

2EX 880

Perhach, William

From: Marlo Lewis [mlewis@cei.org]
Sent: Wednesday, October 15, 2003 1:27 PM
To: Fiddelke, Debbie S.
Subject: Competitive Enterprise Institute Commentary on the McCain-Lieberman Climate Stewardship Act

Op-ed posted today at Tech Central Station <http://www.techcentralstation.com/101503E.html>

McCain's Nose-Under-the-Tent Strategy

by Marlo Lewis, Jr.

Who does Senator John McCain (R-Ariz.) think he is fooling?

McCain's "Climate Stewardship Act" (S. 139), co-sponsored with Senator Joe Lieberman (D-Conn.), and soon to be voted on in the Senate, started out as a roadmap back to the Kyoto Protocol, the UN global warming treaty that President Bush rejected in March 2001. As originally introduced, McCain's bill would require the United States to reduce emissions of greenhouse gases, chiefly carbon dioxide (CO₂) from fossil energy use, to year 2000 levels in 2010 ("Phase I") and 1990 levels in 2016 ("Phase II"). Not as restrictive as the U.S. Kyoto target (7 percent below 1990 levels during 2008-2012), but close enough for government work. Too close, in fact, to be viable in today's political climate.

To win new supporters, Sens. McCain and Lieberman have announced they will introduce an amendment to strike Phase II from the bill. But does anyone believe for a moment that enacting Phase I would appease rather than embolden the Kyoto lobby, or that enacting Phase I today would not make it easier to enact Phase II tomorrow?

More importantly, any cap on carbon, however modest, would be a precedent-setting defeat for economic liberty and affordable energy. The executive branch has no authority under current law to regulate CO₂ -- the inescapable byproduct of the carbon-based fuels that supply 87 percent of all the energy Americans use. Enacting Phase I would cross a legal and policy Rubicon, launching an era of energy rationing. There would no longer exist any difference in kind between U.S. national policy and Kyoto. U.S. ratification of Kyoto would almost certainly follow.

With or without Phase II, McCain's bill would -- like Kyoto -- establish the institutional framework for a succession of increasingly stringent controls on energy use. Indeed, Section 336 states that the Undersecretary of Commerce for Oceans and Atmosphere shall determine "no less frequently than biennially" whether the bill's emission caps remain "consistent" with the "objective" of preventing "dangerous" human interference with the climate system. Commerce would become a permanent lobbyist within the executive branch for new taxes or caps on carbon-based energy.

So when McCain asks colleagues to support Phase I, he might as well say, "I just want to put the camel's nose under the tent -- what possible harm could there be in that?"

Which raises a more basic question: Why is McCain so blasé about the potential costs of an open-ended regulatory agenda? The answer is that McCain believes Kyoto could be a free lunch -- or even a road to riches. Consider this excerpt from his July 28, 2003 "Dear Colleague" letter on climate issues (Appendix A, p. 12):

Another study found that the perception that emissions reduction targets such as those of the Kyoto Protocol are unavoidably costly or unfair is the result of outdated modeling assessments. In fact, the study demonstrated how the U.S. could meet targets in the Kyoto Protocol by 2010 and exceed them by 2020 while increasing economic output from base line growth projections. By 2010, an integrated least-cost strategy would produce an annual gain of \$50-60 billion per year. By 2020, this gain could grow to \$120 billion per year, or 1% of GDP. On a cumulative net present value basis, the U.S. would gain \$250 billion by 2010 and \$600 billion by 2020.

The study McCain cites is *Cutting Carbon Emissions at a Profit: Opportunities for the U.S.*, published in May 2001 by the International Project for Sustainable Energy Paths (IPSEP). The IPSEP study, in turn, builds upon *Scenarios for a Clean Energy Future* (CEF), a November 2000 analysis prepared by the Interlaboratory Working Group, a team drawn from the Department of Energy's (DOE's) five national labs. In all likelihood, few Senators or their staffs have read CEF, and fewer still have even heard of the IPSEP report. Yet if McCain's bill has an economic justification, those studies are it.

IPSEP argues as follows. (1) Implementing the domestic policies detailed in CEF -- a doubling of public and private funding for energy efficiency and renewable energy research, development, and demonstration (RD&D) programs, targeted tax incentives, expansion of efficiency standards, and the like -- would reduce America's "energy bill" by \$60 billion in 2010 and \$120 billion in 2020. The concomitant decline in energy intensity and shift to low- and non-carbon fuels would meet 30 percent of the U.S. Kyoto target in 2010 and half in 2020. (2) Adding a \$65 per ton carbon charge would fully achieve the U.S. Kyoto target in 2010, while a \$77 per ton charge would reduce emissions to 20 percent below 1990 levels in 2020. (3) Capping carbon would raise energy costs and slow economic growth. However, policymakers could offset any GDP loss by using the proceeds from carbon taxes or permit sales to cut taxes on labor and capital. After netting out the positive and negative impacts, Americans would still reap the "energy bill" savings from the CEF policies.

Two problems leap to mind. First, S. 139 omits the only component of IPSEP's "least-cost strategy" with proven economic value. Tax cuts can stimulate growth and, in principle, offset GDP losses from carbon regulation. However, McCain's bill makes no provision for tax cuts. Instead, following political rather than economic logic, S. 139 would use the proceeds from carbon permit sales to boost welfare payments ("transition assistance to dislocated workers and communities"), not GDP. According to IPSEP, cutting taxes on investment would be the most productive way to "recycle" carbon charges back into the economy. However, when was the last time McCain's comrade, Sen. Lieberman, called for tax cuts on dividends, capital gains, or corporate profits?

Second, McCain and IPSEP ignore opportunity costs. Even if the "least-cost strategy" worked exactly as advertised, it would not be a free lunch. Consumers would still lose billions in unrealized GDP growth, because the economy would be even stronger if Congress just cut taxes on capital and labor without taxing energy. In addition, the financial, administrative, and scientific assets dedicated to energy efficiency and renewable energy programs would compete with RD&D investment in other high-tech fields. Where is the evidence that, dollar for dollar, research on, say, wind turbines yields higher economic and environmental dividends than research on fossil energy exploration and production technologies?

IPSEP's "point of departure" is the CEF study by DOE's five labs. IPSEP and McCain seem completely oblivious to the self-serving nature of that report. CEF forecasts billions in energy savings if -- but only if -- Congress doubles the labs' RD&D budgets.

Unlike the DOE labs, the U.S. Energy Information Administration (EIA) has nothing to gain or lose from adoption or rejection of the CEF policies. In an October 2001 report. [1] requested by Senators Lieberman and Jeffords (I-Vt.), EIA identified several problems in the CEF study.

Hyped RD&D. "A specific link cannot be established between levels of funding for research and development and specific improvements in the characteristics and availability of energy technologies," says EIA. "Because these funding increases are questionable and the link between funding and technology development is tenuous, the suggested technology improvements based on these research and development policies are also questionable."

EIA is too kind. CEF's RD&D agenda is mostly old wine in new bottles. For example, DOE has spent billions over two decades trying to develop and commercialize non-hydro renewable electric generation. Yet DOE backing, multi-billion dollar taxpayer and ratepayer subsidies, and state-level mandates ("portfolio standards") requiring utilities to deploy such technologies, have not made renewable generation competitive. Currently, non-hydro renewables contribute less than 3 percent of total U.S. electric generation.

DOE has not only backed losing horses, it has also failed to invest in winners. As energy expert Rob Bradley observes: "The fuel of choice for electricity generation has turned out to be the fuel that the DOE did not feature in its R&D portfolio -- natural gas." Bradley estimates that out of \$60 billion (in FY96 dollars) expended from FY78 through FY96, DOE spent only 1 percent (\$787 million) on natural gas. [2] McCain's faith in politically-directed RD&D ignores what MIT's Thomas Lee, Ben Ball, Jr., and Richard Tabors consider a key "lesson learned" from previous energy programs: "The experience of the 1970s and 1980s taught us that *if a technology is commercially viable, then government support is not needed and if a technology is not commercially viable, no amount of*

government support will make it so." [3]

Implausible cost and efficiency estimates. CEF forecasts that, with the right mix of programs, a central air conditioner with 70 percent greater efficiency than the least efficient unit would, by 2011, cost no more than the least efficient unit. "It seems unlikely that either research and development or voluntary programs could reduce technology costs to that level," comments EIA. "Other technology assumptions also appear unrealistic -- for example, the assumption that generating plants using CO₂ sequestration technology would achieve the same efficiency as those that do not." Similarly, EIA finds "extremely unrealistic" CEF's projection -- "not attributed to any specific policy" -- of a 16 percent *per year* efficiency increase in natural gas consumption between 2011 and 2020.

Make believe "hurdle" rates. Consumers and firms do not rush out and buy the latest appliance, equipment, or vehicle just because the discounted value of future energy bill savings would exceed the extra cash required to purchase the most efficient model. Motorists tend to value the utility, performance, and safety of an automobile more than its fuel economy. Businesses consider not only whether the returns on an energy-efficiency investment would exceed the up-front cost, but also whether other investments would produce higher profits. In markets where energy costs are expected to decline (the U.S. long-term trend), people naturally attach less value to future energy savings.

Consequently, an energy efficiency investment must have a relatively high rate of return -- what economists call the "hurdle rate" -- before consumers and firms will consider it worth the expense. In EIA's analysis, hurdle rates for the most energy-efficient models can be as high as 83 percent for electric water heaters, 90 percent for clothes dryers, 125 percent for room air conditioners, and 391 percent for clothes washers. The CEF study, by contrast, assumes a 15 percent hurdle rate for all major appliances. [4] This assumption, notes EIA, implies that "non-financial factors play no part" in consumer decisions -- a ludicrous notion. It also means that consumers are willing to lose money for the sake of energy efficiency, because "many of these purchases are financed through credit card accounts with rates above 15 percent."

Low-balled electricity demand. According to EIA data, electricity consumption for "miscellaneous" household uses, which include clothes washers, dishwashers, and home electronics, increased 70 percent from 1990 to 1997. In the CEF scenarios, electricity demand in this category increases slowly over the next 20 years. Given the historical growth in miscellaneous uses, and the fact that some appliances, such as those with heating elements, cannot incorporate energy efficiency into their design, EIA finds it "difficult to credit this magnitude of electricity savings from voluntary programs and State market transformation programs, as stated in the CEF report." Similarly, EIA finds it "difficult to credit" CEF's projected energy savings in miscellaneous commercial electricity uses such as telecommunications equipment, automated teller machines, and exit signs.

Make believe market failures. Based on engineering-cost studies, which purport to show handsome profits from relatively modest efficiency investments, CEF and IPSEP conclude that market "barriers" and "failures" must be preventing consumers and firms from seizing so many win-win (good for the economy, good for the environment) opportunities. EIA rejects that assessment, noting that "many of the presumed market failures are actually rational, efficient decisions on the part of consumers given current technologies, expected prices for energy and other goods and services, and the value they place on their time to evaluate options."

As economists Ronald Sutherland and Jerry Taylor point out, when a homeowner chooses to save his money for junior's college tuition payment rather than "invest" it in a high efficiency refrigerator, or declines to install the most efficient air conditioning system because he plans to sell his house before any net savings would materialize, that is not a market failure. When markets cater to such revealed consumer preferences, they are working efficiently. [5]

Studies like CEF postulate widespread market failure because they confuse energy efficiency with the efficient use of energy resources. Where energy is relatively abundant and inexpensive compared to labor and capital (the long-term U.S. experience), using lots of energy is economically efficient while investing heavily in conservation is not. It depends entirely on the circumstances facing each firm whether minimizing energy consumption (the goal of energy efficiency) would also minimize the firm's total cost (the goal of economic efficiency) rather than simply restrict output or shrink profits. Government is no better qualified to determine whether "we" use too much energy than it is to determine whether "we" use too much labor or capital. Thus, federal efforts to bias investment in favor of energy conservation are likely to misallocate resources. Adding a carbon tax would just pile inefficiency on top of inefficiency.

McCain's bill is a house of cards. Its economic justification is a study (IPSEP) that proposes tax cuts -- a policy not included in S. 139. That study, moreover, is built on another (CEF) that exaggerates the prowess of politically directed RD&D; low-balls advanced technology costs, consumer hurdle rates, and future energy demand; and proposes to remedy illusory market failures. Are Senators who may be inclined to support S. 139 prepared to defend the assumptions, logic, and results of those studies?

The Climate Stewardship Act would not be a free lunch, much less the imagined bonanza of IPSEP's "least-cost strategy," and the economic damage would grow over time as Phase I evolves into Phases II, III, etc. But pro-consumer, pro-energy policymakers should take heart. With a modicum of clarity, discipline, and resolve, they not only can keep the camel's snout out of the tent, they can also give the beast a bloody nose.

Marlo Lewis is a senior fellow at the Competitive Enterprise Institute.

NOTES

1 EIA, *Analysis of Strategies for Reducing Multiple Emissions from Electric Power Plants with Advanced Technology Scenarios*, October 2001. See especially pp. 14-15, 53-54, 58-59, 85-86

2 Robert L. Bradley, Jr., *Renewable Energy: Not Cheap, Not 'Green,'* Cato Policy Analysis, No. 280, August 27, 1997.

3 Thomas Lee, Ben Ball, Jr., and Richard Tabors, *Energy Aftermath: How We Can Learn From the Blunders of the Past to Create a Hopeful Energy Future* (Boston: Harvard Business School Press, 1990), p. 167 (original emphasis).

4 Interlaboratory Working Group, *Scenarios for a Clean Energy Future*, November 2000, Appendix A-1.9.

5 Ronald Sutherland and Jerry Taylor, *Time to Overhaul Federal Energy R&D*, Cato Policy Analysis, No. 424, February 27, 2002, p. 13.