Externalities Mean Definite Costs, Questionable Benefits

National Coal Association

Using residual and external environmental values in setting goals, screening conservation programs or in resource planning is not desirable environmental or regulatory policy, Dr. Richard Schmallensee told the Florida Public Service Commission during conservation and demand-side management hearings last week.

Dr. Schmallensee testified on behalf of the Center for Energy and Economic Development, saying that while environmental values appear on the surface to match textbook approaches to internalize externality costs, this simple view ignores many important issues, both conceptual and practical.

Dr. Schmallensee is currently Director of the Massachusetts Institute of Technology's Center for Energy and Environmental Policy, and a former member of President George Bush's Council of Economic Advisors. He listed several flaws in the externality theory including:

- The use of an externality approach in integrated resource planning or in screening for appropriate conservation programs will distort economic decision making rather than create the desired incentives;
- While imposing externalities appears to fulfill economists' prescription for internalizing externalities, in reality these programs tend to run at cross purposes to a complex set of existing environmental regulations on many different levels from local authorities to state, federal and environmental regulatory authorities – which already internalize many environmental effects; and
- Regulatory policies that incorporate environmental values for facilities under the authority of the commission may exacerbate environmental externalities rather than reduce them because of the piecemeal nature of the coverage.

Environmental values will only be applied to emissions from facilities under the jurisdiction of the commission. Hence, the cost of these facilities will rise, Dr. Schmallensee said, resulting in higher rates for utility customers.

"Alternatives to utility generated power are becoming increasingly accessible to large utility customers. If costs from environmental value are passed on to utility customers, a growing number of customers may find alternative power supplies an attractive option. Thus the pursuit of environmental goals in the utility planning process may circumvented by shifts in demand to non-utility supplies. Rather than reducing societal costs, such shift may increase both electricity rates and air pollution," he said.

Dr. Schmallensee warned that the application of externality values to utility planning would be especially damaging for the Florida economy, because Florida's electric rates are among the highest in the Southeast.

He maintained that any benefits of short-term expenditures are likely to be outweighed by the longer-term effects on higher electric rates and the impacts on residential users as well as business and industrial development.

The commission and the Florida legislature should be wary of measures which appear to address environmental procedure and have obvious costs, but provide no guarantee of any net environmental benefits, Dr. Schmallensee warned.
Massachusetts Court Rejects Environmental Externalities

National Coal Association

The concept of environmental externalities suffered the latest in a recent series of judicial and regulatory setbacks late last month when the Massachusetts Supreme Judicial Court struck down rules that would have imposed an adder on the costs of coal-fired power.

The unanimous four-member panel rejected provisions adopted by the Massachusetts Department of Public Utilities (MDPU), saying the agency's decision "reflected the value of environmental externalities beyond the range of its statutory authority to do so." Appellants in the case were NCA and the Massachusetts Electric Co. (MECO).

The court noted that the MDPU, in setting externality values, had used "what has been called the implied valuation method, a method that does not directly value the financial impact of the effects of a pollutant, but rather measures the costs of less harmful polluter, will be selected and reducing the emission or (its) effects ...."

The court, however, recognized that "(it) seems to be generally agreed that in theory and logic the use of the damage valuation method would be the better approach, that is, determining 'a set of comprehensive and accurate damage costs for all pollutants'."

The court found that using either method in the Integrated Resource Management process "does not cause pollution damage costs to be specifically reflected in the electric utility rates paid by an electric utility's customers," the court said.

Rather, the court found the consequence "is simply that a currently more costly alternative source, one that is perceived to be a less harmful polluter, will be selected and the electric utility, and ultimately its ratepayers, will pay more for electricity."

While recognizing the MDPU had broad authority to regulate electric utilities, the court said the agency "does not have the responsibility for the protection of the environment."

The court also disagreed with the MDPV's conclusion "that increased costs (and hence higher rates) are justified solely because of the potential or real effect of pollution on other than ratepayers, or, as the department put it, on 'the rest of society in the form of increased health care expenses, economic impacts on material and agricultural resources, and a reduced quality of life'."

NCA had argued in the case that the department "has no jurisdiction under state law to mandate the use of monetized environmental externality values in the resource procurement decision of electric activities."

MECO had filed suit against the rule because, it said, the rule would raise rates as much as $70 million a year for MECO customers alone -- "costs . . . that ratepayers otherwise would not have to pay."

The ramifications of the decision are great, both for Massachusetts specifically, and for the general externalities initiative being pushed by environmentalists in several states.

At this point, Massachusetts, which in many respects led the charge for environmental externalities among states, has no values. As a result of the court decision, reimposition of the values would be difficult without legislative action granting the MDPU such authority.

From the broader perspective, the Massachusetts court decision, based on statutory authority, comes after a Nov. 22 decision in which the Illinois Commerce Commission (ICC) rejected externalities on their merits. The ICC was starkly critical of concepts the U.S. Department of Energy will consider in public hearings scheduled for January 19.