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EDITORIAL DESK

## California Can Tame Its Crisis

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CAMBRIDGE, Mass. -- The lesson to be learned from California's exploding electricity prices and the threat of bankruptcy for its utility companies is not, as some have suggested, that electricity deregulation is inherently a bad idea. California's system blew up when the flaws in the way it implemented reform collided with a run of bad luck.

In early 1993, when the California Public Utilities Commission began a comprehensive review of the state's electricity industry -- then running under the old pattern of regulated utility monopolies -- the state was under pressure from industrial consumers to reduce prices that were among the highest in the nation. The high prices were attributed to the utilities' costly nuclear power plants, expensive long-term contracts with independent power suppliers and excess generating capacity, and to inefficient regulation. The commission's vision for reform, articulated in 1994, was built around a new industry structure.

The generation of electricity by existing plants and the entry of new plants would no longer be regulated by the state, and their power would be sold in a new, competitive wholesale market. Homeowners, factories and businesses would have the choice of using the transmission and distribution wires of their old local utility companies for "direct" access to the power sold in these new wholesale markets or continuing to buy power from the utilities themselves.

This vision was not some hare-brained scheme. It was heavily influenced by reforms in Britain in 1990 that reduced costs for both production and distribution of power and led to substantial investment in clean, gas-fired power plants and retirement of old, inefficient coal plants. California reformers held out the promise that wholesale prices would fall to 3 cents a kilowatt hour from 7 cents, driven by many small, new, efficient generating plants burning natural gas.

Then came four years of legislative, administrative and public debate. California's new electricity market ended up being designed in a highly politicized process, heavily influenced by people with little knowledge of the business and by middlemen who stood to benefit from an inefficient market. What eventually emerged was the most complicated electricity market ever created, with many features that had never been tried. Wholesale prices were deregulated, but retail prices were not, so that the customers who ultimately used the power had no incentive to conserve or to shop around for better deals. Utilities were required to sell most of their power plants and banned from signing long-term contracts with suppliers; they were required to buy in spot markets.

The new wholesale market began operating in April 1998, and by that summer problems were already showing. Still, California came reasonably close to the promised 3-cent power until this past May, when the state ran into bad luck: dramatically higher gas prices, higher demand, lower imports from other states.

Spot electricity markets work poorly when supplies are tight; prices can rise to extraordinary levels and can be manipulated by suppliers. The utilities, locked into purchasing on the spot market, paid up to one dollar a kilowatt hour for power on peak days, but could charge their customers only 6 cents. After months of this price imbalance, the utilities were near insolvency. The customers, meanwhile, had no incentive to reduce consumption. California remained highly dependent on the utilities because, with no incentive to shop around, people had not switched to competing retail suppliers. And delays in site approvals had meant that no new generating plants were completed.

The answer for California now is not to return to the old, costly system of regulated monopolies, but to apply the harsh lessons it has learned from designing a flawed system. Competitive electricity markets will not work if consumers are completely insulated from wholesale market prices. Long-term contracts can protect consumers from volatile prices and price manipulation by suppliers. New generating plants must be built.

If the California regulatory commission and federal regulators had moved this past September, when the current problems became crystal clear, to fix the flawed parts of the state's market structure, they would have significantly reduced the ultimate magnitude of the problem.