# Blackouts Are Now Rolling through California

## Why Not the Heads of State Regulators?

by Thomas W. Hazlett

JANUARY 28, 2001 - "California's deregulation scheme," railed Gov. Gray Davis this month, "is a colossal and dangerous failure."

A failure, certainly. But the governor confuses deregulation with perestroika, a top-down restructuring by commissars in Sacramento who, as Davis' words indicate, remain clueless about California energy markets.

An act passed unanimously by the Legislature in 1996 left controls on retail electricity rates in California while wholesale prices were free to float. This led logically and inexorably to what elliptical policy analysts call an "incomplete success," and what we know as a "crisis."

When the wholesale rate is below the retail rate, policy wonks debate efficiency in stuffy academic conferences. But when the price lines cross, investors go primal.

Two of California's big three utilities say they have lost in excess of $12 billion since last June buying wholesale and selling retail. At first, this red ink comes out of shareholder wealth. Share prices have tumbled for PG&E, Southern California Edison (owned by Edison International), and--to a lesser extent--San Diego Gas & Electric (owned by Sempra Energy).

Debt financing is next; too bad we can't seem to harness the energy being generated by creditors fleeing the scene. Public bond markets are closing, bank windows shutting, and energy wholesalers demanding cash on delivery. Now, California has seen power outages--the next source of capital. Think of blackouts as energy conservation for customers and a savings plan for utilities: when selling at a loss, lack of sales is a windfall.

How did we get here?

Under the old rules, monopoly power franchises were issued. Scale and scope economies--one provider per region, top-to-bottom integration of generation and distribution--were exploited, ratepayers protected by price controls. Customers' bills were adjusted such that shareholders kept up with the Dow Joneses. The system hid lots of inefficiencies. But plants got built, power grids operated, and electricity delivered.

In 1978, things slowly began to change. That's when PURPA (the Public Utility Regulatory Policy Act) was enacted by Congress, mandating that utilities purchase power generated by independent producers. The basic idea was excellent--let new competitors into the market, allowing entrepreneurship, cost savings, and windmill operators a chance to flourish. But PURPA went beyond opening the market, rigging prices for independent power at above-market levels. These high-priced contracts accumulated over several years, as did utility investments in power plants that became, in many cases, white elephants.

One weakness of traditional utility regulation is the "heads we win, tails we win" payoff enjoyed by investors. By the mid-1990s, many utilities in California and elsewhere had burdened themselves with relatively high-cost power, some forced upon them by PURPA, some voluntarily assumed on advice from Rosy Scenario. Demand for this power proved weak. Yet investors still recouped outlays since regulated rates reflected such outlays (which were approved by regulators). But pressure developed to give ratepayers a break.

By 1998, electricity rates in the Golden State averaged 23 percent above Arizona's, 55 percent above Nevada's, and 84 above Oregon's. It seemed a no-brainer to seize these bargain prices for California's customers, shaking free of the utilities' high-cost commitments. While local distribution of power would continue to be provided by a monopoly at cost, electricity would be supplied by competitors.

Two critical elements shaped this market restructuring. First, retail rates were to remain capped until March 31, 2002 or later. Given the generous spread between retail and wholesale prices, the utilities stood to profit handsomely during the transition. Ironically, this was the bargain utilities lobbied for, seeing this interim margin as compensation for the high-cost contracts and facilities being phased out of the "rate base." But before that could happen, a surprisingly robust economy and various acts of God sent wholesale energy prices--set in a market regulated not by California's Utility Commission but by the Federal Energy Regulatory Commission (FERC)--surging. The generous retail price floor turned into an onerous price cap.

The restructuring plan was a shambles, due in no small part to the key policy change promulgated in the electricity reform: vertical disintegration of the utilities. To energize the competitive wholesale electricity market, regulators told the firms to divest much of their plants and long-term contracts. These generation sources were pushed into a wholesale exchange where the utilities (along with other big energy users or distributors) would buy power. The impact of restructuring was to hoist the spot electricity market to economic supremacy.

A problem there. People build homes and factories assuming that affordable power will flow day after day, year after year. With oodles of fixed investment and California lifestyles relying on energy inputs, it is difficult to adjust purchases to reflect continuous changes in market conditions. As is stashing some megawatts away for a scorching, maximum air-conditioner day.

The natural inclination is to purchase energy long-term, assuring supply and avoiding the severe price spikes known to haunt electricity markets. Yet, the largest buyers of electricity were chased out of long-term planning. Instead of having ample reliable sources of power generation to buffer demand swings (and to bargain down wholesale suppliers), the utilities were naked to market swings.

This truly risky scheme was compounded by tightness on the supply side. Environmental rules and not-in-my-back-yard politics make permitting for a new power generation station just about your least favorite way to spend a decade. Even transmission facilities, which could help lower wholesale prices by bringing additional competitive sources to California's wholesale market, are stymied. Currently, San Diego Gas & Electric is pleading for approval of "Valley-Rainbow," an electric transmission line routed through Riverside County. Locals oppose the project as benefiting San Diegans, despite the fact that improved access to the Western power grid would benefit citizens statewide.

The solution? Experts are sticking their fingers in sockets to avoid answering this question. Every direction lies a mine field. New generation plants are a great idea, but multiyear construction projects won't help much in 2001. Allowing private utilities to get back into generation through ownership or contract is also logical, but buying plants or energy in today's market would incur the huge expense that triggered the crisis. Years for build-out again needed.

What about Gov. Gray Davis' helping tidbits? He offers such gems as stopping electricity exports (California is a net importer), putting $1 billion in state funds on the table (the utilities are losing $40 million a day), or threatening to seize power generation facilities (perhaps doing for new energy supplies in California what Castro's nationalization did for casino investment in Havana).

Such policy panic may well compound the uncertainties of restructuring, smashing power generation investment incentives.

Severin Borenstein, a noted energy economist at Berkeley's business school, is unimpressed with the political menu. While he believes that FERC should apply (or threaten) short-term wholesale price caps to allow economic long-term contracts to be executed, restoring solvency, the ultimate solutions lie with increased supplies and accurate pricing signals for consumers. Conservation awareness will experience an epiphany the instant that hot summer day power rates reflect hot summer day scarcity.

He wisely cautions against over-reaction. "The difficulties with the outcomes so far should not be interpreted as a failure of restructuring, but as part of the lurching process toward an electric power industry that is still likely to serve consumers better than the approaches of the past." While states attempting to rationalize electricity policy should heed the mistakes of California's disjointed effort, they should not forget the inefficiencies of investment shielded from competitive forces. California's own leaders, who now propose state-funded facilities to generate energy, already have.

--30--

Thomas W. Hazlett is a Senior Fellow at the Manhattan Institute for Policy Research in Washington, D.C.