

Inferring Carbon Abatement Costs in Electricity Markets: A Revealed Preference Approach using the Shale Revolution

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Abstract

This paper examines how carbon pricing would reduce emissions in the electricity sector. We show how both carbon prices and cheap natural gas reduce, in a nearly identical manner, the historic cost advantage of coal-fired power plants. The shale revolution has resulted in unprecedented variation in natural gas prices that we use to estimate the potential effect of a carbon price. Our estimates imply that a price of \$20 (\$70) per ton of carbon dioxide would reduce emissions by 5% (10%). Furthermore, carbon prices are much more effective at reducing emissions when natural gas prices are low. In contrast, modest carbon prices have negligible effects when gas prices are at levels seen prior to the shale revolution.

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1 Introduction

Climate change is a global problem with uncertain and potentially costly effects lasting centuries. Regulators are implementing or considering diverse policies to mitigate climate change. Market-based instruments are recognized by economists as cost effective even though skeptics question their effectiveness. Although debated frequently, a federal price on carbon remains elusive in the US.¹

This paper examines how a carbon price is likely to affect emissions from the US electricity sector, which accounts for about one third of US greenhouse gases (EPA 2013). Firms can respond to carbon prices immediately by altering the mix of power plants used to meet demand: this is known as fuel switching. The EPA’s Clean Power Plan proposed rule expects fuel switching (“building block two”) to be the major mechanism for compliance.² Lafrancois (2012) estimates that switching generation from the currently operating coal plants to the available, underutilized capacity at natural gas plants could reduce carbon dioxide (CO₂) emissions from the electricity industry by 23 to 42 percent. Whether or not this is feasible given the constraints on the electricity grid is an empirical question. This paper measures the expected near-term emissions reductions from a range of carbon prices.

In order to do this, we consider how carbon prices influence the marginal cost of producing electricity. The first contribution of this paper is to show how a carbon price provides similar incentives for fuel switching as does a change in the cost ratio: namely the price of coal (per unit of heat content) over the price of natural gas. Briefly, higher carbon prices make coal-fired power plants less competitive than natural gas-fired power plants. Other power plants (nuclear, hydroelectric, and other renewables) have low marginal costs and remain inframarginal.³ Similarly, when the cost ratio rises, natural gas plants gain an advantage: some cheap baseload coal plants may be displaced by even cheaper combined-cycle natural

¹Some policies have set a price on carbon dioxide. These include the EU’s Emissions Trading System, British Columbia’s carbon tax, northeastern states’ Regional Greenhouse Gas Initiative (RGGI), and California’s Cap-and-Trade (CAT) Program. In June 2014, EPA proposed the Clean Power Plan that could be implemented as a cap-and-trade program. Past attempts to set a national carbon price include the Waxman-Markey bill.

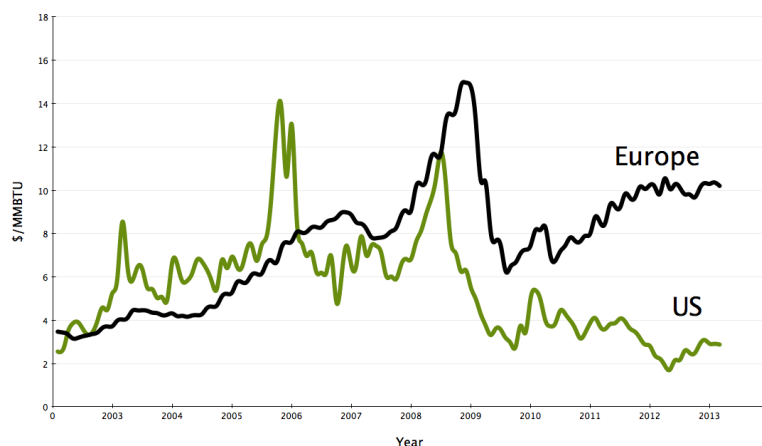
²The EPA (2014) reports the expected emissions rate reductions for each building block and state. For 20 states, fuel switching accounts for the majority of the reductions while building blocks 1, 3, and 4 are dominant in 1, 14 and 14 states, respectively (Vermont is exempt).

³Oil-fired power plants produced less than 1% of the electricity during our sample (EIA 2014).

gas plants. While broadly this is true of other pollutants, we discuss why the mapping from cost ratios to carbon prices is substantially more precise. This mapping is important since we have no national carbon price that we could use to identify the marginal cost of abating carbon. Even where there are regional policies, there is limited variation in carbon prices.

On the other hand, we have recently observed abundant variation in natural gas prices. Technological advances in drilling (*i.e.*, hydrofracturing) have allowed firms to extract natural gas from shale formations. This “shale revolution” has resulted in a short run glut of gas: natural gas production has increased 26 percent from 2005 to 2012.⁴ Furthermore, there are limited options to export substantial quantities of natural gas outside of North America. As a result, gas prices have dropped from over \$12 per million British thermal units (mmBTU) to less than \$2.⁵ In 2012, gas in the US was less than a third of the cost of gas in Europe (see Figure 1).⁶

Figure 1: US and European Natural Gas Prices



Using recent variation in fuel prices, we estimate the relationship between CO₂ emissions and the coal-to-gas cost ratio using a flexible functional form. This revealed preference approach measures actual behavior of firms in the market, whatever may be their incentives and information sets as well as the constraints of their power plants and the electricity grid.

⁴The Energy Information Administration (EIA) provides data on monthly natural gas production at www.eia.gov/dnav/ng/hist/n9010us2m.htm (accessed August 7, 2014).

⁵Henry Hub prices were \$12.69 per mmBTU in June 2008 and \$1.95 in April 2012. The EIA provides these monthly prices at www.eia.gov/dnav/ng/hist/rngwhhdm.htm (accessed August 7, 2014).

⁶The sharp drop in prices in 2008 reflects the recession. Since then, European prices have returned to levels seen before the recession while US prices remain low due to shale gas production (EIA 2012). These data are nominal prices from the World Bank Commodity Price Data (Pink Sheet).

Our analysis controls for several factors, including electricity load (the quantity consumed), temperature, generation from non-fossil sources, and net imports from Canada. In addition, we use time period fixed effects to proxy for macroeconomic shocks, other policies affecting the electricity sector, and general trends in power plant entry and exits. This paper uses aggregate market-level data and does not control for the set of operating power plants. Therefore, our cost ratio coefficients may also capture any effects of entry or exit, retail pricing, or other factors that are correlated with fuel prices and are not perfectly correlated with the controls. Thus, while our focus is on fuel switching, we recognise that our estimates may capture a broader set of near-term abatement responses.

The first set of results directly examines how fuel prices affect carbon emissions. We find that when gas prices fall from \$6 per mmBTU to \$2, holding coal prices fixed, we predict a ten percent drop in aggregate CO₂ emissions. Next we map this response curve into carbon prices. When baseline prices of natural gas are low, carbon prices are effective at reducing emissions. In particular, at the Energy Information Administration's expected fuel prices over the next decade (EIA 2012), we find that even a carbon price of \$10 (\$20) per ton of CO₂ would reduce emissions about two (five) percent. A mandate of a ten percent reduction would be costly: the carbon price would need to be approximately \$70/ton and would cost over \$6 billion a year.

In contrast, when coal holds a sizable cost advantage over natural gas, a marginal change in the cost ratio has no notable effect on emissions. Even a moderate carbon price would have a limited impact on emissions. For example, if gas prices return to historic levels (due to environmental regulations either banning or raising the costs of hydrofracking), then even a price of \$20 per ton of CO₂ would reduce emissions by less than one percent. Even a \$70/ton price would only reduce emissions by approximately six percent.

We also decompose the emissions effects by fuel type to test if our findings are consistent with fuel switching. We find that a carbon price increases emissions from gas plants: a \$20 carbon price (relative to EIA-forecasted fuel prices) increases aggregate emissions by less than one percent through this mechanism. However, the emissions reductions from coal plants more than offset this effect. The same \$20 price will decrease aggregate emissions by almost six percent because of coal plants operating less. Finally, we show how a carbon

price can result in co-benefits by reducing local emissions, in aggregate, in an approximately proportional manner. We find spatial heterogeneity in this response, which matters for health effects (Burtraw, Krupnick, Mansur, Austin & Farrell 1998).

We acknowledge that, in addition to the impacts we estimate, carbon prices provide further incentives for a multitude of responses that go beyond fuel switching (Fowlie, Goulder, Kotchen, Borenstein, Bushnell, Davis, Greenstone, Kolstad, Knittel, Stavins, Wara, Wolak & Wolfram 2014).⁷ Consumers facing higher electricity prices will conserve energy, for example, by using energy-efficient technologies. Firms will build power plants that pollute few, if any, carbon emissions. In addition, companies may invest in order to make existing power plants operate more efficiently. These options are important in considering the overall effect of a carbon policy in the long run. However some carbon policies, like California's CAT and RGGI, are designed to protect consumers from rate increases. Furthermore, these other options take time (power plants are long lived) while policy tends to seek short-term performance.⁸ Carbon pricing will lead to new investments and demand response in time, however the near-term response from fuel switching can be an important component from a political perspective.

Our research relates to two recent literatures. One simulates counterfactual short-run effects of a carbon tax on emissions using calibrated or structurally estimated models.⁹ A second literature examines how the low natural gas prices reduced emissions from the power sector using calibrated models and reduced-form estimates.¹⁰ Many of these papers estimate

⁷Fell & Linn (2013) model how carbon prices compare with other renewables policies through a number of pathways to reducing emissions.

⁸For example, the EU ETS was criticized for over-allocating permits making the policy ineffective in its first few years (Ellerman & Buchner 2007). Similarly, RGGI has had extremely low prices which has led regulators to tighten the cap in 2013.

⁹Papers using calibrated models to simulate outcomes include Metcalf (2009), who uses MIT's Emissions Prediction and Policy Analysis model, and Newcomer, Blumsack, Apt, Lave & Morgan (2008) construct supply functions based on static, least-cost optimization. Least-cost dispatch models assume firms (1) minimize costs, (2) have perfect information, (3) take all input prices as given, (4) do not face start up costs, ramping constraints, or other unit commitments, and (5) are only subject to the constraints of the grid as modeled by the researcher. In contrast, Cullen (2015) estimates a structural, dynamic model of power plant production decisions in the Texas electricity market to simulate counterfactual outcomes.

¹⁰Calibrated least-cost dispatch models include Venkatesh, Jaramillo, Griffin & Matthews (2012). Reduced-form estimates include Holladay & LaRiviere (2014), Linn, Muehlenbachs & Wang (2013), Knittel, Metaxoglou & Trindade (2014), Pratson, Haerer & Patio-Echeverri (2013), and Lu, Salovaara & McElroy (2012). Holladay & LaRiviere (2014) use hourly data for each of the eight North American Electric Reliability Corporation (NERC) regions to estimate the marginal emissions from regional fossil-fired gross generation.

how a carbon price would reduce emissions from the US electricity industry. However, comparing the findings for a given carbon price is not straightforward.¹¹ Our study complements these papers by using observed market behavior to generate reduced-form estimates of near-term abatement costs. The main advantage of our approach over a least-cost dispatch model is that we are not assuming any behavior of firms in estimating the relationship between emissions and fuel prices. Our paper accounts for the integrated grid across regions, estimates a flexible functional form of the daily cost ratio, and examines a longer time horizon with greater heterogeneity in natural gas prices.

We proceed with a brief discussion of the electricity industry in Section 2. Section 3 shows how cost ratios map into carbon prices and discusses caveats. Sections 4 and 5 describe the data and empirical model, respectively, on the link between fuel costs and carbon emissions. Section 6 shows the results of this model and then uses these estimates to examine the implications for carbon pricing. Section 7 extends our analysis to study a high gas price situation and to measure the co-benefits of pricing carbon, namely reductions in local pollutants. Section 8 discusses the long-run effects of carbon pricing. Finally, we offer our conclusion in Section 9.

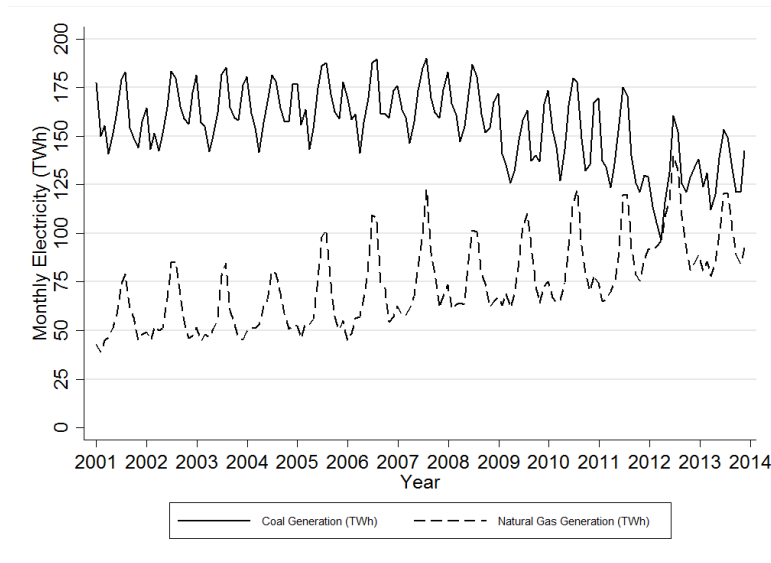
2 Background

Coal-fired power plants produce most of the electricity in the US (EIA 2014). On average, these baseload plants have low operating costs, are slow to adjust, and are costly to start up. However, there is substantial heterogeneity in the marginal cost of operating these plants. Some older, less efficient plants operate only during relatively high demand months. Most gas-fired generators fall into two categories: gas turbine peaker plants and combined cycle gas turbines (CCGT). Peaker plants have relatively low capital costs and high marginal costs. They operate during high demand hours, as power is prohibitively expensive to store and

Linn et al. (2013) and Knittel et al. (2014) show how plant-level monthly production decisions change with cheap gas. Pratson et al. (2013) calculate the average cost of electricity generation for individual fossil plants and relate it to the coal-to-gas cost ratio. Lu et al. (2012) relate the monthly share of coal generation in a census region to the cost difference between natural gas and coal.

¹¹There are differences in the underlying assumptions on baseline fuel prices, demand response, units of analysis, format of the results, region of analysis, and time period of analysis. While such a comparison would be interesting, it is beyond to scope of this paper.

Figure 2: Monthly Generation by Fuel Type



demand varies substantially over hours of the day and across seasons. In contrast, baseload CCGT plants are the most efficient fossil plants at turning the fuel’s energy into power: *i.e.*, they have low heat rates. As such, some gas-fired power plants may have lower marginal costs than the most efficient coal plants *even* if coal costs less, per BTU, than natural gas.

Lower gas prices have been a boon for gas-fired generators in the US. Efficient gas power plants found themselves in the position to undercut coal-fired power plants. Figure 2 shows the monthly average electricity generation for power plants burning coal or natural gas from 2001 to 2013.¹² While coal-based generation has generally been declining since the start of this century, a notable drop occurred in 2012 when natural gas briefly overtook it as the dominant fuel source. Note that this fuel switching primarily occurs across plants, not within a given plant.¹³

The degree to which production switches from coal to gas generation will depend on several factors. From a static dispatch framework, fuel switching depends on the relative fuel prices, the relative heat rates, the available capacity of gas plants, and the demand for electricity. In addition, intra-day fluctuations in electricity demand may be important as some generators are not well suited for starting and stopping production frequently. Start-up

¹²This figure is based on EIA form 923 data that we describe in Section 4. See Figure B.8 in the online appendix for a figure on the generation shares by region, fuel type, and month.

¹³See Knittel et al. (2014) for a discussion of fuel switching within dual-fuel plants.

costs, ramping rates, minimum down times, and other intertemporal constraints limit firms' operation decisions (Mansur 2008, Cullen 2015). In addition, coal plants may be limited in the short run by contractual obligations to receive new coal shipments not easily resold.¹⁴

Furthermore, the transmission grid limits how much power plants can produce. As electricity is not stored, power supply and demand must equate at all times. This is subject to the network of transmission lines' capacity constraints, as well as the plants' intertemporal constraints (Mansur & White 2012, Davis & Hausman 2015). Therefore, optimal dispatch from a least-cost static model differs from the dynamic optimization.

Finally, observed production may differ from a static model's prediction for a number of other reasons. Namely, power plants face forced outages whereby they cannot operate when planned. Firms may have imperfect information about trading opportunities (Mansur & White 2012). Firms may exercise market power (Borenstein, Bushnell & Wolak 2002, Mansur 2007*b*, Puller 2007, Bushnell, Mansur & Saravia 2008). For these reasons, our analysis will use regressions to identify how firms actually respond to relative fuel prices.

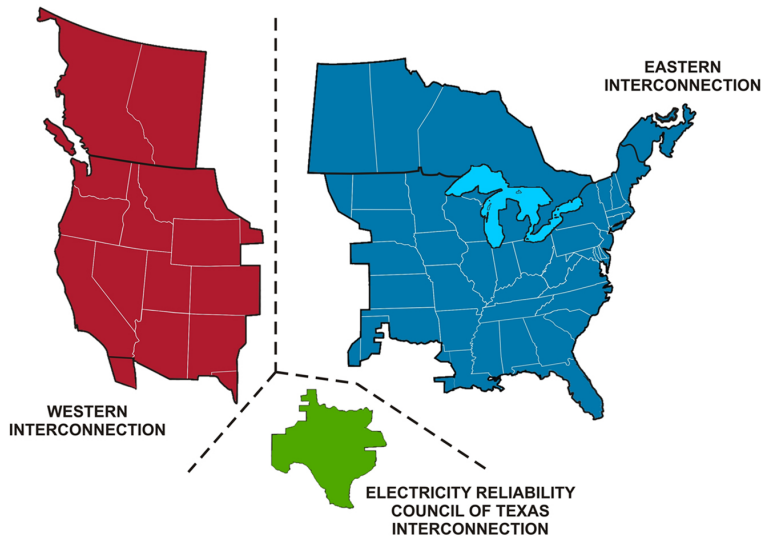
The US electricity grid consists of three interconnections: East, West, and ERCOT (see Figure 3). Electricity produced in each interconnection is synchronized, allowing electricity to flow freely throughout the interconnection. Relatively little energy is transferred via direct current lines between interconnections due to the costs involved in transferring power between asynchronous grids.¹⁵ Analysis on a finer geographic scale is possible, but presents problems for measuring net emissions reductions in each area due to energy transfers between sub-regions within an interconnection.¹⁶

¹⁴This effect may lower the marginal cost of production to near zero or even negative if there are stockpiling constraints.

¹⁵Novan (2015) provides an example of some power plants in SPP capable of selling into ERCOT. In addition, DC lines do connect interconnections like from Quebec to New England.

¹⁶ We revisit this issue when discussing the co-benefits of carbon pricing in Section 7.2.

Figure 3: Electricity Interconnections



3 Theory

3.1 Mapping Carbon Pricing

Pricing carbon makes natural gas-fired generators more competitive with those burning coal. For a fossil-fired power plant, the marginal cost of producing electricity (MC) is primarily a function of its heat rate (HR), price of fuel (P_{fuel}), fuel carbon content ($CO_{2,fuel}$), and carbon price (P_{co2}):¹⁷

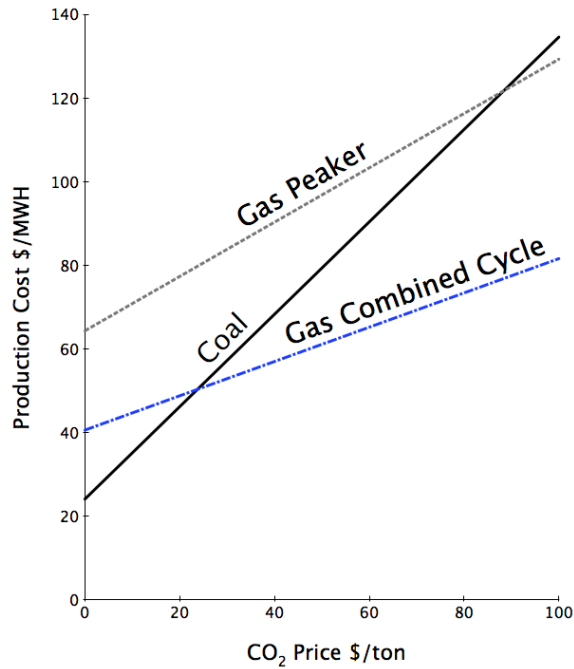
$$MC = HR \cdot (P_{fuel} + CO_{2,fuel} \cdot P_{co2}) = HR \cdot C_{fuel}. \tag{1}$$

We denote the total cost of burning fuel, C_{fuel} , as the sum of the price of procuring the fuel plus the CO_2 costs incurred by the firm. Although pricing carbon dioxide emissions increases marginal costs for both gas and coal plants, coal contains approximately twice as much CO_2 per unit of energy as natural gas. Thus, pricing carbon will affect the marginal costs of coal plants more than those of an equivalent gas plant. As previously mentioned,

¹⁷Heat rate is measured in mmBTU/MWh, price of fuel (P_{fuel}) is in \$/mmBTU, fuel-specific carbon content ($CO_{2,fuel}$) is in tons/mmBTU, and the carbon price (P_{co2}) is in \$/ton. Also, we omit from this discussion any variable operating and maintenance ($VO\&M$) costs. These would include expenses for major overhauls, treating water, pumping water for cooling towers, replacing filters, *etc* associated with usage of the generator. In addition, firms may have costs associated with pollutants other than CO_2 (*e.g.*, sulfur dioxide permit prices). While these costs were extremely small relative to fuel costs during most of our sample, our analysis controls for them.

CCGT plants are more efficient than coal plants. These both lead to marginal costs rising more steeply with carbon prices for coal plants than gas plants. Figure 4 illustrates the change in marginal costs for an average coal plant relative to gas-fired technologies (CCGT and peaker) as the price of carbon increases.¹⁸

Figure 4: Carbon Prices and Generator Marginal Costs



In our study, we will not observe positive carbon prices, but we do observe substantial variation in coal and gas costs. We define a measure of the relative cost of fuels using the coal-gas cost ratio :

$$CR = \frac{C_{coal}}{C_{gas}} = \frac{P_{coal} + CO_{2,coal} \cdot P_{co2}}{P_{gas} + CO_{2,gas} \cdot P_{co2}} \quad (2)$$

Since a carbon price increases the cost of burning coal more than burning gas, it will increase the coal-to-gas cost ratio holding fuel prices constant. For example, if coal were priced at \$2.25/mmBTU and gas were priced at \$5.75/mmBTU, this would imply a baseline cost ratio of 0.39. Putting a \$40/ton price on CO₂ would increase the cost of burning coal to

¹⁸Typical heat rates for each technology are used to create this illustration. The heat rates are as follows: coal (10.73 mmBTU/MWh), CCGT (7.07), and gas peaker (11.2). To calculate emissions costs, we use the following emissions factors for the carbon content of natural gas (117.0 lbs/mmBTU) and coal (210.86 lbs/mmBTU) based on the rates reported by the EIA (<http://www.eia.gov/tools/faqs/faq.cfm?id=73&t=11>). We weight bituminous, lignite, and subbituminous rates based on the aggregate annual fuel consumption of coal by power plants in 2011 (EIA form-923).

\$6.47 and the cost of burning gas to \$8.09, holding fuel prices constant. This in turn would imply that the cost ratio would increase from 0.39 to 0.80. This is illustrated in panels (a) and (c) of Figure 5. Changing the price of carbon changes the relative costs of coal and gas and their cost ratio. For high enough carbon prices, the cost of burning coal will exceed the cost of burning gas.

Changes in the price of gas or coal will also lead to changes in the cost ratio. Assume the same baseline fuel prices (2.25 and 5.75 for coal and gas, respectively) and cost ratio (0.39). In the absence of a carbon price, if gas prices were to fall from \$5.75 to \$2.81, then the cost ratio would increase from 0.39 to 0.80, holding coal prices constant. This is illustrated in panels (b) and (d) of Figure 5. We can see from the figure that for each cost ratio created by changes in gas prices we can find an identical cost ratio that could be created by a carbon price under fixed fuel prices. Either changes in gas prices or changes in carbon prices could create variation in the relative costs of fossil fuel generators.

Herein lies the intuition for our subsequent results. We use variation in the cost ratios observed in our data to understand how emissions change when gas generators become more competitive with coal plants. Since pricing carbon will change the relative costs of gas and coal generators in an identical manner, we then project our results into the space of carbon pricing to obtain an estimate of the near-term abatement cost curve in the electricity industry. This relationship is clear when we note that we can rearrange Equation 2 to express the carbon price as a function of the cost ratio and the baseline fuel prices of gas and coal:

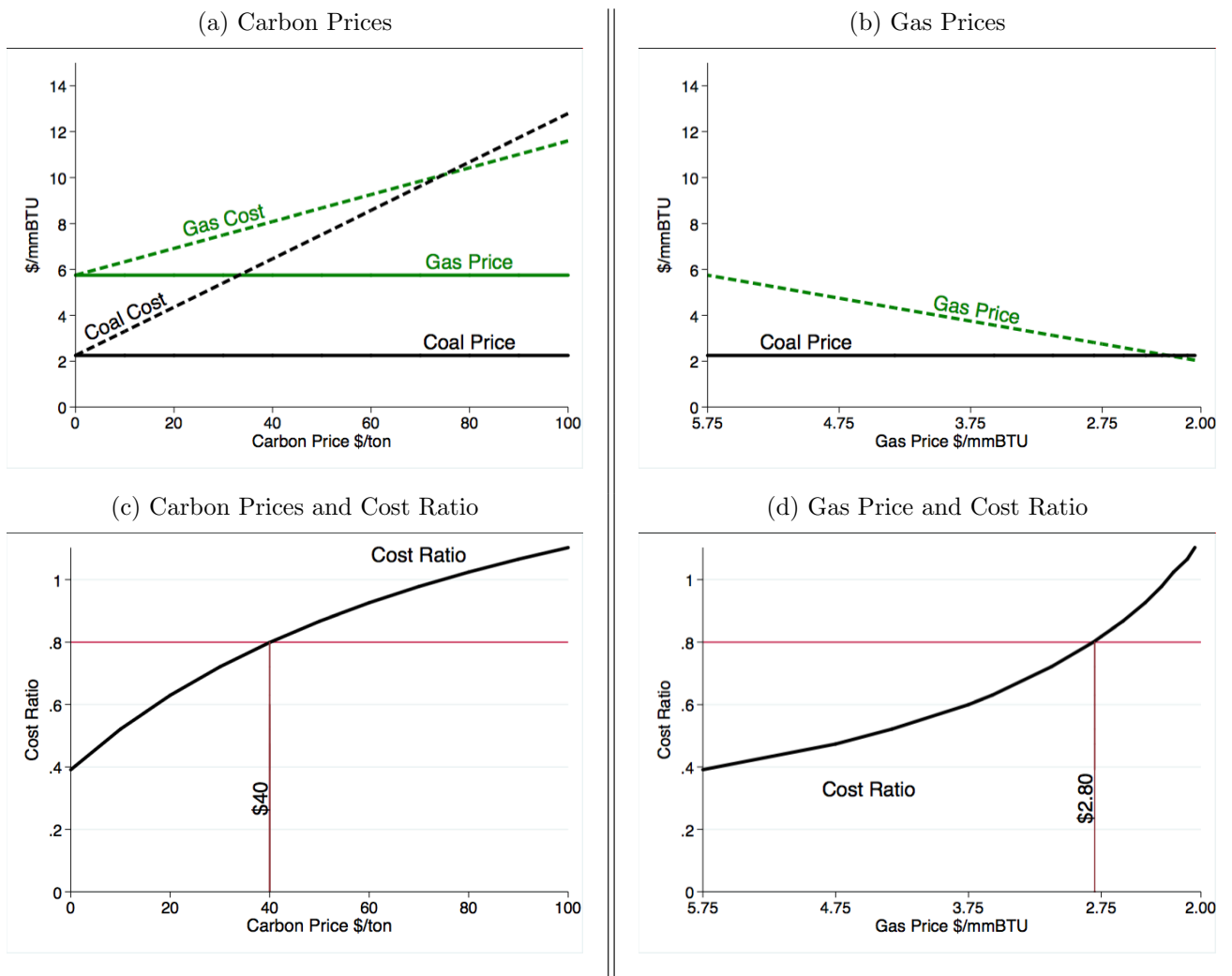
$$P_{co2} = \frac{CR \cdot P_{gas} - P_{coal}}{CO_{2,coal} - CR \cdot CO_{2,gas}} \quad (3)$$

The assumptions necessary for this mapping to be valid are discussed in the next section.

3.2 Identification and Caveats

Here we examine the similarities and differences between cost ratios and carbon prices. We know that pricing carbon will lead to higher coal/gas cost ratios and *higher* fuel prices. The question is: can we use our experience with high coal/gas cost ratios and *lower* fuel prices to understand carbon pricing? This is equivalent to establishing the conditions under which the cost ratio is a sufficient statistic for emissions from the electricity sector.

Figure 5: Relationship between Gas Prices, Carbon Prices, and Cost Ratios



Emissions in the electricity sector depend on both the equilibrium quantity of electricity demanded and technological mix of supply. For illustrative purposes, let us compare a high cost and a low cost scenario with the same cost ratio as we did previously ($CR = 0.8$).¹⁹ Figure 6 shows a set of simple supply curves where generators are ordered by their constant marginal costs.²⁰ For a given realization of demand, it is clear that the production and emissions of each generator are identical in both cases. Thus fixing the quantity demanded, the cost ratio is a sufficient statistic for emissions when marginal costs alone dictate production. For a given cost ratio, the ordering of generators by marginal costs will be identical regardless of the level of fuel costs.

However, even though the cost ratio is identical we would expect the equilibrium price for electricity to be higher in the high fuel cost case. Higher electricity prices will be at least partially passed through to consumers. The demand reduction due to these higher prices will lead to lower carbon emissions for the same cost ratio. Only with a perfectly inelastic demand curve will cost ratios be a sufficient statistic for emissions. Thus, the results will be able to highlight the degree to which technology switching can contribute to emissions reductions under a carbon price absent any demand response.²¹ In addition, this scenario is consistent with policies targeting supply-side effects and insulating consumers from price increases by rebating carbon costs back to their electricity bill.²²

Even conditional on quantity demanded, the cost ratio may fail to be a sufficient statistic for emissions if the supply side of the market changes with the level of fuel costs. In general, the profits of a generator at a fixed cost ratio will change with the level of prices. However, this will affect emissions only if the difference in profits either affects the dispatch order of generators or induces changes in installed capacity.

At first it may not be obvious why profits, and not relative marginal costs, would dictate

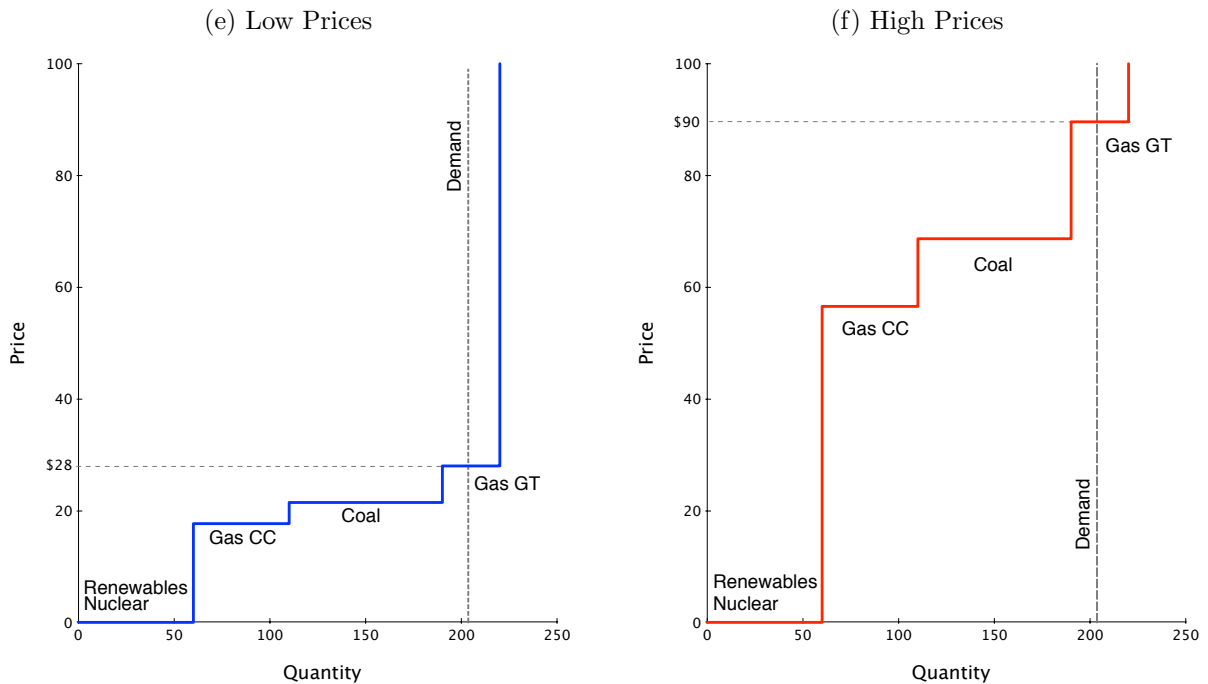
¹⁹The prices used for the gas and coal are identical to the previous example. For the low cost scenario, we let $P_{coal} = \$2.25$ and $P_{gas} = \$2.81$. For the high cost scenario, we let $P_{coal} = \$6.47$ and $P_{gas} = \$8.09$. In both cases the cost ratio is 0.8.

²⁰This assumes price-taking firms and no intertemporal or transmission constraints.

²¹The analysis also assumes that the behavior of low marginal cost renewable and nuclear generators are unaffected by higher equilibrium electricity prices. Given that these generators already have incentives to operate at full capacity whenever possible, this assumption seems reasonable.

²² Although this approach is not well suited for estimating the demand response to carbon pricing, we can examine how the technological response would change if demand were at a lower level. In the appendix, Figure A.5 shows very similar declines in emissions due to a carbon price at lower levels of demand.

Figure 6: Hypothetical Supply Curves with the Same Cost Ratio



the production of generators. However, there are short-run and medium-run dynamic considerations in operating a generator. In the short run, generators make operating decisions amid fluctuating intra-day demand. This necessitates that some generators shut down and restart leading them to incur costs of adjustment. Generators will start production only if they expect to cover their start-up costs while operating. Since the profits of generators will be different under the two scenarios with the same cost ratios, firms may undertake different startup decisions.²³ The degree to which changes in dynamics affect the outcomes is difficult to judge given our approach. However, structural dynamic estimation of electricity markets indicates that start-up costs are a secondary factor effecting fuel switching under a carbon tax (Cullen 2015). In the medium run, plants must cover their fixed costs of operation. If they cannot cover their fixed costs they may temporarily exit the market by mothballing their plant. The plants with high fixed costs and high adjustment costs tend to be larger and dirtier facilities such as coal plants. To the extent that the low fuel costs in our data would make it more difficult for these plants to cover these costs, our results would tend to

²³The effect may be lessened if start-up costs scale with the fuel prices. Although fuel costs are a central part of start-up costs, they are not the only component, thus will not scale perfectly with fuel costs.

overestimate the reduction of emissions due to carbon pricing. In addition, firms may have greater incentive to exercise market power when fuel prices are high: this will also affect the dispatch order and therefore emissions (Mansur 2007 *a*).²⁴

Even if identical cost ratios were to imply the same dispatch order, the additional profits in the high cost scenario would provide greater incentive for investment in inframarginal generators. In particular, clean generating technology with little or no carbon emissions would become much more attractive as investments. For this reason, the exact mapping between carbon prices and gas prices only holds when there is no investment in new capacity.

In addition, relative marginal costs must be the primary driver of electricity production and emissions in the short run. It must also be the case that firms treat a shock to marginal costs that is due to fuel prices the same as they would a comparable shock to marginal costs that is due to carbon prices.²⁵ Differences in volatility between fuel and carbon prices are unlikely to affect our near term estimates.²⁶

This mapping requires a uniform pollution content for a given fuel type.²⁷ To summarize, our method will have little to say about the reductions in emissions that will come from longer run adjustments in capacity or demand, but will be able to trace out the near-term abatement cost curve for the electricity sector.

²⁴High fuel prices will result in a steeper marginal cost curve of the competitive fringe. Strategic firms facing a less-elastic residual demand function have greater incentive to exercise market power (see Mansur (2013)).

²⁵Fabra & Reguant (2014) find evidence that firms in the Spanish electricity market treat these shocks similarly.

²⁶Carbon prices can be either taxes or permit prices for cap-and-trade systems. While a tax might exhibit certainty in the near term, the permit price could be quite volatile. Even if natural gas prices are more volatile than carbon prices, it is unclear that uncertainty has a direct effect on the near-term emissions from existing generators. Firms procure natural gas for their generators based on day-ahead or longer term contract prices. Regardless of how the natural gas was purchased, the production decisions are based on the spot prices of natural gas and electricity because natural gas is a liquid commodity: there is an opportunity cost of using the natural gas that is based on the current natural gas price. Therefore, the uncertainty or volatility of input prices (for fuels and pollution allowances) do not change operating decisions when the input markets have liquidity. Furthermore, power plants have limited ability to stockpile natural gas on site. Section 8 discusses the long term implications of price volatility.

²⁷Unlike other pollutants, the carbon content of a given fuel type is relatively homogeneous. Furthermore, there are no economically feasible end-of-pipe abatement technologies. In contrast, the ratio of nitrogen oxides emissions across plants, for example, varies widely because of differences in technologies and operational decisions. Thus while mapping cost ratios to carbon emissions is reasonable, we do not recommend using this approach for the pricing of other pollutants.

4 Data

Our data are compiled from several public sources and cover January 2006 to December 2012. The Continuous Emissions Monitoring System (CEMS) of the Environmental Protection Agency (EPA) measures hourly output of CO₂, sulfur dioxide (SO₂), and nitrogen oxides (NO_x) from generators larger than 25 megawatts. We aggregate the hourly generator-level emissions information to construct daily CO₂ emissions. Generators are then aggregated by interconnection to create a measure of daily, regional CO₂ emissions. We aggregate the other pollutants by NERC region.

Second, we use data on electricity consumption (or load) provided by the Federal Energy Regulatory Commission (FERC). FERC Form 714 provides hourly information on electricity load by balancing area. We aggregate load to the daily level and sum across areas to arrive at daily electrical load by interconnection.

Third, we use EIA Form 923 data on production of electricity from non-fossil sources and prices paid for coal deliveries by power plants. EIA provides monthly electricity production by NERC region for nuclear and hydro power plants as well as for renewable sources (such as wind, solar and geothermal). We aggregate these data to the interconnection level for each type of non-fossil monthly electricity production: nuclear, water, and renewables. We also collect data from the National Energy Board of Canada on monthly net imports of power into each interconnection in the US.²⁸ We use monthly data on permit prices for SO₂ from CantorCO2e and the EPA Clean Air Markets progress reports.

Fuel prices are aggregated by interconnection. In practice, there is some spatial heterogeneity in coal prices and, to a lesser degree, in natural gas prices. How much a power plant generates will depend on its own marginal costs as well as that of other plants: all fuel prices affect the order of dispatch. We simplify the vector of all power plants' fuel costs by looking at the average price of each fossil fuel.²⁹

²⁸See <http://www.neb-one.gc.ca/CommodityStatistics/Statistics.aspx?language=english>, accessed August 27, 2014.

²⁹Incorporating all power plant fuel costs into the model is important for modeling integrated power markets where electricity frequently trades in large volumes. However, including the full vector of fuel prices in the model is problematic. First, it is unwieldy to interpret and explain the results that would come out of that specification. Second, our dataset would not have enough power to reliably estimate coefficients for hundreds of price variables and their interactions. Thus, some form of aggregation is needed to make

The EIA reports coal prices by transaction (plant, month, contract type, coal type, coal source, *etc.*).³⁰ We use this information to create a weighted-average price for each month and interconnection. In particular, we use data from 2001 to 2012 for spot prices only (dropping long term contracts over 12 months). For each interconnection, we regress coal costs on sulfur, ash, and BTU content, an indicator of surface mining, plant fixed effects, and indicator variables for each month of the sample. We estimate the model using weighted least squares, where we weight using a transaction’s volume (in tons). The appendix reports the estimates (see Table A.1) and how they are used to construct a monthly coal price index for each region, holding coal composition fixed (see Figure A.1).

Finally, we use data from the Intercontinental Exchange (ICE) on the spot prices for natural gas at trading hubs around the country. ICE is an independent open-access electronic exchange for trading wholesale energy and metals commodities. For each gas hub, they report the average trading price for transactions on that day. For each interconnection, we weight the hub prices by the nameplate capacity of surrounding gas generators to arrive at a daily average spot price of natural gas. Although gas generators may have long term financial contracts for gas, the spot price for natural gas represents the opportunity cost to generators for using the gas to generate electricity versus selling it on the spot market. The general trends in the data are illustrated in Figure 1 using monthly averages.

Table 1 reports the mean and standard deviation for each interconnection. The East is the largest market by far with over four times the load in the West, which in turn is more than double ERCOT. The East is also the most carbon intensive with emissions over six times that in other markets.³¹ The table also reports the summary statistics on the fuel prices for each region. All markets show substantial temporal variation in the cost ratio. While some of the variation in fuel prices is across regions, most of it is over time. The coal-to-gas cost ratio is 0.43 on average in the East and slightly smaller in the other markets.

progress on this research question. Aggregating to average prices allows us to have a summary statistic for fuel prices that can be estimated and easily interpreted. Averaging also reduces idiosyncratic measurement error in the fuel prices that might occur at the individual price level. However, average prices may not be able to capture the richness of the non-linear relationships between the vector of fuel prices. The effect of aggregation on the results is theoretically unclear.

³⁰In reverse chronological order, the data sources are EIA-923, EIA-906, EIA-920, FERC 423, and EIA-423.

³¹We report load in gigawatt-hours (GWh) per day and emissions rates in tons of CO₂ per megawatt-hour (MWh), where a GWh is one thousand MWh and one million kWh.

Table 1: Summary Statistics

Variable	Units	Eastern	ERCOT	Western
CO ₂ Emissions	1000s tons/day	5,005 (768)	527 (89)	802 (119)
Load	GWh/day	7,456 (879)	866 (159)	1,835 (168)
Emissions Rate	Tons/MWh	0.67 (0.04)	0.61 (0.05)	0.44 (0.05)
Coal Price	\$/mmBTU	2.50 (0.42)	2.20 (0.34)	1.84 (0.24)
Gas Price	\$/mmBTU	5.49 (2.28)	5.10 (2.13)	5.04 (1.95)
Cost Ratio		0.43 (0.88)	0.41 (0.81)	0.35 (0.76)

Notes: Our data include 2,557 daily observations covering January 2006 to December 2012. Data are aggregated for three NERC interconnections: Eastern, ERCOT, and Western. Emissions are from the EPA CEMS. Load consumption data are from FERC form 714. The emissions rate is defined as the ratio of CO₂ emissions to load. We estimate the coal price index for each region as described in the text. Gas prices are from ICE. The cost ratio is the coal price over the gas price.

In the next section, we use these data to trace out the emission response of the electricity system to changes in input costs while controlling for important features of the market. However, we first calculate how much of a reduction in carbon emissions is feasible given the current stock of power plants.

As a simple back-of-the-envelope calculation, we examine whether there is sufficient capacity at natural gas facilities to have a substantial effect on carbon emissions.³² Table 2 reports the share of carbon emissions that could be reduced in 2012, assuming a derating factor of 90%. Similar to Lafrancois (2012), we see that there is enough unused gas capacity to reduce emissions by about 40%. These results vary over time.³³

Table 2: Potential Shares of Carbon Emissions Reduced from Fuel Switching

Eastern	ERCOT	Western
0.42	0.37	0.40

5 Empirical Model

We aim to create a simple, yet flexible model that can trace out the response of emissions to changes in relative fuel prices that can accommodate the varied technologies on the grid and their complex interactions in electricity markets. The method used is similar to the literature that econometrically estimates the relationship between emissions and either electricity consumption (Holland & Mansur 2008, Graff Zivin, Kotchen & Mansur 2014), electricity generation (Callaway & Fowlie 2009, Siler-Evans, Azevedo & Morgan 2012, Holladay & LaRiviere 2014, Davis & Hausman 2015), or wind production (Cullen 2013, Kaffine, McBee & Lieskovsky 2013, Novan 2015, Fell & Kaffine 2014).

The model is a reduced-form regression with daily emissions (CO_{2t}) in an interconnection as the dependent variable. For day t , the estimating equation is:

$$CO_{2t} = s(CR_t|\beta) + s(load_t|\theta) + s(temp_t|\omega) + X_t\psi + D\gamma + \epsilon_t. \quad (4)$$

³²See Section B.2 of the appendix for details on the methodology.

³³The table B.1 in the appendix shows shares for each year from 2001 to 2012 for derating factors of both 90% and 80%. In 2001, unused gas capacity was the limiting factor so that only 25% of emissions could be reduced. Starting in 2003, investment in gas capacity had grown such that unused gas capacity exceeded coal production in nearly every hour in the West and in ERCOT, and about 12-29% of the time in the East.

The variable $load_t$ is the total daily electricity load on the interconnection and $temp_t$ is the average temperature of the day. Since production and its associated emissions may respond in a complex non-linear fashion to the cost ratio, load, and temperature, we use a flexible, semi-parametric functional form for $s(\cdot)$ to trace out the emissions response of the system. Specifically, we use a cubic spline with six knot points for each of the variables.³⁴ We control for other factors, X_t , in more traditional parametric ways. We capture the within-day distribution of hourly load using the minimum, maximum, and standard deviation of daily load. We also control for monthly non-fossil electricity production (wind, solar, hydro, nuclear, etc.), net imports of electricity from Canada, and the SO₂ permit prices. Finally, we include a dummy variable (D) for each quarter in the time series to control for trends in generating capacity, macroeconomic shocks, as well as seasonality in generator availability. The importance of these controls is discussed below.

For identification, we rely on exogenous shocks to natural gas prices. When selecting controls, we need to include variables that would directly affect the interconnection emissions that might also be correlated with the variation in input fuel costs. The quantity of electricity demanded, or load, obviously meets this criteria. The quantity demanded on a given day, although driven by weather and day-specific demand shocks, may be correlated with the spot price for gas. This may be because electricity generators demand more gas when electricity demand is high or simply a correlation in the demand for electricity and the demand of gas outside the electricity sector, such as home heating. For example, lower electricity demand (and emissions) due to a negative macroeconomic shock would be correlated with low prices for natural gas due to the same shock. Failing to account for electricity demand would tend to overestimate the response of emissions to the relative fuel prices. Thus we include daily electricity demand in the interconnection as a control variable. We also include monthly net imports of electricity from Canada to control for demand satisfied by generators outside the US system.³⁵

³⁴In Section A.3 of the appendix, we test the robustness of our results to different numbers of knots and find the results to be stable with four or more.

³⁵The Eastern interconnection is most affected by international imports. On average, imports supply 1.3% of monthly load. The Western interconnection on the other hand is a net exporter of electricity, but it only exports 0.4% of monthly production on average. ERCOT does not have significant international transfers of electricity.

Daily temperature in the interconnection is included as an independent control to appease the laws of thermodynamics. Although weather shocks do affect electricity demand, we are already directly controlling for demand shocks in the model. However, temperature can directly affect the efficiency of fossil fuel generators due to thermodynamic considerations. When the outside temperature is lower, thermal generators can take advantage of the larger temperature differential to produce more electricity with the same amount of fuel. Thus emissions may be lower during colder time periods even after controlling for electricity demand.

Non-fossil electricity production has low marginal costs and therefore is not likely to change in response to gas or coal prices. However, they may be correlated with them. For example, wind power installations have been growing at the same time as technological innovation has led to more shale gas extraction. Likewise, seasonal variation in the availability of hydroelectric generating capacity may influence the spot prices of natural gas.

We include moments of the distribution of daily demand to account for any within-day dynamics in the production of electricity. For example, a day with high variability in electricity demand throughout the day may require more flexible, but less efficient generators than a day with the same total electricity demand but lower variability (Holland & Mansur 2008). For this reason we include the minimum, maximum, and standard deviation of within-day demand as controls. Finally we include the price SO_2 permits which directly affect the marginal cost of certain coal generators. In order to account for serial correlation and heteroscedasticity, we use Newey-West standard errors allowing for a seven-day lag structure.

Our choice of the cost ratio as a functional form for fuel costs is advantageous for several reasons. First, as discussed previously in Section 3, using the cost ratio implies that the ordering of generators by marginal costs will be identical for a given cost ratio regardless of the level of fuel costs. Second, using the cost ratio serves as a parsimonious function that translates the two dimensions of fuel costs (*i.e.*, coal and natural gas) into a single dimensional object that is simple to interpret. Finally, note that since coal costs are relatively constant over our time period combined with our flexible estimation method implies that using cost ratio produces very similar results when compared with using other functional forms, such

as fuel costs differences, as shown in Section A.2 of the appendix. Since we are using semi-parametric methods, the values of the coefficients are not easily interpretable. Rather, with the estimated coefficients, we graphically trace out the emissions response of the electricity generating system to changes in the relative costs of coal and gas.³⁶

6 Results

6.1 Main Results

The estimated effect of relative fuel prices on emissions in each interconnection are shown in Figure 7. For ease of interpretation, we plot results against a decreasing natural gas price which is a monotonic transformation of the cost ratio for a fixed coal price.³⁷ Dashed lines show the 95% confidence interval for the estimates using Newey-West corrected standard errors.

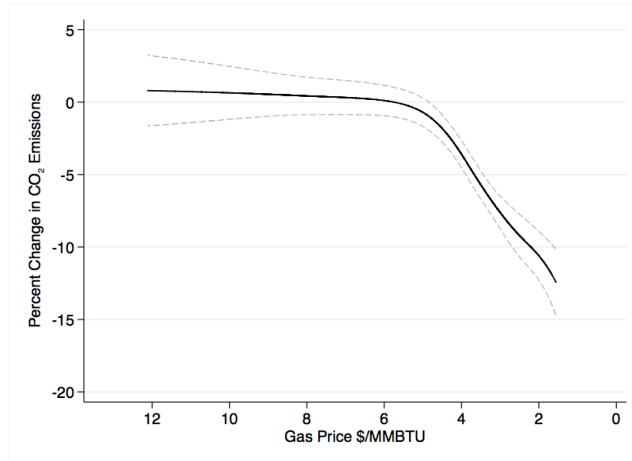
The results show statistically insignificant changes in emissions for high gas prices. That is, when gas prices are above \$6 (per mmBTU), changes in gas prices do not result in switching between high polluting plants and cleaner facilities. Not until the gas prices approach \$4-\$5, do emissions begin to fall. For the Eastern interconnection, emissions fall by about 10% when the gas price falls to \$2. At this gas price, carbon emissions fall by about 10 and 13 percent in ERCOT and the Western interconnection, respectively. The rate of decline is also steeper in both ERCOT and the West than in the East. This may be due to the fact that the East is a much larger grid with more heterogeneity in the generating capacity. Keep in mind that \$2 reflects *historically* low gas prices and brings much of the gas-fired fleet on par with coal-fired generators. Though the reduction in emissions is significant, it does not begin to approach the 40% estimates predicted by the back-of-the-envelope calculation in Section 4. This suggests that dynamics, transmission constraints, or other factors excluded from simpler models greatly reduce the emissions reductions possible from fuel switching.

³⁶For completeness and replicability, we include the full set of estimated parameters with their associated standard errors in Table B.2 of the appendix.

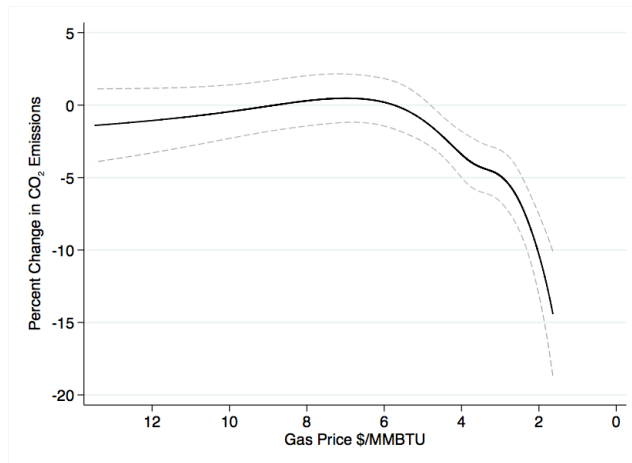
³⁷For these graphs we fix the coal price using predictions for future coal prices in EIA (2012). In particular, we set the coal price at \$2.25/mmBTU. Control variables, such as demand and non-fossil electricity production, are held at their average levels in the sample.

Figure 7: Estimated CO₂ Response to Fuel Prices

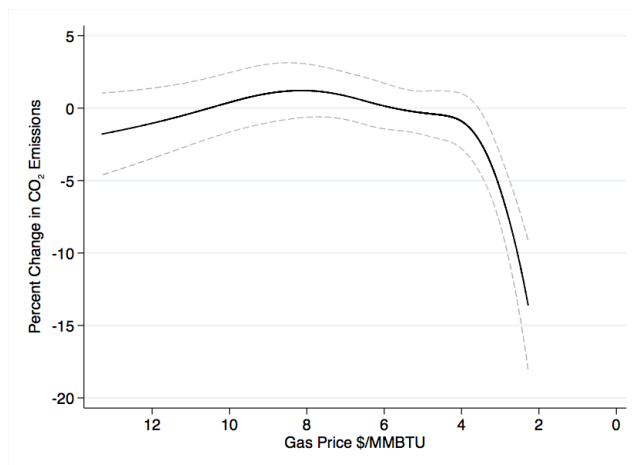
(a) Eastern Interconnection



(b) ERCOT Interconnection



(c) Western Interconnection



6.2 Effect of Carbon Price on Carbon Emissions

We use the electricity industry’s experience with low gas prices to explore how the industry may respond to a carbon price. As a first step, we need to choose a baseline level for fuel prices from which to compare the effect of various carbon prices. We assume that these prices are exogenously determined, with prices returning to the long run average costs of extracting and processing the fuels. The EIA (2012) forecasts that average delivered coal prices will be \$2.25/mmBTU and gas prices will be \$5.75/mmBTU in 2025. This implies a baseline cost ratio of 0.39, which will serve as our benchmark.³⁸

Next we map the emissions response curves from Figure 7 into carbon prices using Equation 3. For each region, Figure 8 shows the estimated emissions reductions that would come from a carbon price (in \$/ton of CO₂) under these assumptions. The figures focus on the cost ratios that correspond to positive carbon prices under the baseline fuel costs. They show that emissions fall steeply at lower levels of a carbon price, but then the rate of change decreases for higher levels of a carbon price. These results indicate that much of the emissions reduction from technology switching can be captured with a relatively modest price on carbon. High prices on carbon do result in some further reduction in carbon dioxide emissions, but it seems that the large impact from a high carbon price is likely to come from retooling the generating infrastructure.

A national supply curve for abatement can be constructed by horizontally summing these three markets after multiplying the percent changes in emissions by their respective baseline emissions levels as shown in the last column of Table 3.³⁹ We can see that a carbon price of \$20/ton would reduce daily emissions by over 320,000 tons or 4.9% of total electricity sector CO₂ emissions. However, to achieve a ten percent reduction, the carbon price would need to be closer to \$70/ton and would cost over \$6 billion per year.⁴⁰

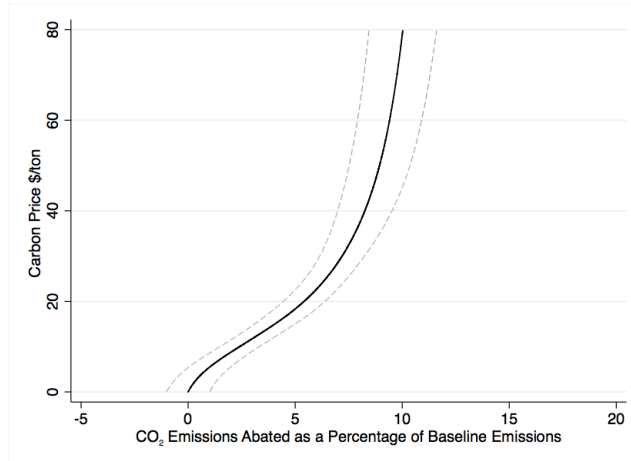
³⁸When calculating a carbon price from fuel prices, we do not account for the impact that an increasing carbon price may have on the equilibrium price of fuels. That is, a higher carbon price will lead to increased demand for natural gas which could increase the price of gas. Estimating the price elasticity of supply for each fuel type is beyond the scope of this paper. Rather, we assume that baseline fuel prices are fixed and exogenous. Given that incorporating any price response of fuels to a carbon price would tend to decrease the emissions reductions for higher carbon prices, our results represent generous estimates of emissions reductions from a carbon price.

³⁹Baseline daily CO₂ emissions are 5,174,485 tons in the East, 574,506 tons in ERCOT, and 870,567 tons in the West.

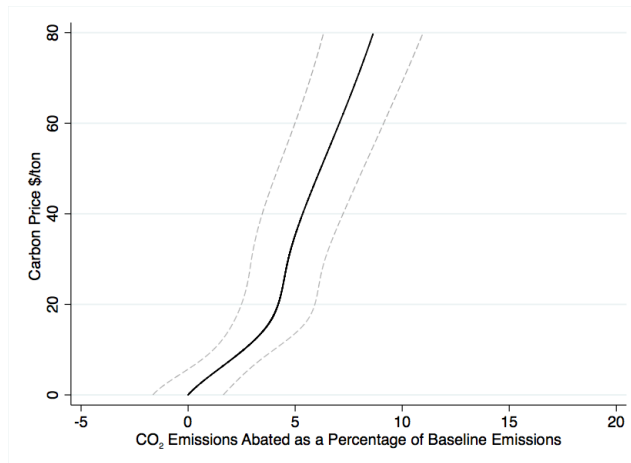
⁴⁰For each day in our dataset, we integrate under the imputed emissions response curves from Figure 8 in

Figure 8: Imputed CO₂ Response to Carbon Prices

(a) Eastern Interconnection



(b) ERCOT Interconnection



(c) Western Interconnection

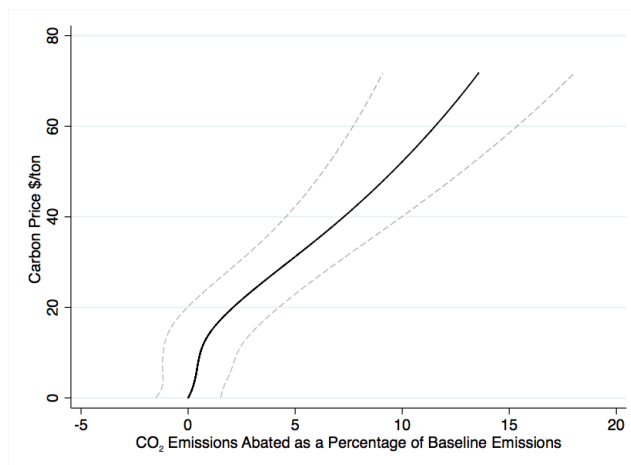


Table 3: Predicted Emissions (and Percentage Abatement)

Tax	East		ERCOT		West		All	
0	51.7	(0.0%)	5.7	(0.0%)	8.7	(0.0%)	66.2	(0.0%)
10	50.5	(2.4%)	5.6	(2.6%)	8.7	(0.6%)	64.8	(2.2%)
20	49.0	(5.4%)	5.5	(4.2%)	8.5	(2.1%)	63.0	(4.9%)
30	48.0	(7.2%)	5.5	(4.7%)	8.3	(4.7%)	61.8	(6.7%)
40	47.5	(8.3%)	5.4	(5.3%)	8.1	(7.2%)	61.0	(7.9%)
50	47.1	(8.9%)	5.4	(6.2%)	7.9	(9.5%)	60.4	(8.8%)
60	46.9	(9.4%)	5.3	(7.1%)	7.7	(11.5%)	59.9	(9.5%)
70	46.7	(9.8%)	5.3	(7.9%)	7.6	(13.1%)	59.5	(10.0%)
80	46.6	(10.0%)	5.2	(8.6%)	7.5	(13.6%)	59.3	(10.4%)

Notes: Prediction emissions are in 100,000 tons/day.

6.3 Effect on Carbon Emissions by Fuel Type

The previous sections have examined aggregate emissions from all sources collectively. In this section, we decompose the emissions changes by fuel type in order to test if the behavior of certain types of power plants is consistent with fuel switching. In particular, fuel switching would imply that coal generators decrease emissions while gas generators increase their production and associated emissions. In the previous subsection, we show that aggregate emissions fall since gas generators are cleaner than the coal generators whose production they are replacing. We test this insight in our data.

To decompose emissions, we identify a plants primary type using the fuel consumption data from EIA form 923. To determine the plants type, we calculate the total quantity of fuel burned (mmBTU) by each generator type at the plant from 2003 through 2012.⁴¹ Most facilities use multiple fuels either because start-up fuel is required or because a facility has multiple generators types at its location.⁴² For example, a facility might house one large coal generator and several smaller gas generators. However, as this section tests whether (dominant) coal plants decrease emissions in response to a carbon price and conversely for (dominant) gas plants, we do not attempt to model the fuel mix of some plants. Our plant classification reflects the binary nature (all coal versus all gas) of most plants in the CEMS

order to calculate the total cost of abatement.

⁴¹A type is defined by fuel and prime mover.

⁴²Start-up fuel is typically used at coal-fired power plants to preheat the combustion chamber so that coal can be properly combusted. Some use fuel oil to ignite coal until the combustion chamber reaches a critical temperature and the process becomes self sustaining.

data.⁴³

The results confirm that fuel switching is driving our results. Table 4 shows that reductions in emissions from coal facilities are larger than aggregate reductions in each of the three regions. Gas facilities, on the other hand, increase their emissions, but by a much smaller amount than decreased emissions from coal facilities. The results at other carbon prices show the same qualitative relationship. As carbon prices increase, emissions decrease steeply at coal plants and increase more modestly at gas plants.

Since a mix of generators may exist a facility of a given fuel type, our results should not be strictly interpreted as the reduction in emissions from burning a particular fuel, but rather as the reduction in emissions from facilities consume mostly that fuel type. The fact that gas generators may be collocated at coal facilities means that the reduction in emissions from burning coal will be biased toward zero. For example, emissions at a facility dominated by coal may have a larger decrease in emissions from coal generators that is attenuated by increased production from gas generators at the same facility. Likewise if coal generators are located at facilities dominated by gas generation, the increase in emissions from gas facilities will be biased toward zero.

Table 4: CO₂ Emissions Abated at \$20/ton by Fuel Type*

	East	ERCOT	West
Coal	-5.97 (0.45)	-6.16 (1.09)	-3.29 (1.02)
Gas	0.40 (0.25)	2.33 (0.61)	1.21 (0.58)
Other	0.18 (0.06)	-0.37 (0.08)	- -
Total	-5.39	-4.21	-2.08

**Percentage of baseline emissions*

⁴³For the plants that we denoted as coal plants, we measure the percentage of BTUs that were consumed that came from coal. For the median "coal" plant, 99.6% of the BTUs were from coal, with an interquartile range of 97.4% to 99.8%. Of the plants that we denote as gas plants, the median plant consumed 99.9% of percent is from gas (with an interquartile range of 96.4% to 100%).

6.4 Robustness

Given the complexity of electricity markets, it is quite likely that the response of emissions to coal and gas prices is highly non-linear. To be sure that our specification is not constraining our results, we examine the robustness of the results to our functional form assumptions of coal and gas prices and specification of the cubic spline. We find that the results do not change significantly when using different functions of fuel prices (see Figure A.2). Likewise the results are stable over a range of possible knot points for the cubic spline (see Figure A.3).

We also examine the distribution of the fuel and carbon price data. Figures B.3-B.5 show the density over the relevant domain. The relatively uniform density of data suggests that we are not relying on a only few observations plus functional form to identify the response of the system to relevant carbon prices. Thus we have some confidence that our results are not being driven by functional form.

We examine the sensitivity of the results to dropping our controls and to differing time fixed effects. The controls are very important for correctly estimating the effect of gas prices on emissions. For example, failing to control for load leads to much larger estimated reductions from low gas prices. The specification of time fixed effects is less dramatic, but still important. Notably one specification includes month-of-sample fixed effects that control for all variation in our estimated coal prices. Even within a month, we observe modest fuel switching due to variation in daily natural gas prices. The full results of the sensitivity analyses can be found in Section B.6 of the appendix.

Our main results reflect multiple near-term effects from low natural gas prices, including fuel switching and possible entry and exit. In order to separate these effects, we focus on the aggregate emissions from a balanced sample of power plants. Specifically, we remove any plants that may have entered or exited at some point during the sample.⁴⁴ By examining a stable set of plants, we exclude, for example, a coal plant that exited due to low electricity prices driven by cheap gas. Using the stable set plants, we apply the same methodology as in our main specification. We find that the results using the stables plants are very similar and statistically indistinguishable over the relevant range of carbon prices (see Figure B.9). This

⁴⁴A plant is considered stable if it produced in each year from 2006 to 2012.

suggests that while the methodology can account for several near-term effects, our findings are primarily the result of fuel switching.

We have considered concerns of potential endogeneity. We rely on exogenous variation in natural gas prices for identification. While we control for the effect that electricity demand and temperature might have on fuel prices, a random shock to daily emissions, *conditional* on electricity demand, could shift the market demand for fuels. For example, suppose a large coal fired-power plant is forced to shut down for a few days. All else equal, this increases demand for natural gas and while at the same time emissions fall. In theory, this could increase the price of natural gas and introduce bias into our the coefficient estimates. This would imply that our estimates are an underestimate of the true effect. However, we argue that these biases are likely to be small. First, we have included most of the factors that affect fuel choice like production from non-fossil power plants, net imports, *etc.* Second, the storage of electricity and fuels are dramatically different: While power is prohibitively expensive to store, fuels are storable commodities. Today's natural gas price reflects current both weather conditions and electricity load, but also expectations about future demand. Thus, one day's demand shock may have limited effect on prices.

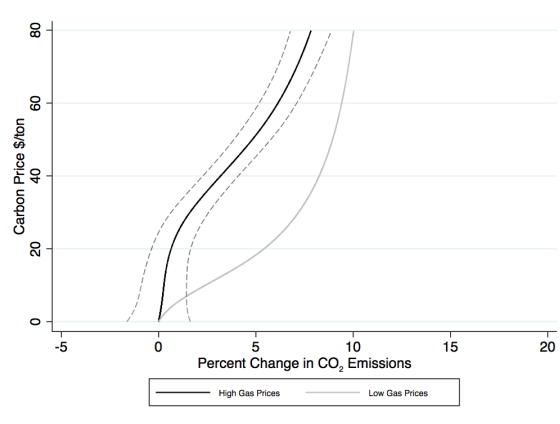
7 Extensions

In this section, we extend our analysis to examine other counterfactual situations. First, we highlight that the effectiveness of a carbon price depends crucially on the market price for gas and coal. Then we use our methodology to examine the co-benefits of pricing carbon. Specifically, we estimate the extent to which regulating carbon may reduce other harmful pollutants, like sulfur dioxide and nitrogen oxides, which are typically emitted alongside of carbon dioxide.

7.1 Carbon Pricing Under High Gas Prices

The results of the paper thus far are based a counterfactual situation where future market prices for fuels reflect EIA's predicted fuel prices for 2025. However, it is possible that gas prices will be much higher than expected. We can use our estimates to examine how

Figure 9: Emission Response Limited in a High Gas Price Scenario



Notes: Response is for the Eastern Interconnection. The base case is on the left, and the high gas prices case is on the right.

effective carbon prices would be at reducing emissions in a high-natural-gas-price world.⁴⁵ We do so by assuming that US fuel prices also returned to the levels seen in the spring of 2008.⁴⁶ Figure 9 shows the effect of carbon pricing under that assumption side by side with our main results which have lower natural gas prices. The figure shows that, when natural gas prices are high, carbon prices are much less effective at reducing carbon emissions. For example, a \$20/ton carbon price reduces carbon emissions in the East by about six percent in the base case (see Figure 8a), but by less than one percent when gas prices are high. In other words, in order to achieve a carbon emission target, a much higher carbon permit price would be required if gas prices were high. The intuition for this is quite straightforward. Since dirty coal generators enjoy a much larger marginal cost advantage when gas prices are high, a price on carbon is much less effective at inducing generation from cleaner generators.

⁴⁵ For example, new environmental regulations could increase the cost of shale gas production or even impose a ban on fracking.

⁴⁶ Before shale gas became a major share of US gas production, the US and Europe had similar natural gas prices (see Figure 1). While the recession lowered European gas prices, they returned to pre-recession levels by 2012. In April of 2008, fuel prices were \$2.46/mmBTU for coal and \$10.28/mmBTU for natural gas, implying a coal-to-gas cost ratio of 0.24.

7.2 Co-Benefits of Carbon Price

By changing the dispatch of power plants, carbon prices are likely to reduce other pollutants like SO_2 and NO_x that have local and regional health effects.⁴⁷ For each interconnection, we replicate the estimation and simulation methods of Sections 5 and 6.2 where we replace the dependent variable in Equation (4) with the daily emissions of either SO_2 or NO_x within a given interconnection. We estimate how these emissions depend on the coal-to-gas cost ratio, which we then convert into a carbon price as above.

Figure 10 shows the aggregate response of SO_2 emissions to carbon prices. We see that a \$20/ton carbon price results in about a 6% drop in emissions in each region. However, the functions differ at other prices. For example, a 10% drop in SO_2 emissions would require a carbon price of \$40 in the East or the West, but almost double that in ERCOT. Figure 11 shows the response curves for NO_x emissions by region. Here a large reduction in NO_x emissions would occur from a much larger carbon price in the East than in the other regions.⁴⁸

⁴⁷Burtraw et al. (1998) and Chestnut & Mills (2005) examine the environmental benefits of federal regulations of local pollutants. See Schmalensee & Stavins (2013) for a recent discussion of these policies.

⁴⁸Note that these figures mask important spatial variation. Unlike CO_2 emissions, the location of these local emissions matters for estimating the marginal damages. While a precise estimate of these marginal damages is beyond the scope of this paper, we do examine the spatial distribution of these emissions. In particular, we modify Equation (4) by defining the dependent variable as the daily emissions (SO_2 or NO_x) within a given subregion of an interconnection. Figure B.6 in the appendix shows the regional variation in responses. Figure B.7 maps these subregions as defined in the EPA's eGrid database.

Figure 10: SO₂ Response to Carbon Price by Interconnection

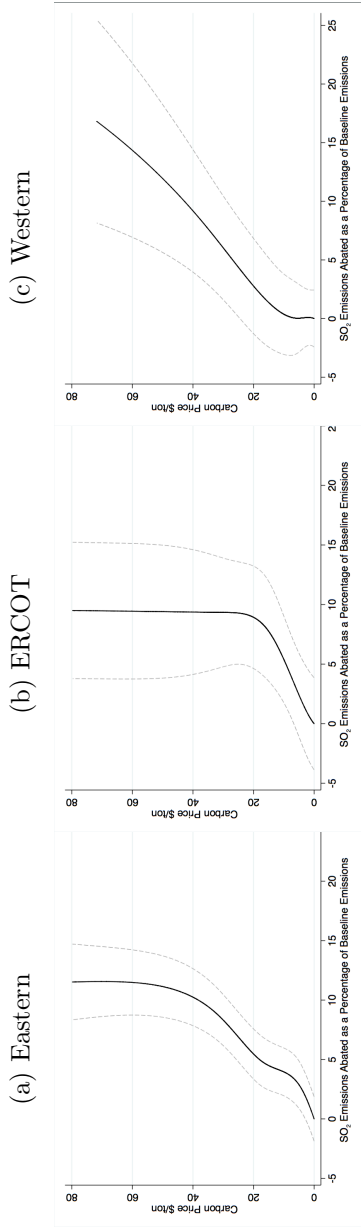
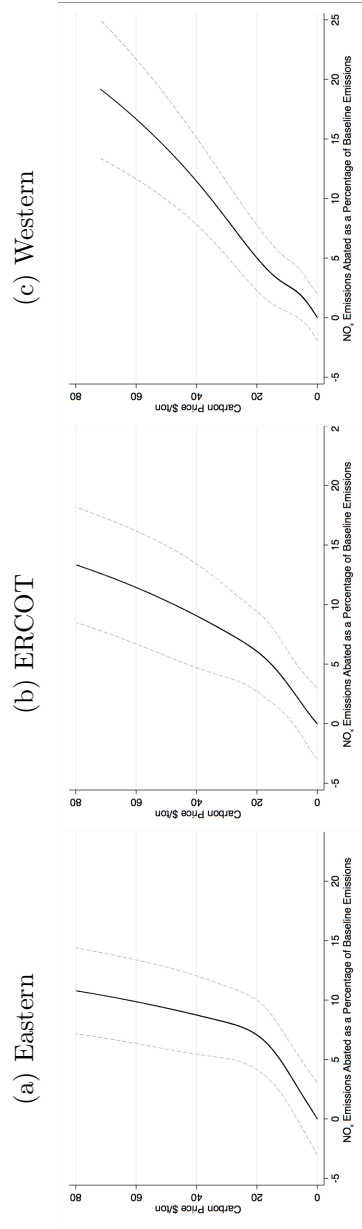


Figure 11: NO_x Response to Carbon Price by Interconnection



Some caution should be used in interpreting these results. If a cap-and-trade market already exists, for SO₂ for example, then an additional carbon price cannot affect aggregate emissions (assuming the cap continues to bind). This does not mean that the market will be unaffected: a carbon price reduces demand for SO₂ permits, the permit prices will fall, and the spatial distribution of emissions will change. Even for the direct effects on CO₂ emissions, the California and RGGI markets are now capping emissions in their respective areas. During our sample period, RGGI permits were quite low and California was just starting to trade, making it very unlikely that these policies affect our estimates. However, going forward, it is important to keep in mind how state, regional, and national carbon policies interact (Goulder & Stavins 2011).

8 Discussion

Understanding how a carbon price will affect polluting firms in the near term may be an important first step in demonstrating the overall effectiveness of such an instrument for use in the long run. That said, our results should not be viewed as the ultimate effect of a carbon policy since carbon pricing is capable of leading to new investment in cleaner technology, the exit of carbon-intensive power plants, and changes in demand levels and patterns which may further reduce emissions over a longer time horizon. For example, Cullen & Renolds (2016) develop an equilibrium model of generator investment and find that a carbon price as low as \$20/ton may induce the exit of most coal facilities and encourage substantial entry of renewables. Other work using structural modeling finds substantial reductions in electricity demand due to pricing carbon. Newcomer et al. (2008) calculate that a \$50/ton carbon price would reduce the quantity of electricity demanded by 10% offpeak and by 4% on peak in the MISO region (assuming a constant elasticity of -0.1). For a similar carbon price, Cullen (2015) finds a 19% decrease in aggregate demand in ERCOT (assuming a constant elasticity of -0.7).⁴⁹

However, other long run effects may diminish the amount by which a carbon price reduces emissions. Namely, if long run fuel supply functions are not perfectly elastic, then a carbon

⁴⁹See Reiss & White (2005) for estimates of the price elasticity of electricity demand and a discussion of the relevant literature.

price will cause prices to rise for low-carbon fuels, like natural gas, and will cause prices to fall for high-carbon fuels, like coal. To gauge the impact of this effect, we exploit our main results to develop a back-of-envelope calculation for the likely increase in gas prices under carbon pricing due to increased demand for natural gas in the electricity sector. We find that a carbon price of \$20 (\$70) would increase natural gas consumption by 15% (32%) in the electricity sector leading to a 5% (11%) increase across all sectors.⁵⁰ Assuming a long-run supply elasticity of natural gas of 0.81, as estimated in Hausman & Kellogg (2015), this implies an increase in the price of natural gas of 4% (9%). The details supporting these calculations can be found in Appendix C. While not insignificant, this indicates that the equilibrium fuel price response is not likely to seriously reduce either the near-term or the longer term emission reductions of carbon pricing in the electricity sector.

9 Conclusion

This paper provides estimates, based on observed behavior rather than simulations, of the impact of carbon pricing on electricity-sector emissions. We show how lower gas prices and a carbon price can affect the relative costs of generators in similar ways. This paper exploits significant variation in natural gas prices that resulted from a rare combination of factors: a large recession, the start of the shale revolution, and limited capacity to export gas. In the near future, the federal government projects an end to these low prices as exports rise and the economy recovers (EIA 2012). In this paper, we use the recent price variation to estimate how the electricity sector's carbon emissions respond to fuel cost shocks, and examine conditions under which this response to relative fuel prices can inform us about how a price on carbon dioxide will change emissions in the near term.

Our results indicate that carbon prices will result in a modest effect on emissions: even a price of \$70 per ton of carbon dioxide will reduce emissions only 10%. However, much of the reduction in carbon dioxide emissions can be captured with a relatively modest carbon price: a price of \$20 reduces emissions by 6%. Furthermore, carbon prices are much more effective at reducing emissions when natural gas prices are low. In contrast, modest carbon

⁵⁰During our sample period, the power sector accounted for 31% of total US natural gas consumption (http://www.eia.gov/dnav/ng/ng_cons_sum_dcu_nusa.htm).

prices have negligible effects when gas prices are at levels seen prior to the shale revolution. Finally, we show how a carbon price can result in co-benefits by reducing local emissions, in aggregate, in an approximately proportional manner.

Many emissions trading policies including the EU ETS, RGGI, and RECLAIM have been criticized for their effectiveness in reducing emissions in the short run.⁵¹ While the overarching objective of climate policy is to reduce aggregate cumulative emissions of greenhouse gases, much of the focus to date has been on the short-run impacts. We argue that understanding how firms substitute between fuels is important for knowing how effective a market-based instrument can be in the near-term, where the policy debate over carbon pricing seems to focus.

⁵¹Tvinnereim (2014) discusses several reasons why many cap-and-trade policies have had lower permit prices than expected. Concerns over RECLAIM were due to high prices, non-compliance, and environmental justice (see Fowlie, Holland & Mansur (2012) for an analysis of these concerns).

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URL: www2.epa.gov/sites/production/files/2014-06/documents/20140602tsd-goal-computation.pdf

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A Appendix

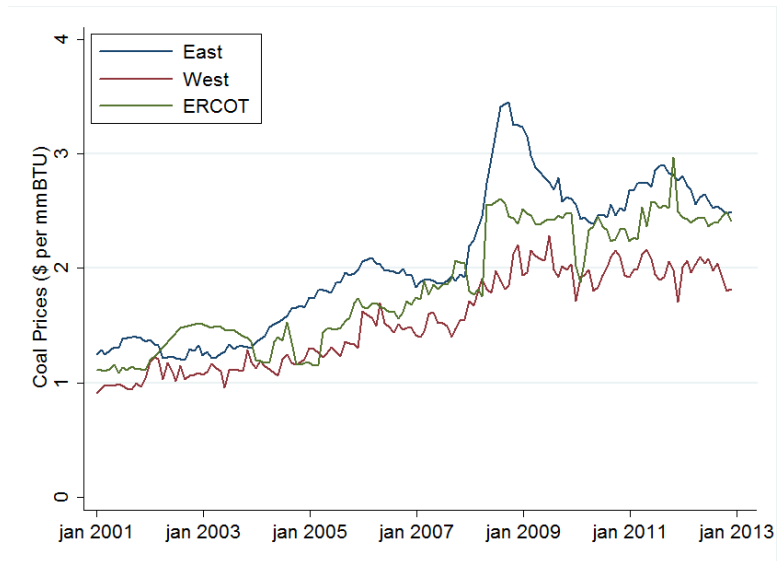
A.1 Coal Price Regressions

Section 4 discusses the method we use to calculate a coal price index. In this appendix, we report the regression results for each region (see Table A.1). We also show the national average for comparison. While the type of coal a power plant purchases may change in response to natural gas prices, we are concerned that the heterogeneity in coal transactions within a plant may also reflect noise. So, we construct a coal price index based on the average coal characteristics in a region as of January 2001. We then add the monthly fixed effects to the base price, thereby keeping the coal composition constant for a region. This coal price index is shown in Appendix Figure A.1.

Table A.1: Coal Price Index Regression Results

Variable	National	East	West	ERCOT
Sulfur	-13.59*** (1.38)	-13.59*** (1.36)	-10.51* (5.77)	1.40 (12.86)
Ash	2.09*** (0.26)	2.69*** (0.33)	-1.53*** (0.35)	0.40 (2.00)
Mine	-7.99*** (1.81)	-10.88*** (1.88)	19.31*** (5.99)	32.33*** (7.13)
Btu	4.40*** (1.40)	4.37*** (1.42)	5.33*** (0.95)	5.24* (3.09)
Month-Year F.E.	Yes	Yes	Yes	Yes
Plant F.E.	Yes	Yes	Yes	Yes

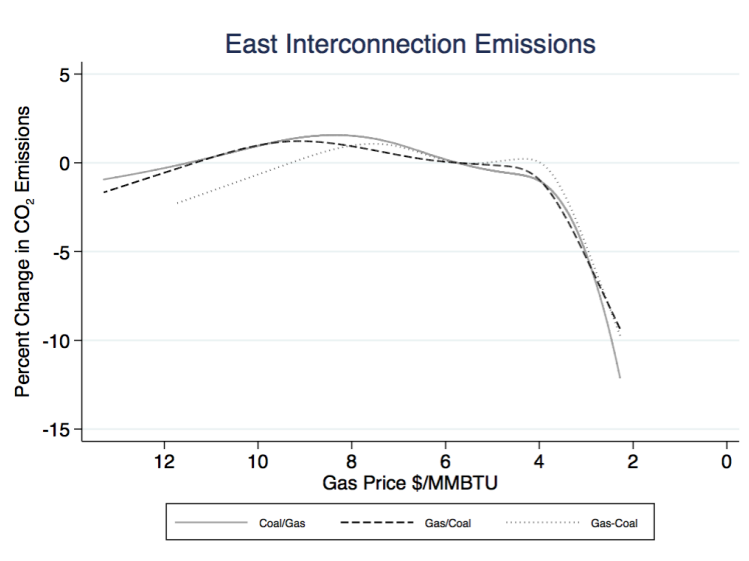
Figure A.1: Monthly Coal Price Indices



A.2 Robustness to Function of Relative Fuel Costs

Figure A.2 estimates the level of emissions in the East as a function of fuel prices using three different functional forms of relative fuel prices. They are (1) our main specification of coal/gas ratio, (2) the inverse ratio of gas/coal, and (3) the price difference of the natural gas price minus the coal price (in \$/mmBTU). All three ratios show very similar mappings of gas prices to emissions, holding coal prices fixed.

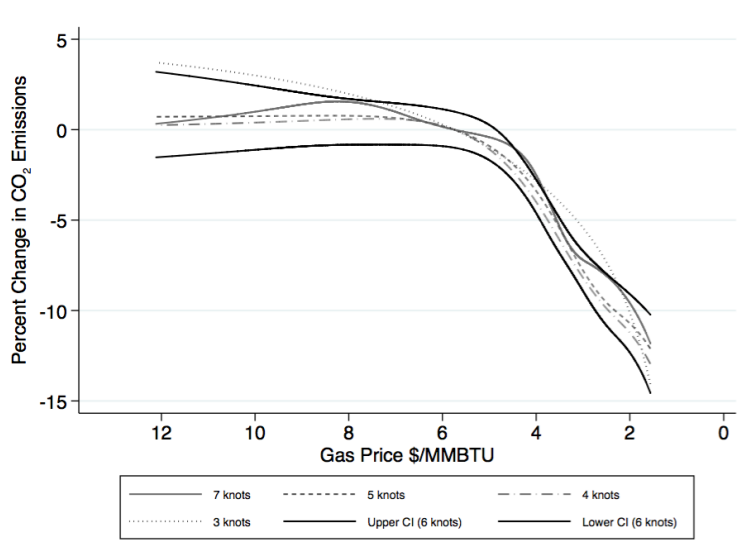
Figure A.2: Robustness to Functional Form of Fuel Costs



A.3 Robustness to the Number of Knots

The main results use six knots in the cubic splines of several variables, including the cost ratio. Figure A.3 shows how the predicted emissions in the East change with the number of knots in comparison to Figure 7a. We see that for four and five knots, the results are virtually identical to the model with six knots and lie completely within the 95% confidence of the six knot specification. For the model with only three knots, the emissions response is overstated at high gas prices, where there are few observations. This model also smoothes over the sharp drop in emissions around \$5/mmBTU. The model with seven knots is more sensitive to noise in the data that leads to non-monotonicity in the response curve. It is also almost entirely within the 95% confidence interval of the six knot specification. Overall, the results are qualitatively and statistically insensitive to the number of knots used to form the cubic spline.

Figure A.3: Robustness to Number of Knots



A.4 Electricity Demand

Our analysis does not account for the change in electricity demand that may occur when equilibrium electricity prices increase under a carbon price. Although we cannot impute the demand response to higher counterfactual electricity prices, we can understand how a price on carbon would affect emissions if demand were lower. We do this by splitting the sample by the median daily demand in each month of the sample. That is, we define high demand days in a month to be those days whose demand is higher than the median demand in that month. Low demand days are those below the median. We do this by month of sample to avoid selection on seasonality or time trend. That is, we avoid comparing only winter months to only summer months or the beginning of the sample to the end of the sample. In a month, some days will be happen to be higher demand due to weather and other shocks to demand. This limits the difference in demand between the high and low demand groups, but ensures

a comparable sample. The average difference between the high and low demand sample is about 10% of demand as shown in table A.2. This can be seen in the kernel densities of the two regimes. Figure A.4a shows the density of demand has a similar shape but shifts in the high and low demand regimes. Although there is a shift in the distribution of demand, the distribution of gas/coal cost ratios is almost identical in the two regimes as shown in Figure A.4b. We use the same specification used for our main results to estimate the response of emissions to variation in the cost ratio in both the high demand and the low demand sample. The results, shown in Figure A.5, demonstrate that there is very little difference between the high and low demand samples. Only in ERCOT at very low gas prices is there a divergence. As we would expect, low demand implies a higher response to relative prices.

Table A.2: Average Daily Demand (GWh) in High and Low Demand Samples

	Low	High	% Difference
East	7053	7855	10.2
ERCOT	810	922	12.2
West	1758	1910	8.0

Figure A.4: Distributions by Demand Regime: Eastern Interconnection

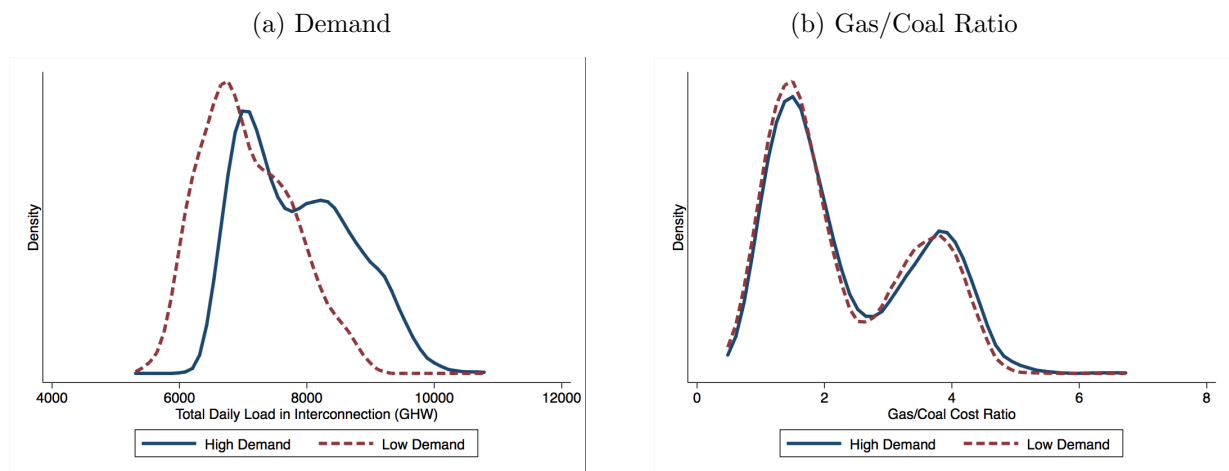
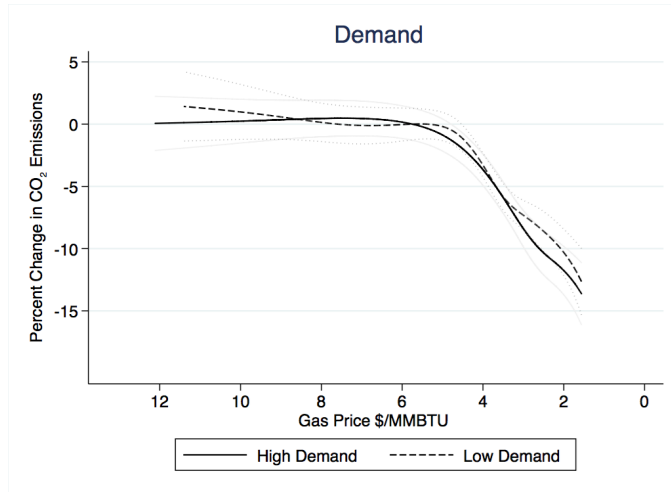
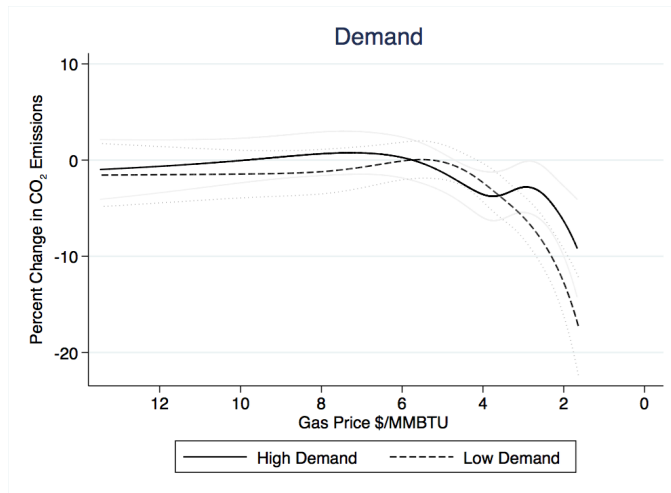


Figure A.5: CO₂ Response in High and Low Demand Periods

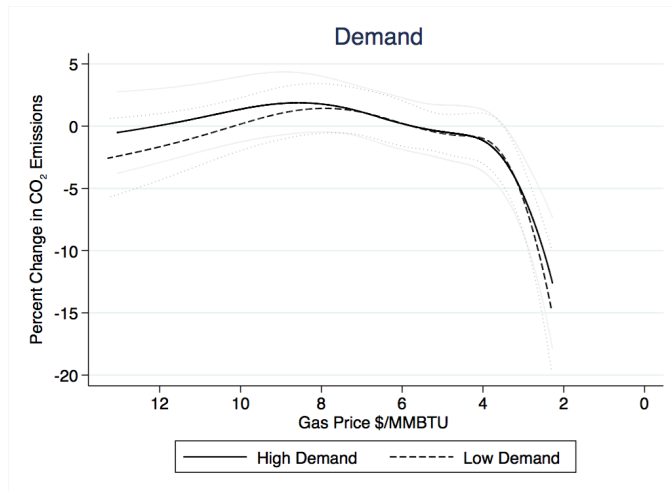
(a) Eastern Interconnection



(b) ERCOT Interconnection



(c) Western Interconnection



B Appendix for Online Publication

B.1 Gas Prices and Coal/Gas Cost Ratio

For comparison with the coal prices, Figure B.1 shows variation in gas prices over time for each of the three regions. Figure B.2 shows the variation in the ratio of the coal to gas price which is the variable of interest in our estimation procedure. Both gas prices and the ratio show substantial variation over time and across regions. Even in later time periods we see substantial variation in the coal to gas price ratio. Even after 2010 we have cost ratios that range between 0.5 and 1.25. These correspond to carbon prices less than \$10 and greater than \$100 at our baseline prices for gas and coal.

Figure B.1: Daily Gas Price Index by Region

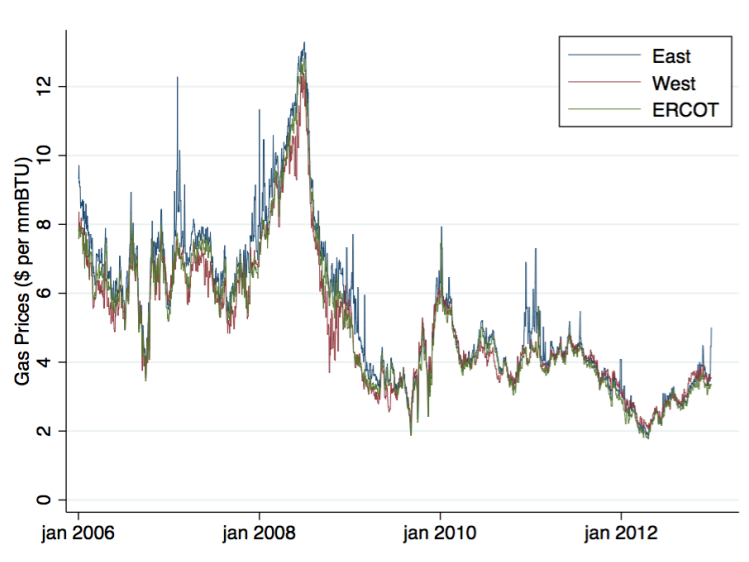
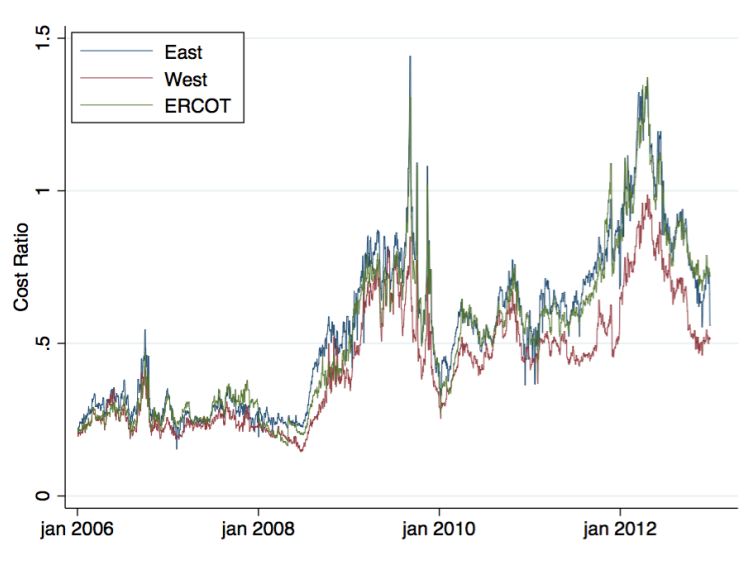


Figure B.2: Coal/Gas Price Ratio by Region



B.2 Simple Model of Potential Fuel Switching

This section of the appendix describes the methodology that we use to calculate the potential for fuel switching. First we calculate the total electricity generated (gen_{ift}) in interconnection i , fuel type f , and hour of sample t :

$$gen_{ift} = eiagen_{ifm} \cdot \frac{cemsgen_{ift}}{\sum_{t \in m} cems_{gen_{ift}}},$$

where $eiagen_{ifm}$ is the aggregate monthly net generation reported in EIA form-923 and $cemsgen_{ift}$ is the hourly gross generation reported by CEMS.⁵² In other words, we use the variation within a month reported by CEMS to distribute the EIA monthly generation.

Next we calculate the nameplate capacity by fuel type, month, and interconnection. We define unused capacity as the difference between hourly generation and available capacity, where available capacity is nameplate capacity that is derated to account for the fact that power plants shut down for routine maintenance or because of forced outages. We test the robustness of our calculations to several different derating factors (75% to 100% for each 5% increment).

Finally, we calculate the carbon implications by comparing the unused capacity of natural gas plants within an interconnection and hour with the contemporaneous generation from coal-fired power plants. For each hour and interconnection, we calculate the generation from coal generators that could be reallocated to idle natural gas capacity. This produces a measure of potential fuel switching. Surprisingly, in most hours, we find that there is substantial unused gas capacity to completely offset all coal generation, even for low derating rates. In order to convert generation into potential carbon reductions, we use the emissions

⁵²We use a second measure of hourly generation (\widetilde{gen}_{ift}) based on heat input data from CEMS to allocate $eiagen_{ifm}$ across hours in a month: $\widetilde{gen}_{ift} = eiagen_{ifm} \cdot (cemsheat_{ift} / \sum_{t \in m} cemsheat_{ift})$, where $cemsheat_{ift}$ is the hourly heat input reported by CEMS. The results are quite similar.

factors mentioned in footnote 18 and the average heat rate by year, interconnection and fuel type: $(\sum_{m \in yr} eiaheat_{ifm} / \sum_{m \in yr} eiagen_{ifm})$, where $eiaheat_{ifm}$ is the aggregate monthly heat input reported in EIA form-923 for interconnection i , fuel type f , and month m in year yr .

Note that this calculation makes many assumptions about transmission capacity, power plant operation capabilities, information, and incentives that we argued in Section 2 were unreasonable and motivation for a more careful analysis that we revisit Section 5. Nonetheless, we report the simple model in order to get a sense of how much unused gas capacity is available.

Table B.1 shows the potential reduction in carbon emissions by year for two derating rates, 90% and 80%. The paper reports the results just for 2012 with a derating rate of 90%.

Table B.1: Potential Shares of Carbon Emissions Reduced from Fuel Switching

Year	Derate at 90%			Derate at 80%		
	East	ERCOT	West	East	ERCOT	West
2001	0.28	0.31	0.26	0.24	0.30	0.21
2002	0.37	0.33	0.40	0.33	0.33	0.38
2003	0.44	0.34	0.41	0.41	0.34	0.40
2004	0.47	0.39	0.42	0.44	0.39	0.41
2005	0.46	0.39	0.44	0.43	0.39	0.43
2006	0.45	0.39	0.42	0.43	0.38	0.42
2007	0.45	0.39	0.41	0.42	0.39	0.40
2008	0.46	0.39	0.41	0.44	0.38	0.41
2009	0.47	0.39	0.41	0.45	0.38	0.40
2010	0.44	0.40	0.43	0.42	0.40	0.43
2011	0.45	0.40	0.44	0.42	0.39	0.44
2012	0.42	0.37	0.40	0.41	0.36	0.40

B.3 Results and Data Distribution

In this section, we take the results shown in Figures 7 and 8, and overlay histogram of variable of interest to show the density of data that identify the curve. We also show the location of the knot points used in estimation. These are shown for the East electricity generation region, but the pattern is similar in the West and ERCOT. Figure B.3, shows the results as gas prices decrease with the coal price fixed at the long run base case as in Figure 7a. The six knot points spaced according to the distribution of the cost ratio at the 5, 23, 41, 59, 77, 95 percentiles. Importantly, the histogram shows that the data are dense in the areas where the gas price is relatively low. Identifying the response of generators to low gas prices is what allows the model to make predictions about the response of generators to a price on carbon.

Figure B.4 transforms the results be a function of carbon prices as detailed in the body of the paper. The curve is identical to the one in Figure 8a, but with percentage change on the y-axis. We again have imposed the knot points and the histogram of the data onto the estimated response curve. There are many data points up through about \$60/ton after which the density of the data begins to be stretched out. Note that only 5 knot points show up in this graph. This because we only report the results for carbon prices less than \$80/ton. There are implied carbon prices in excess of \$200/ton, but the data are sparse for higher carbon prices. Thus, we have to rely more on the function form to identify the behavior of generators for very high carbon prices. Also, these prices are less interesting from a policy perspective. For comparison, the results over the full range of implied carbon prices is shown in Figure B.5.

Figure B.3: Estimated CO₂ Response to Fuel Prices

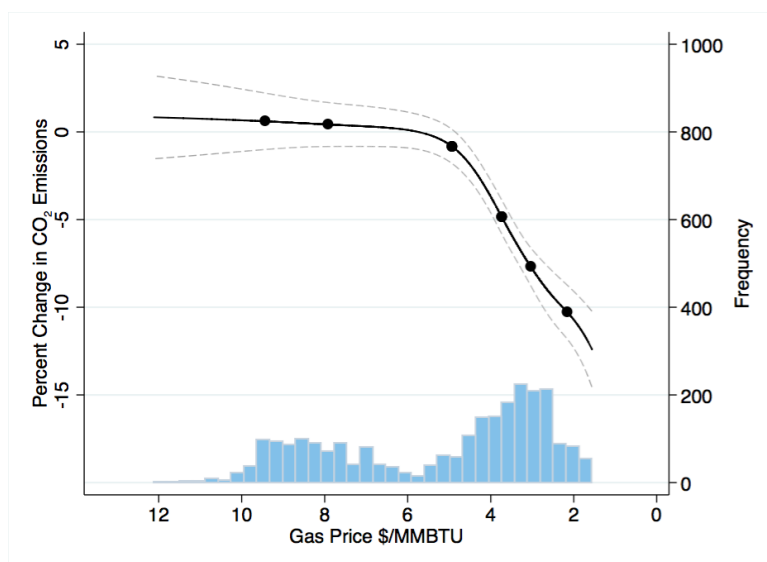


Figure B.4: Imputed CO₂ Response to Carbon Prices

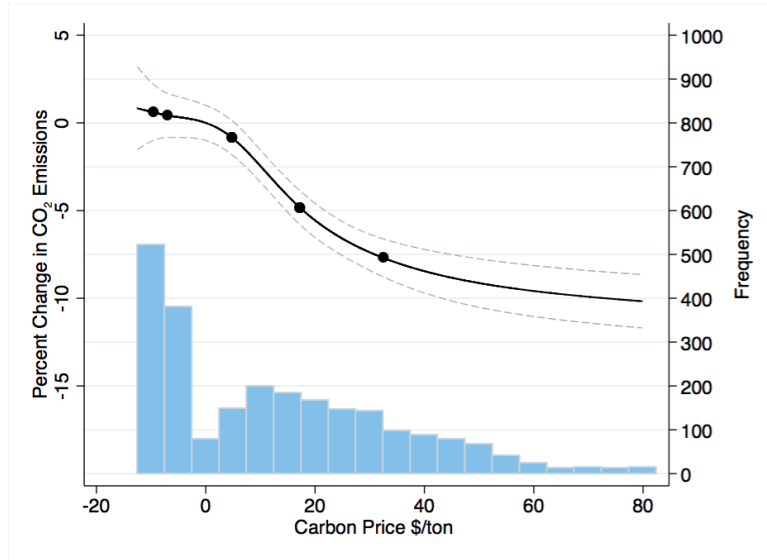
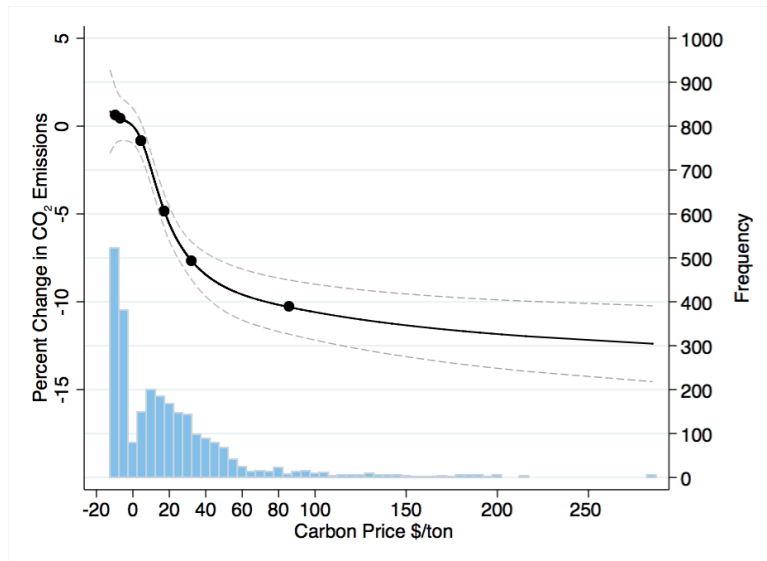


Figure B.5: CO₂ Response for Full Range of Imputed Carbon Prices



B.4 Parameter Estimates

Table B.2 presents the parameter estimates and Newey West standard errors that allow for a seven-day lag structure for our main results. Variables which are represented as a restricted cubic spline have five parameters associated with them. These five parameters are associated with transformed versions of the original variable. The transformation incorporates the choice of the knot points and the restrictions on the cubic spline. Due to their transformation, the individual parameters do not have a straightforward interpretation. However, we report the estimates for completeness and replicability.

Table B.2: Parameter Estimates

Variable	East		ERCOT		West	
	Coef.	S.E.	Coef.	S.E.	Coef.	S.E.
Price Ratio 1	-205218	(521921)	93719	(62411)	352024	(160581)
Price Ratio 2	4760365	(1.75e+07)	-2142828	(2260089)	-8828279	(5094672)
Price Ratio 3	-1.33e+07	(2.42e+07)	2385139	(4171850)	1.29e+07	(8159820)
Price Ratio 4	2.16e+07	(1.17e+07)	910225	(2701735)	-4620928	(4988153)
Price Ratio 5	-1.55e+07	(9142587)	-2379661	(1601897)	-764223	(3604246)
Daily Load 1	.788	(.0416)	.42	(.0438)	.37	(.0515)
Daily Load 2	-.189	(.295)	.921	(.955)	-.0982	(.371)
Daily Load 3	-.329	(1.53)	-3.05	(2.63)	-1.7	(2.31)
Daily Load 4	1.65	(2.19)	3.09	(2.44)	5.94	(4.06)
Daily Load 5	-1.76	(1.41)	-1.16	(1.1)	-6.14	(2.99)
Std Dev Load	-10.8	(2.75)	9.55	(2.42)	-2.76	(3.24)
Max Load	2.72	(.9)	-1.48	(.803)	1.99	(1.14)
Min Load	-6.36	(1.3)	4.8	(1.26)	-1.41	(1.2)
Temperature 1	-15753	(2128)	67.7	(399)	-1900	(803)
Temperature 2	48711	(11663)	-1117	(1580)	-969	(6152)
Temperature 3	-131112	(46188)	-1303	(6788)	14344	(23569)
Temperature 4	210643	(76370)	26024	(16414)	-15611	(33735)
Temperature 5	-61719	(104930)	-61978	(29001)	17179	(29878)
Non-fossil	.0101	(.00167)	-.0133	(.00172)	-.00813	(.000674)
Electricity Imports	.0548	(.0146)			.0142	(.006)
SO ₂ Prices	-280	(71.7)	53.6	(10.1)	40.4	(21.1)
F.E. 2006 Q2	-176292	(38052)	5511	(8404)	-25670	(17796)
F.E. 2006 Q3	-328363	(46541)	30799	(7180)	53294	(16994)
F.E. 2006 Q4	-99481	(78366)	38940	(6989)	90511	(17635)
F.E. 2007 Q1	-289146	(69998)	28511	(8359)	43597	(20572)
F.E. 2007 Q2	-124088	(53675)	31097	(7367)	18065	(19651)
F.E. 2007 Q3	-198244	(51447)	35511	(8034)	55407	(19871)
F.E. 2007 Q4	-51159	(51394)	45189	(7095)	78231	(18779)
F.E. 2008 Q1	-217079	(62074)	40065	(8723)	48960	(18903)
F.E. 2008 Q2	-282016	(73059)	82441	(10525)	49589	(24150)
F.E. 2008 Q3	-488521	(74887)	78210	(11649)	80486	(25276)
F.E. 2008 Q4	-150002	(73451)	59770	(12654)	97737	(26246)
F.E. 2009 Q1	-381247	(84577)	46438	(13461)	68137	(27406)
F.E. 2009 Q2	-175991	(86804)	61084	(14322)	-6509	(30209)
F.E. 2009 Q3	-408618	(94665)	68576	(14683)	90599	(30585)
F.E. 2009 Q4	-319035	(85683)	76810	(13658)	95831	(28526)
F.E. 2010 Q1	-533501	(86725)	51957	(13920)	49514	(27808)
F.E. 2010 Q2	-274691	(89587)	68685	(16532)	26262	(30891)
F.E. 2010 Q3	-437117	(88881)	93294	(14893)	95810	(29840)

F.E. 2010 Q4	-242801	(85932)	91877	(14820)	79171	(30085)
F.E. 2011 Q1	-483165	(90909)	91413	(14985)	-385	(33313)
F.E. 2011 Q2	-277878	(88872)	99518	(15075)	-71088	(30391)
F.E. 2011 Q3	-473267	(101035)	107840	(15263)	19183	(32634)
F.E. 2011 Q4	-506237	(95251)	88076	(14744)	52658	(31134)
F.E. 2012 Q1	-693847	(102784)	64690	(15812)	60991	(33189)
F.E. 2012 Q2	-475982	(100653)	66837	(18255)	207	(34720)
F.E. 2012 Q3	-644173	(106752)	90908	(15769)	33146	(34896)
F.E. 2012 Q4	-577845	(96159)	85238	(15545)	76350	(30975)
Constant	643968	(335912)	62601	(41208)	316994	(109735)
Observations	2557		2557		2557	
R^2	0.980		0.954		0.938	

Standard errors in parentheses

Notes: Load is daily load; Non-fossil is non-fossil generation; Temp is temperature; Imports is Canadian net imports of electricity. F.E. is time fixed effect.

B.5 Co-pollutants

This section complements the analysis shown in Figures 10 and 11 of the text by examining how the effects of SO_2 and NO_x are disbursed spatially. The EPA subregions of the US are showing graphically in the Figure B.7 . Figure B.6 shows how a price of \$20 per ton of carbon dioxide would affect CO_2 , SO_2 , and NO_x emissions in each region. The methodology is identical to that described in the paper. In particular, note that the independent variables are still at the interconnection level.

We see from the figure that the emissions response varies regionally. The subregions SRVC (the North Carolina, South Carolina, and Virginia region), RFCE (the New Jersey, Maryland, Delaware, and eastern Pennsylvania region), and NEWE (New England) show the largest reductions of about ten percent for CO_2 .

However, this does not lead to the largest percent reductions in local pollutants. The co-benefits (in percentage terms) are largest in SRVC and SRSO (the Alabama and Georgia region) for NO_x , and NEWE, SRVC, and CAMX (California) for SO_2 . Note that California has very little SO_2 . The regional responses of three pollutants are positively correlated across pollutants. However, they do show very different patterns.

Figure B.6: Emissions Response to Carbon Price by Subregion

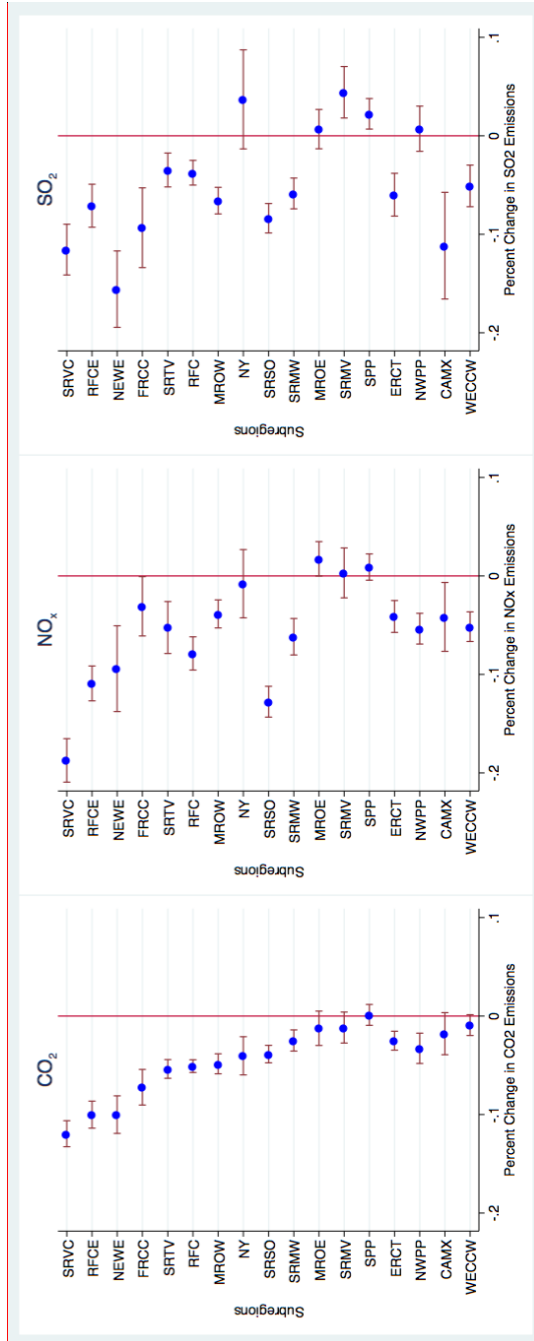


Figure B.7: Map of eGrid Subregions

eGRID Subregion Representational Map

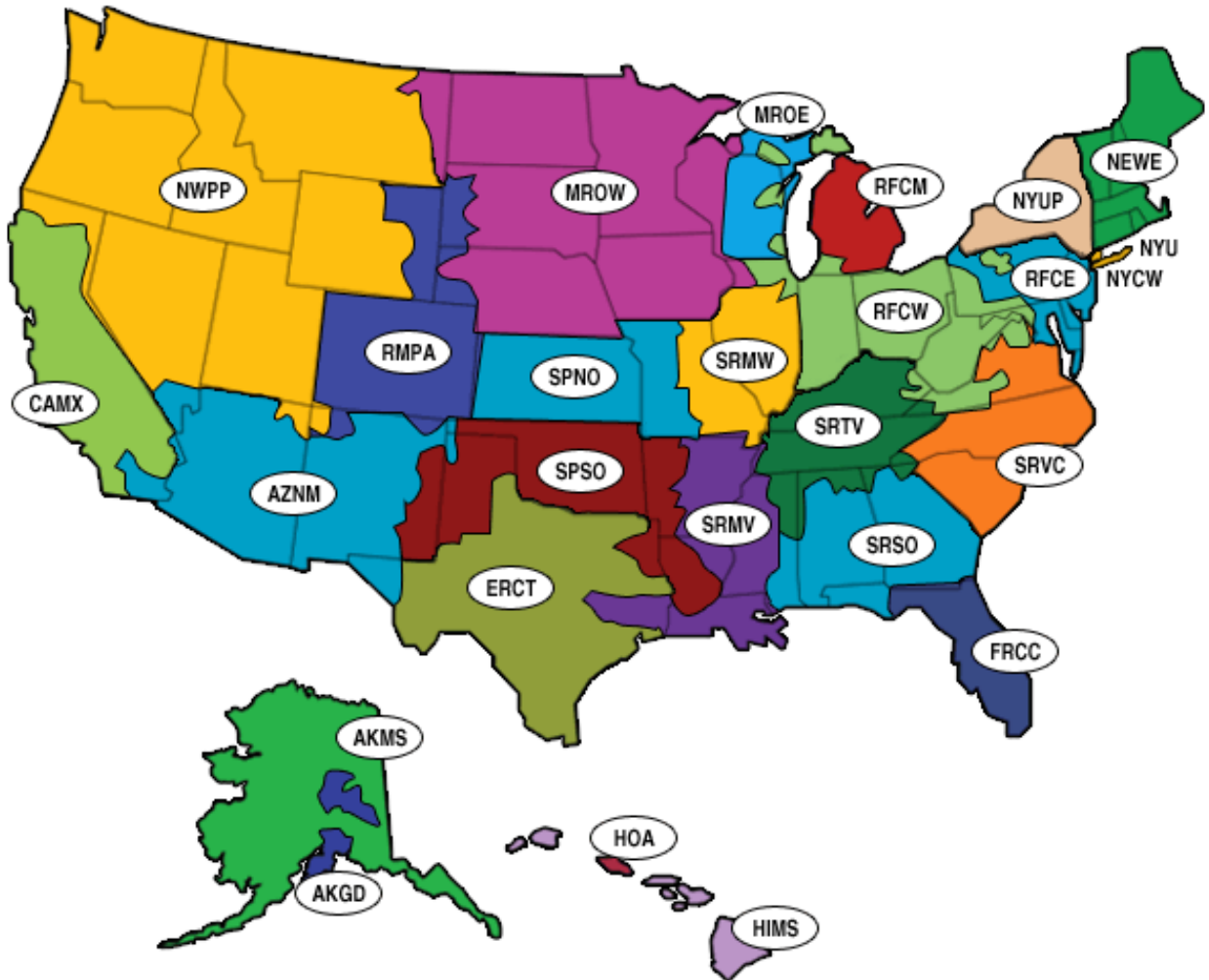
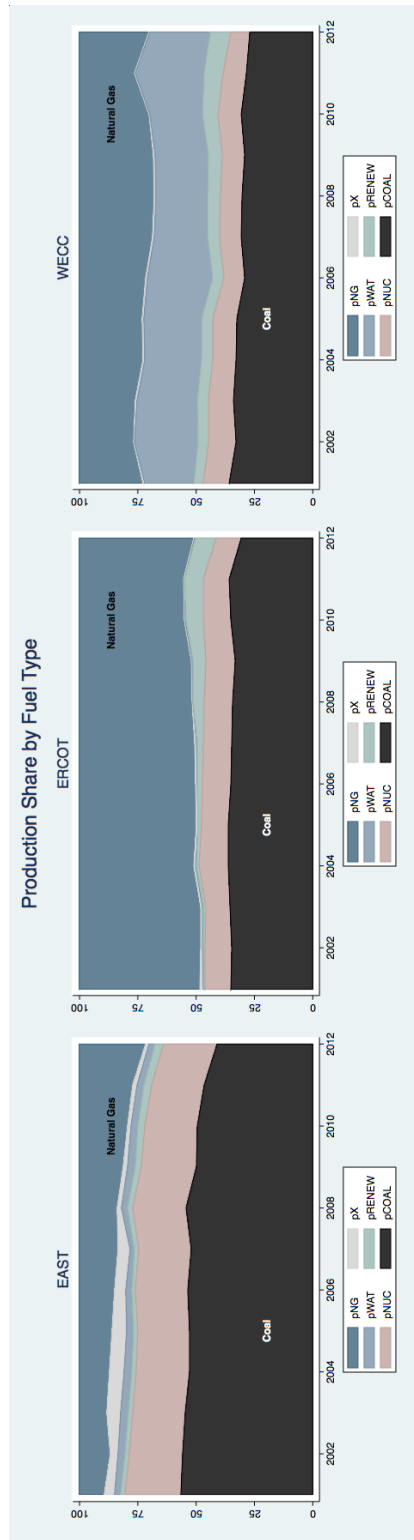


Figure B.8: Generation Shares by Fuel Type and Month



B.6 Sensitivity Analysis

In this appendix, we test the sensitivity of our main results. Table B.3 show the robustness results for each Interconnection to the controls of the model. The predicted percent change in emissions at a \$20 carbon is used as the benchmark value. The first column uses no controls, but includes season-of-sample fixed effects. Further columns add controls for electricity load, temperature, non-fossil generation, electricity imports and sulfur dioxide permit prices. The final column, which includes all controls, is the preferred specification used for the main results in the paper. In each interconnection, failing to control for electricity demand shocks leads to a much higher estimates of emissions reduction due to a carbon price. Other controls tend to mitigate the estimated effects, but differences are not as pronounced. In the West, however, controlling for non-fossil generation is particularly important due to the large share of hydro capacity in the region.

We also explore the sensitivity of the results to various time fixed effects as well as sub-samples of the data in Table B.4. The first column includes all the controls in the main specification, but no season-of-sample fixed effects. The subsequent columns add progressively finer, time-based fixed effects up to month-of-sample fixed effects. The final two columns split the sample into the first and second half of the sample. Including fixed effects in for a time trend is important for the results. Adding year fixed effects, which would control for trends in the types of generating capacity on the grid, reduces the estimated impact in each region. Controlling additionally for seasonality, with season-of-sample fixed effects, increases the predicted effect of a \$20 carbon price, though not dramatically. However, using month-of-sample fixed effects absorbs much of the variation in prices necessary to identify the effect. Month-of-sample fixed effects greatly reduce the estimated impact of a carbon price in all interconnections and render it statistically insignificant in ERCOT and the West.

Table B.3: Robustness to Controls

 CO_2 Change at \$20/ton

	(1)	(2)	(3)	(4)	(5)	(6, Main)
East	-24.3*** (1.35)	-7.86*** (0.46)	-6.67*** (0.45)	-5.85*** (0.46)	-5.64*** (0.50)	-5.54*** (0.50)
ERCOT	-23.1*** (2.31)	-4.61*** (1.08)	-4.22*** (1.22)	-3.92*** (1.02)	-3.92*** (1.02)	-3.96*** (1.00)
West	-7.79*** (1.24)	1.08 (0.99)	0.98 (1.20)	-2.59** (1.10)	-2.15 (1.14)	-2.05 (1.14)
Load	No	Yes	Yes	Yes	Yes	Yes
Temperature	No	No	Yes	Yes	Yes	Yes
Non-fossil	No	No	No	Yes	Yes	Yes
Imports	No	No	No	No	Yes	Yes
SO_2 Prices	No	No	No	No	No	Yes
Time F.E.	Season	Season	Season	Season	Season	Season
Obs	2557	2557	2557	2557	2557	2557

Standard errors shown in parentheses.

Table B.4: Robustness to Time Effects

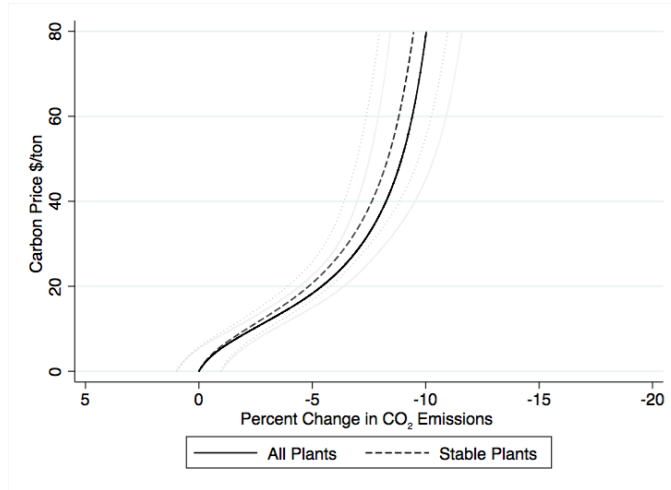
 CO_2 Change at \$20/ton

	(1)	(2)	(3, Main)	(4)	(5)	(6)
East	-5.64*** (0.59)	-4.16*** (0.57)	-5.54*** (0.50)	-2.87*** (0.30)	-4.22*** (0.90)	-4.54*** (0.63)
ERCOT	-5.51*** (0.82)	-3.00*** (0.97)	-3.96*** (1.00)	-0.07 (1.04)	-2.75 (1.54)	-5.47*** (1.10)
West	-4.29*** (0.82)	-1.45 (0.91)	-2.05 (1.14)	-0.24 (0.99)	-4.49** (1.80)	-2.30** (1.01)
Load	Yes	Yes	Yes	Yes	Yes	Yes
Temperature	Yes	Yes	Yes	Yes	Yes	Yes
Non-fossil	Yes	Yes	Yes	N/A	Yes	Yes
Imports	Yes	Yes	Yes	N/A	Yes	Yes
SO_2 Prices	Yes	Yes	Yes	N/A	Yes	Yes
Time F.E.	No	Year	Season	Month	Season	Season
Sample	Full	Full	Full	Full	2006-2009	2009-2012
Obs	2557	2557	2557	2557	1278	1279

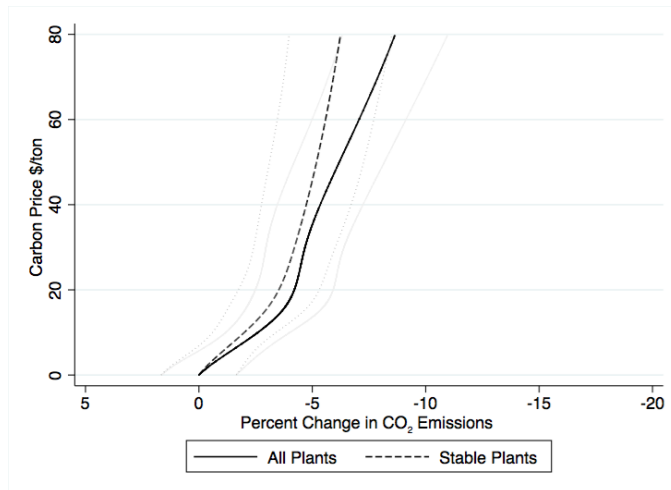
Standard errors shown in parentheses.

Figure B.9: Stable Plants' Response to Carbon Price by Interconnection

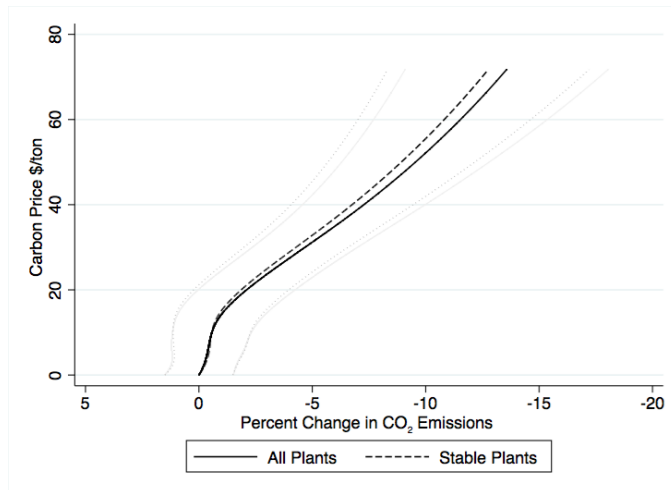
(a) Eastern Interconnection



(b) ERCOT Interconnection



(c) Western Interconnection



C Carbon Price Effect on Natural Gas Prices

In this appendix we use a back-of-the-envelope calculation to approximate the change in the natural gas price resulting from a carbon price. Our results in the body of the paper estimate the reduction in aggregate emissions from pricing carbon holding fixed the expected future fuel prices, the generating capital and electricity demand. Under these assumptions, the predicted reduction in emissions observed must come from increased electricity production from natural gas and decreased electricity production from coal. Since the increased demand for natural gas may lead to higher than expected future natural prices, our estimates of carbon emission reductions may be overstated. In this section, we will use our model estimates and assumptions on generator characteristics to gauge the extent to which natural gas prices might increase due to carbon pricing.

First, in Table C.1 we aggregate the model results across regions to produce the national reduction in CO₂. We see that at a \$20 carbon price the model predicts a decrease in carbon emissions by 321,000 tons per day on average. This represents a 5% reduction in overall emissions. Similarly, a \$70 price leads to 655,000 fewer tons of carbon dioxide or 10% of baseline emissions. Holding the quantity of electricity demanded constant, a one ton reduction in emissions implies that the electricity sector burns more natural gas and less coal. How much more gas will be burned depends on the relative efficiencies of the relevant natural gas and coal burning power plants. We use data to calibrate the relative efficiencies of representative power plants. Table C.2 shows the average tested efficiencies (heat rates) of gas combined cycle and coal plants (EIA 2012). These averages are likely to be a conservative characterization of the relative efficiencies of natural gas and coal power plants that comprise fuel switchers; in practice the most efficient gas plants will tend to substitute for the least efficient coal plants all else equal. However, using average efficiencies will give us a general idea of the potential change in natural gas demanded due to fuel switching.

We combine the plant efficiencies with information on the carbon content of coal and natural gas in order to calculate the CO₂ emissions by unit of production for natural gas combined cycle and coal plants.⁵³ The generator heat rates multiplied by the carbon content of the fuel burned gives the CO₂ emissions per unit of electricity as shown in the last column of the table. From these figures, one can see that switching one MWh of production from an average coal plant (emission rate of 1.07) to an average gas plant (emission rate 0.45) would lead to a -0.62 ton decrease in CO₂ emissions. Dividing the predicted changes in emissions from Table C.1 by this number gives the implied production switching necessary to produce those emission reductions. For example, the 321 thousand ton reduction in emissions shown in Table C.1 implies that 581 GWhs of production switched from coal generators to gas generators. This 581 GWhs of production would necessitate burning an additional 3.9 trillion Btus of natural gas. This represents a 15% increase in natural gas consumption in the electricity sector. Bear in mind that this is a generous estimate of the additional gas burn necessary to achieve the CO₂ reduction since the numbers in Table C.2 are conservative estimates of the relative efficiency of gas and coal plants engaged in switching.

Next we want to understand how a 15% increase natural gas consumption in the electricity

⁵³Note that characteristics of combined cycle gas plants are used for the calculations since these are the most likely switchers. They are the most efficient and most plentiful type of gas fired power plants.

sector might affect the price for natural gas. First, we need to understand what effect this will have on the overall demand for natural gas. Using data from the EIA of monthly natural gas consumption across all sectors, the 15% increase in demand from the electricity sector implies only a 5% change in overall gas consumption.

Using estimates of the supply elasticity for natural gas, we can calculate the expected change in natural gas prices due to increased demand for natural gas under a carbon price. Recent work estimates the supply elasticity of gas to be in the neighborhood of 0.81 (Hausman & Kellogg 2015). This would imply that a 4% (9%) change in the price of natural gas due to a \$20 (\$70) carbon price.⁵⁴ While these findings imply that our estimates of emissions reductions from carbon pricing may be slightly optimistic, these gas price changes are relatively small. A full analysis of the long run effects of a carbon price would need to account for the supply elasticity of fuel as well as the other factors discussed in the discussion section.

Table C.1

	Carbon Price	
	\$20	\$70
National CO_2 Emissions Reduction		
Thousands of tons daily	-321	-665
Percentage	-5%	-10%
Electricity Production (GWh)		
Δ Coal	-518	-1072
Δ Gas	518	1072
Fuel Consumption (Btu x 10^{12})		
Δ Coal	-5.2	-10.8
Δ Gas	3.9	8.2
Percentage Change in Gas Consumption		
Electricity Sector	15%	32%
All Sectors	5%	11%
Percentage Change in Gas Prices		
Supply Elasticity 0.81	4%	9%

⁵⁴W

Table C.2: Average Generator Efficiency

	Heat Rate (<i>mmBTU/MWh</i>)	Fuel CO ₂ (<i>lbs/mmBTU</i>)	CO ₂ Rate (<i>tons/MWh</i>)
Coal	10.11	211	1.07
Gas	7.62	117	0.45