N.C. Can Dodge California's Power Pitfalls

by Andrew Brod
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A bill was recently introduced in the U.S. Senate that would set a cap on wholesale electricity prices in western states for the next few years. The bill was introduced by a California Democrat and an Oregon Republican, so it appears to have a decent shot at passage.

A few decades ago, such a bill wouldn't have raised eyebrows. Government intervention in energy and electricity markets used to be commonplace. But this law has been proposed as a result of California's very recent attempt to deregulate its electricity markets.

If this confuses you, join the club. Doesn't deregulation mean *not* bypassing the market to restrict prices?

Of course it does, and yet deregulation has been getting the blame for the steady melt-down of California's electric-power industry. It's an unfair accusation, but it threatens to slow progress in 25 other states, including North Carolina, that have plans to deregulate their electricity markets.

Before we look at what went wrong in California, let us first review the thinking behind deregulation in general. Let me emphasize that I'm not talking about the type of deregulation that eases health, labor, and environmental standards, a la President Reagan. The deregulation I want to discuss began a bit earlier, under President Carter, and removes government from pricing decisions.

The basic motivation of price deregulation is that market prices are *informative*. Prices reveal what's going on in a market in ways that government overseers generally cannot replicate, at least not without spending lots of money on studies and reports. When a market price is high, that *means* something. When it falls dramatically, that means something too.

When a policy of price deregulation is implemented properly, the results can be impressive. Yet the public may not even be aware of what the deregulation has achieved.

During the 1970s, the public was keenly aware of gasoline shortages and other problems associated with the OPEC oil embargo and the Iran crisis. U.S. law prevented oil prices from rising high enough to ration out the reduced supply of crude oil. The results were gasoline rationing in some states, alternate-day buying, waiting lines at gas stations, and many angry people.

But by the time Iraq invaded Kuwait in August of 1990, oil prices had been largely deregulated. After the invasion, oil prices spiked up sharply due to fears of imminent supply interruptions. Within a couple of months, they had doubled. Nobody had any doubt about the message conveyed by the price spike.

But six months after Iraq invaded, prices had fallen back into the neighborhood of their pre-invasion levels. Thanks to the flexible-price contracts the industry could now employ, there were no significant shortages and no lines at gas stations. And nobody seemed to notice how well the country had been served by that example of deregulation.

Unfortunately, deregulation isn't always so easy. When U.S. airlines were deregulated in the late 1970s, federal officials didn't consider the effects on individual routes and at individual airports. Airfares have fallen overall, but some routes have been monopolized by airlines that have taken advantage of the unregulated parallel market for airport gates.

Something similar resulted from federal deregulation of cable television rates in the 1990s. The legislation included no provisions to encourage competition at the local level, and consequently local governments have tended to grant exclusive franchises to cable companies. (Free public-access channels are among the perks provided in exchange for a monopoly.)

But in some areas around the country, both urban and rural, competition among cable companies is the rule. In those areas, cable rates are dramatically lower and service is as good as (if not better than) in areas with local monopolies.

Developments in the airline and cable-television industries illustrate an important point. A government program that only partially deregulates an industry runs the risk of unforeseen and adverse consequences. And that brings us back to California and electricity.

The 1996 California law that deregulated the state's electric-power industry included some interesting provisions. The law forced California utilities to sell off much of their generating capacity, thereby requiring them to buy electricity on the open market. The law removed price controls on this wholesale market, but not on the retail market. And it prohibited utilities from using long-term contracts to buy wholesale electricity, forcing them to buy day-to-day on spot markets.

So imagine that you run an electric utility in California. You can no longer generate electricity yourself, so you have to buy it. You're forced to buy on the spot market, so you're unable to hedge against potentially volatile wholesale prices. And if wholesale prices rise significantly, you can't pass those higher costs on to consumers.

And rise they did. The state of California bet that wholesale electricity prices would fall, and it bet big. Instead, wholesale prices rose dramatically due to worldwide price increases for oil and natural gas, the most important fuels for electricity generation.

According to the federal Energy Department, wellhead prices of natural gas ranged from \$1.50 to \$2.30 per thousand cubic feet from 1995 through 1999. In early 2000, gas prices began to rise steadily, and by December the price had risen to $6.35. A month later in January 2001, natural gas prices were over $8 per thousand cubic feet.

In North Carolina, utilities are allowed to pass on increased costs to consumers, as they should be. But California's quasi-deregulation prevented electric utilities from doing so. And the cost there has been *much* higher than mere electricity price increases. Southern California Edison and Pacific Gas & Electric, the state's two major utilities, have lost about $13 billion and are approaching insolvency.

Electricity consumers in California have suffered through rolling black-outs and brown-outs this winter. The costs to businesses that depend on a continuous flow of electric power have been enormous.

The state government has had to step in to buy electricity on behalf of its struggling utilities because electricity producers are unwilling to sell to them. The state has spent over $3 billion in the wholesale electricity market so far, and before long it could deplete a $10 billion fund set aside for this purpose.

The state has also done a lot of talking about the electricity market. It has accused the out-of-state electricity companies that were invited to buy California power plants (including Charlotte's Duke Energy) of "price gouging." It has called for the federal government to regulate out-of-state wholesale electricity prices.

An official of the California Public Utilities Commission was quoted as saying, "we think right now that the electricity market is dysfunctional." He's right. But the cause of the dysfunction isn't the evils of the free market or the greed of out-of-state electricity companies. The culprit is the state's own bizarre deregulation plan.

The most important lesson North Carolinians can learn from the California debacle is that deregulation, like any other government program, can be implemented badly. Electricity deregulation is a complex process, involving many difficult issues.

Deregulation doesn't free public-utilities commissions from having to make tough choices about how many power plants to license. Deregulation requires PUCs to deal with the thorny issue of stranded costs, which are capital expenditures from years ago that some utilities are still paying off. If a transition to deregulation does not compensate for stranded costs, some municipal power companies in North Carolina fear they will be at a competitive disadvantage under deregulation.

But if done right, electricity deregulation can generate tremendous benefits. Competition in the production and marketing of electricity can yield significantly lower electricity prices than we currently pay. A study by Research Triangle Institute has estimated that when all is said and done, the benefits of encouraging such competition in North Carolina will outweigh the costs.

However, there’s an important hidden assumption in RTI’s report. It assumes that when North Carolina deregulates, it will *not* do it California-style.