

California Steamin'

Contrary to the conventional wisdom, California's energy problems are not the result of deregulation but of reregulation.

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One of the most tragic economic policies in poor Third World countries has been price controls. The inevitable results are shortages of the goods whose prices are controlled. California's government is pursuing the same policy with electricity, keeping the retail price low and causing shortages during peak times.

Why do price controls cause shortages? Because they keep the price below the free-market price, which causes users to want more, and suppliers to supply less, than they would have at the higher price. This is true whether the good whose price is controlled is cocoa in Ghana, gasoline in the United States circa 1979, or electricity in California.

That price controls are the main culprit is particularly easy to see in the case of California electricity. Much of California's electricity is produced from natural gas, and the price of natural gas in December 2000 averaged more than \$6 per million Btus, three times the price only one year earlier. At times in December, the spot price hit more than \$50 per million Btus. As a result, power producers were charging a wholesale price that exceeded the retail price the utilities were allowed to charge. When you lose on every unit sold, you can't make it up on volume.

Why, then, do we hear so many people blame the electricity crisis on deregulation? Mainly because if something is said enough times and no one contradicts it, most people will think it's true. For the last five years, almost everyone who writes about California electricity has said it's deregulated. It's not. Actually, California electricity has been reregulated.

For most of the last century, electricity in California was regulated in the same way that it was virtually everywhere else in the United States. Local governments granted monopolies to electric utilities for each geographic area. Then, rather than allow a monopoly price, regulators set prices to guarantee utilities a certain rate of return.

Deregulation: California Style

In 1996, all of that changed. First, the state government broke up utilities, forcing them to sell some of the electricity-generating part of their businesses. Now the utilities are simply middlemen for much of the power they sell. Second, the government prohibited utilities from making long-term contracts to buy power. That makes as much sense as it does for the government to make long-term leases illegal: imagine what would happen to your rent during a major golf tournament if you had a weekly lease on a house near the golf course. Peak demand recently caused wholesale power prices to reach \$1.40 per megawatt hour, more than 20 times their usual level. Had long-term contracts been allowed, this wouldn't have been as extreme. Governor Gray Davis's charge that the wholesalers are taking advantage of the situation may be true but for an ironic reason: the state government, which he is rumored to be part of, has put them in that position. Third, the government gave power over transmission to an "Independent System Operator." The ISO answers not to the utilities that own the transmission lines but to the government. As a result, no one has an incentive to maintain the transmission system. Fourth, the state kept retail rate regulation not to keep prices low but, ironically, to keep them high to compensate the power companies for some previous malinvestments. Finally, regulation has prevented the construction of any major power plants in California in almost a decade, while demand for electricity has grown by 25 percent in the past 8 years.

If this is deregulation, then Sweden's economy is *laissez-faire*.

Of course, the retail price controls kept the utilities from generating the cash flow needed to buy more power. Power producers, looking at the multibillion-dollar debts of the major utilities, began to doubt that they would be paid for future power and refused to sell. Here's where Gray Davis could have been a statesman. Indeed, he stated on February 16, "Believe me, if I wanted to raise rates, I could have solved this problem in 20 minutes." In other words, he understood that the shortages were due to price controls. Yet he has opposed price increases. Instead, he is using the California state budget surplus to have the state Department of Water Resources buy power, which it then passes on to the utilities in return for IOUs. Implicitly, therefore, the governor is subsidizing power consumption, just as Third World governments responded to shortages of price-controlled foods by subsidizing their purchase.

Because price controls and subsidies keep the price artificially lower, we consumers have not cut back on consumption as much as we would have. Noticing this, Loretta Lynch, the president of the California Public Utilities Commission, even went so far as to call heavy energy users "energy hogs." Imagine that: we use something more when its price is lower—what gluttons we must be. The regulators then add insult to injury by proposing regulations to limit particular uses independent of how much we value them. Gray Davis has said that his overall strategy is to get more power plants built and to have more conservation. But that's what raising electricity prices would lead to.

The Solution

The solution is real deregulation. We could literally end blackouts today by abolishing all price controls. Would prices go up? Absolutely. But that's good for three reasons: first, it will cause consumers to cut back if they aren't willing to pay the higher price on all their electricity uses but will allow those willing to pay more to get it. That way, power goes to those who value it most. That's preferable to, and more efficient than, having the government specify arbitrarily the victims of the next "rolling blackout." The second advantage is that a higher price charged at a retail level will give utilities an incentive to be willing to pay more at the wholesale level and bid power away from users in other states. The third advantage is that the government could stop squandering our tax dollars on electricity.

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The PUC did make some modest progress in late March by voting for a 40-plus percent increase. According to state controller Kathleen Connell, these price increases might not be enough both to pay down the utilities' existing debt to the state government and to finance future purchases. Indeed, the only way to tell what is enough is to deregulate the price and allow competition.

One sure result would be that utilities would make more use of peak-load pricing. Like space on an airplane, electricity can't be stored. That means that during peak times, generally between noon and 6:00 p.m. on weekdays, more power must be produced. Producers of this peak power must be paid a price that

compensates them for producing power for sometimes just a few hours a day. If prices were decontrolled, the utilities would raise prices for afternoon usage and possibly even lower them for, say, early-morning usage. Thus, people could save on their electric bills by doing laundry in the early morning or late at night, for example. Particularly flexible consumers might even pay lower electricity bills.

Compare this kind of "tier pricing" to the kind voted for by the PUC in March. Its tier pricing would set a lower price for household use below some level and a much higher price for use beyond that level. The determination of the tiers reflects some government official's arbitrary view of the ideal amount that each household should use, causing people who are already low users to use too much because they would pay an artificially low price. The efficient kind of tier pricing is peak-load pricing because the prices correspond to true costs of production.

What about the danger that, with deregulation of rates, utilities would use their ownership of transmission lines to charge monopoly prices? Actually, regulation is the cause of electric utilities' monopoly. Before regulation came along in the 1920s, many major cities had a few companies competing in the same areas. Regulation was used to shut them down and not let them compete.

The solution to the problem of monopoly is not more regulation but less. Electric utilities should be allowed once more to integrate vertically into production and transmission. Even today, in Lubbock, Texas, and in 22 other U.S. towns, there is head-to-head competition in production and distribution. Moreover, as Clyde Wayne Crews, an electricity economist at the Competitive Enterprise Institute, has pointed out, competing producers could contract for transmission with cable television companies, phone companies, gas pipeline companies, and numerous other possible carriers that only a free market will reveal. That way we can have real competition. We could see, for example, microturbine operators contracting with transmission companies to compete with the existing utilities. And, of course, we should reduce the regulations that make it difficult for power producers to build new plants. If, say, in 2001, all this competition—in production, transmission, and distribution—were allowed immediately, then by 2005, the fear of monopoly being caused by deregulation would look awfully silly.

Of course, the higher rates will be especially hard for low-income consumers to bear. But there's a straightforward budgetary solution that involves less government, not more. That solution is to slash the sales tax by 3 percentage points. The government would lose about \$10 billion in revenue. That sounds large, but it's comparable to Gray Davis's annual rate of expenditures to subsidize energy purchases. Even a modest-income family that spent \$6,000 a year on taxed items would save \$180, which could cover about half of the increase in its annual electricity bill.

We've had almost a century of government regulation of electricity. Why don't we, instead of just labeling regulation as deregulation, actually deregulate?