resource to meet incremental demand at any given point in the day. Long term efficiencies are created by minimizing the need to build new capacity through sharing of the output of all facilities in the power pool. See 2 ALFRED E. KAHN, *THE ECONOMICS OF REGULATION*, 64-65 (1988). Allowances will need to be available and exchangeable for power pools to continue to work smoothly. Therefore, it will presumably fall upon the FERC, which has jurisdiction to approve power pool arrangements, to ensure that this is accomplished; see also 42 U.S.C.A. § 7651b (d)(2) (indicating that allowances may be used in power pool or allowance pool agreements).

72. For a summary of the characteristics of independent power producers, see FERC statutes, *supra* note 52, at 32,103-3.

73. 16 U.S.C. § 824a-3(a).

74. *Id.* §§ 791-828(c).

75. The FERC has explained in several cases its reasons for treating IPPs differently than traditional public utilities. See generally *Doswell Limited Partnership*, 50 Fed. Energy Reg. Comm'n. Rep. (CCH) ¶ 61,251 (Feb. 28, 1990). Under PURPA, utility companies can purchase electricity from QFs at the company's avoided cost, which is defined as the cost of purchasing electricity from an alternative source. However, when the facility is nonqualifying (e.g., an IPP), the avoided cost rate cannot be accepted as just and reasonable under the Federal Power Act. In such cases, the focus must be shifted to whether or not there were market forces at work to establish price and nonprice terms.

These units will, therefore, be forced to rely upon purchases of allowances from the market.⁷⁶ The majority of market sales, however, will be controlled by public utilities, many of whom regard nonpublic utility generation as unwelcome competition.⁷⁷

Will the FERC take action to ensure that IPPs and QFs will be able to purchase allowances from public utilities? The agency could do so under the public interest standard contained in the Federal Power Act,⁷⁸ but again, such action would probably create a conflict with state public service commission policies on allowances.

In sum, the presence of established state and federal regulatory authority over utilities and their activities poses significant potential for inhibiting active trading in allowances. The inhibiting effects could result from direct regulatory action against trading, or from the creation of policies or precedents which serve to reduce the incentives to trade. Finally, the potential conflict between state regulators and the FERC could add complexity and uncertainty to the laws governing utilities. As such, these laws would counteract the congressional intent of establishing a true free market in allowances.

III. A PROPOSAL

Congress was cognizant of the strong potential for adverse actions by the states, and for conflict between the states and the federal government in implementation of the acid rain allowance trading system.⁷⁹ As well, Congress understood that these developments could frustrate its intent to create a marketplace mechanism which would effectuate the multiple objectives behind the enactment of Title IV.⁸⁰ Nonetheless, Congress, in drafting the Amendments, failed to include a preemption provision, or language that would preclude rate regulators from inhibiting the free trading allowances contemplated in the acid rain reduction statute.⁸¹

This section discusses a proposal for minimizing the likelihood of conflicts between state and federal utility regulators:

76. See HOUSE REPORT, *supra* note 2, at 366.

77. See *id.* at 367.

78. 16 U.S.C. § 824(a).

79. See HOUSE REPORT, *supra* note 2, at 366-68.

80. *Id.*

81. Indeed, Title IV expressly provides that state authority over utility rates is not affected. 42 U.S.C.A. § 7651b(f).

federal legislation to establish an acid rain coordinating committee (Committee, or the proposed committee) comprised of representatives from State Public Service Commissions, the FERC, and EPA.

The Committee would assist state and federal rate regulators, as well as EPA, in the adoption of policies on allowances that are mutually compatible and that further the goal of achieving a true free market in allowance trading. To this end, the proposed committee would meet periodically to review existing and proposed policies, and would issue reports, including suggestions for reform. The Committee's reports and other publications would be transmitted to all state utility regulators, members of the FERC, the EPA Administrator, and to the chairpersons and ranking minority members of each relevant congressional oversight committee. The Committee would have the authority to recommend legislation to Congress, and Committee representatives would be available to testify at hearings held by congressional subcommittees.

The Committee could be empowered to perform potentially significant activities, such as the formulation of a model allowance trading policy, for consideration and adoption by the states. Perhaps the best known example of a model statute that has been adopted by virtually all states is the Uniform Commercial Code. This is noteworthy because allowance trading bears some distinct similarities to commercial transactions. For example, although both allowance trading and commercial trading are areas of predominantly state interest, they involve transactions that go beyond state lines. Thus, the model code approach used for commercial transactions might also be successfully adapted for allowance trading.

Through these and other activities, the Committee would implement a single regulatory program (as opposed to a separate program in each state) as well as a federal program. Although the Committee would have no formal authority to implement policies, its opinions and recommendations on the allowance trading system would carry considerable weight. This informal authority would counterbalance the strong centrifugal forces created by the exercise of regulatory authority by the states.

Interestingly, EPA has already expressed an intention to rely heavily on the use of committees in promulgating regula-

tions.⁸² EPA established an "Acid Rain Advisory Committee," composed of representatives from State Public Service Commissions, industry, and environmental groups, to guide the agency in its preparation of SO₂ regulations.⁸³ In addition, the Agency announced, initially, that it would implement the nitrogen oxide (NO_x) provision of Title IV⁸⁴ by means of a "negotiated rulemaking."⁸⁵ In "negotiated rulemaking," the agency's proposed rule is drafted by a committee representing the parties who will be significantly affected by the rule.⁸⁶ As explained by EPA when it first contemplated a negotiated NO_x rule, "negotiation is especially appropriate in situations which involve the resolution of a limited number of related issues, none of which involve fundamental questions of value or extremely controversial national policy."⁸⁷ More recently, the Office of Management and Budget concluded that the NO_x regulation was too significant and potentially too divisive to be left to negotiated rulemaking, and cancelled the negotiation meeting before it convened.⁸⁸ Subsequently, EPA established a subcommittee of the Acid Rain Advisory Committee to focus on NO_x emissions.⁸⁹

While these committees may serve as suggestive precedents for consensus-building on acid rain regulation, the Committee proposed in this article would have a different function: to encourage EPA, the FERC, and the states to adopt mutually compatible, promarket policies and precedents on allowance trading. The proposed committee would also assist in exposing

82. The Committees would be composed of members who represent interests affected by the Amendments. 55 Fed. Reg. 52,884 (1990).

83. See 55 Fed. Reg. 32,134-35 (1990). This committee was established pursuant to the Federal Advisory Committee Act. 5 U.S.C. app. §§ 1-15 (1988).

84. 42 U.S.C.A. § 7651f.

85. *EPA Acid Rain Advisory Committee Meeting* (December 13, 1990) (Statement of William Rosenberg, EPA Assistant Administrator for Air and Radiation).

86. EPA's Regulatory Negotiation Project is an attempt by EPA to improve regulations through a process of negotiation and consensus-building by EPA and affected parties. Specifically, the committees would attempt to reach a common understanding with respect to the issues in, and language of, the proposed regulations. If and when such an understanding is reached, it becomes the basis for the Agency's proposal.

On November 29, 1990, Congress enacted the Negotiated Rulemaking Act of 1990, Pub. L. No. 101-648, 104 Stat. 4969 (codified as amended at 5 U.S.C.A. §§ 581-590), that provides uniform procedures for negotiated rule-making. The Act states that agencies already have authority to establish negotiated rulemaking committees. 5 U.S.C.A. § 582(6).

87. 55 Fed. Reg. 52,884, 52,885 (1990).

88. OMB "PULLS THE PLUG" ON NEGOTIATIONS TO DEVELOP NITROGEN OXIDES CONTROL PROGRAM, 22 *Env't Rep.* (BNA) 331-32 (June 14, 1991).

89. 56 Fed. Reg. 38,435 (1991).

and resolving conflicts that may otherwise undermine the foundation of the acid rain program, thereby playing a far more crucial role than the committees heretofore contemplated by EPA.

