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Editorial Office  
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# FERC Takes Close Look at Carbon Pricing

*By Mark L. Perlis\**

*A Federal Energy Regulatory Commission virtual technical conference presented the commissioners and their staff with different perspectives on major issues that will arise from implementation of carbon pricing in regional transmission organizations and independent system operators organized electricity markets. The author of this article discusses the technical conference.*

The three sitting commissioners of the Federal Energy Regulatory Commission (“FERC”) recently convened 30 industry experts at a virtual technical conference on state adoption of carbon pricing and its implementation in organized, wholesale electricity markets managed by regional transmission organizations (“RTOs”) or independent system operators (“ISOs”). Public interest was high, with more than 2,000 computers across the country logged on to the discussion, which stretched over nine hours.

Although no carbon pricing measures have been filed by RTO/ISOs for consideration by FERC, the sense of the technical conference was that proposals from states or from RTO/ISOs acting on their own initiative are right around the corner.

## THE ISSUES

Discussion at the technical conference revealed complex and potentially contentious issues that FERC may face when considering proposals to incorporate carbon pricing into RTO/ISO electricity markets:

- 1) *Jurisdiction.* Some states have already adopted regulatory schemes for carbon pricing that impose compliance obligations on electricity suppliers (e.g., state-level cap and trade programs that require electric generators to purchase CO<sub>2</sub> emission allowances, as in California and the Northeast Regional Greenhouse Gas Initiative). The consensus view of the panelists was that, under the Federal Power Act (“FPA”), RTO/ISO tariffs may incorporate state-mandated compliance costs, as a normal input price of producing electricity. But does FERC have jurisdiction to approve in RTO/ISO tariffs carbon pricing that is not an out-of-pocket compliance cost? Panelists posited that RTO/ISOs might propose to require that all generators located within the

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\* Mark L. Perlis, an energy and environmental attorney, is of counsel at Covington & Burling LLP with a federal regulatory and litigation practice encompassing all aspects of the electric utility industry. He may be reached at [mperlis@cov.com](mailto:mperlis@cov.com).

RTO/ISO region include in their marginal cost-based bids an imputed carbon price assessed for each ton of carbon emissions (i.e., the carbon price is not incurred to comply with a state regulatory program)? These panelists opined that FERC has authority to approve an RTO/ISO tariff that requires generators to include the carbon price of their emissions in their cost-based bids.

A third case was also considered: May FERC require that the price of carbon be included in all cost-based bids, even where RTO/ISOs have not chosen to include carbon pricing in their tariffs and states have not chosen to mandate carbon pricing? This case presented a divergence of views on the extent of FERC's jurisdictional authority under the Federal Power Act.

Some panelists believed FERC could mandate that all RTO/ISOs adopt carbon pricing.

Other panelists believed that FERC has limited authority to mandate inclusion of carbon pricing everywhere, whereas FERC has broader authority to approve carbon pricing proposals that individual RTO/ISOs develop through their stakeholder and governance processes.

There was an undercurrent in the discussion to the effect that, in the first instance, FERC might prefer to consider carbon pricing through an RTO/ISO-initiated proposal (via a FPA Section 205 tariff filing) ahead of any request (such as via a complaint filed under FPA Section 206) that FERC consider mandating all RTO/ISOs to adopt carbon pricing rules in their tariffs.

- 2) *Who sets the imputed carbon price and on what basis?* A proposal being developed by a New York Independent System Operator ("NYISO") stakeholder process would require generators to include the carbon price of their CO<sub>2</sub> emissions in offer bids in the energy market. Under this draft proposal, the carbon price would be established by a state agency that would determine the social cost of carbon. Some panelists questioned whether the RTO/ISO should delegate to a state agency to determine the carbon price and other panelists questioned whether FERC should defer to a state agency determination of the appropriate carbon price.

Questions raised but not conclusively answered during the technical conference included:

- Should FERC establish criteria for determining the carbon price?
- Is there a "zone of reasonableness" that FERC could set, so that carbon

prices are not too low and not too high?

- What if different states estimate different social costs of carbon or set the carbon price based on criteria different from the social cost of carbon?
- Should FERC seek to impose uniformity or to encourage diversity of approaches to the setting of a carbon price within each state of a multi-state RTO/ISO and across all RTO/ISO markets in the nation?

Most panelists expected that FERC would be receptive to varying approaches to setting the price of carbon across states within a multi-state RTO/ISO and across all RTO/ISO markets in the country.

3) *Implications of non-uniformity of carbon pricing rules.* Many questions from the commissioners presumed that there would be different carbon pricing rules and different carbon prices charged within a multi-state RTO/ISO and across different RTO/ISOs. These questions probed whether the absence of homogenous rules would:

- Undermine some state emission-reduction policies (a concept known as “emissions leakage”):
- Encourage arbitrary contractual arrangements to circumvent carbon pricing rules (a concept known as “resource shuffling”); or
- Cause generators facing high carbon prices to experience unfair competitive disadvantages vis a vis generators in different states or regions facing lower, or no, carbon prices (a concept implicating economic efficiency and a statutory injunction against “undue discrimination”).

Panelists expressed diverse views relating to which policy and legal concerns the Commission might give priority.

Suffice to say here, RTO/ISO carbon pricing proposals that lack homogeneity across states, resource types, and regions of the country are likely to raise difficult issues relating to differential impacts on electricity prices paid by consumers, potential competitive disadvantages that could interfere with efficient energy markets, and problems of tracing electricity that is exported from energy markets with one carbon pricing regime (e.g., lower carbon prices) to energy markets with a different carbon pricing regime (e.g., higher carbon prices).

Both commissioners and panelists expect that the proverbial devil may surface in the details of implementation of non-homogeneous carbon pricing rules.



- 4) *Revenue recycling.* Carbon pricing will be applied in complex RTO/ISO electricity markets that feature auction-based market-clearing prices for electricity being established in each pricing interval (which could be as short as five or ten minutes), and at multiple pricing locations. In these markets, all generators will be paid the market-clearing price and all consumers will pay the market-clearing price.

Accordingly, carbon pricing proposals will include mechanisms that impose carbon charges on actual emissions, such that zero-emitting resources receive higher net electricity market revenues per unit of electricity sold than carbon-emitting resources receive for their electricity sales.

The flip side of this market design issue is that consumers will be paying the market-clearing price for all electricity consumed, which will reflect the carbon price paid by the least efficient, carbon-emitting resource. Most carbon pricing proposals incorporate “revenue recycling” mechanisms that take a portion of the carbon charges collected in electricity prices and rebate those charges to consumers.

In some states that have already implemented carbon charges, such as California’s carbon cap and trade program, carbon charges collected through the auctioning of emission allowances is spent by the State on a variety of programs that include consumer rebates and also new spending for state-favored environmental investments (such as high-speed rail or vehicle electrification infrastructure). FERC will need to decide whether and how to permit or to require RTO/ISOs to recycle a portion of the carbon charges to buyers in the wholesale electricity markets and, through them, to retail consumers. And, FERC may need to consider the role of states in directing how carbon charges are to be recycled.

- 5) *Will carbon pricing displace other forms of state carbon regulation?* To many economists, carbon pricing is the most efficient and favored policy tool for reducing carbon emissions. However, to date, states have been more likely to adopt subsidy programs and indirect carbon pricing programs, such as renewable portfolio standard requirements, that incentivize low- or zero-emission generation resources. A question that many panelists asked was whether, with the advent of carbon pricing through the electricity market, states could or should be required or expected to reduce their reliance on subsidy and indirect pricing programs. If not, it was argued by some that consumers will be paying twice for the same carbon reductions and zero-emitting resources will, in effect, be paid double for their zero-carbon profile.

Some panelists suggested that FERC may want to encourage or direct that states reduce their reliance on subsidy programs, if RTO/ISOs in their region adopt carbon pricing. Other panelists argued that retention of other subsidy programs should be a matter of states' prerogatives, subject only to limitations imposed by the legal doctrine of preemption.

## **CONCLUSION**

The FERC technical conference presented the FERC commissioners and their staff with different perspectives on each of these, and other, legal, economic and market design issues that will arise from implementation of carbon pricing in RTO/ISO organized electricity markets. Now, all that FERC has to do is wait for and respond to the first RTO/ISO carbon pricing tariff proposals to be submitted for review and approval under FPA Section 205.