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The Market Flaw California Overlooked

By STEVEN STOFT

BERKELEY, Calif. — California's energy market is on the verge of collapse. Wholesale electricity prices have soared in the last six months. The state's largest utilities are threatening that they will be bankrupted unless they are allowed to raise consumer electricity rates by 30 percent.

How could this have happened when deregulation was supposed to increase efficiency and bring down electricity prices? The seeds of this market disaster rest in the flawed deregulation regime that the state and federal regulators approved three years ago.

On April 1, 1998, California opened up a market for wholesale electricity. For almost a century both wholesale and retail electricity prices had been regulated, but now power was to be sold to utility companies by unregulated suppliers at unregulated wholesale prices.

Before deregulation, utilities — like Southern California Edison and Pacific Gas and Electric — generated their own power. But they made costly mistakes, with the regulators' approval, in building power plants and signing long-term contracts. A deregulated wholesale market where private, unregulated suppliers would compete to produce power was supposed to eliminate these inefficiencies. Under deregulation, stockholders, not consumers, would pay for mistakes, and entrepreneurs with a bottom line would have incentive to hold down costs.

But in order to create competitors for the new market, utilities were forced to sell their power plants to out-of-state companies like Dynegy and Duke Energy. The utility's cost of power would no longer be the cost of generation, but the price the company paid in the wholesale market. In theory, this would save money.

The plan might have worked. But the wholesale market has a fatal flaw: The consumers of electricity are largely disconnected from wholesale prices. And for the utilities, what was worse was that deregulation did not change the fixed, regulated prices that consumers pay. So, when wholesale prices soared this summer, the utilities could not pass this enormous increase through to customers.

When there is plenty of supply, this market flaw stays hidden. And so it did in California from April 1998 through April 2000, when power was plentiful and the major utilities' costs to purchase it were relatively low.

Last summer the power supply began to tighten. On hot days there was not enough to meet demand. So wholesale prices often headed north, not stopping until they hit the price cap of \$750 a megawatt hour, which was roughly 10 times the normal price. But even that price cap has since been dismantled by federal regulators.

The retail price now charged by California's two big utilities is based on a wholesale price of around \$60 a megawatt hour. After six months of buying power for about \$250 a megawatt hour, the utilities ran into deep financial trouble. The problem may be solved by letting them pass through the wholesale prices, and some of that is now in the works, but that leaves the customers holding the bag.

And passing through wholesale prices on a monthly basis will not fix the flaw in the wholesale market. Monthly rate changes for consumers do not keep up with the daily fluctuations in wholesale prices, which means that customers cannot play their proper role in the market. If the price of gasoline jumped 10 times to \$300 a tank, drivers would fill up less often, thus forcing prices back down. That is how the market should work.

But when the wholesale electricity price in New York went up a hundredfold for a few hours in May, people didn't turn off their air conditioners. This is because the retail price didn't change at all. Without any decrease in demand, suppliers have no reason to lower their price. After all, utilities are forced to keep buying at any price because they cannot cut off power to their customers. The failure of consumers to respond is the fundamental flaw that makes prices reach exorbitant levels when there is a little scarcity or when suppliers have even a little market power.

The profits from some generating plants reportedly jumped more than 500 percent during the past six months. Under normal market competition, an extra 10 percent profit is plenty to attract new suppliers. Yet these windfall profits in California may not draw new investment into power production. While some officials at the Federal Energy Regulatory Commission have argued that prices should be allowed to go still higher in the hopes of attracting more investment, investors know that such outrageous prices cannot be sustained for the three years it would take to build a new plant. At this point, higher prices provide less incentive to build because they are less believable. Other factors, like regulatory delays in power plant sitings, are the real impediment to new investment.

California now needs both a quick fix and some fundamental market repairs. The first step must be to stop these windfall profits with a firm regional wholesale price cap. This is necessary for the success of the federal energy commission's longer- term solution, which is to allow California utilities to buy power with multiyear contracts, a move that could reduce the market power of the suppliers and stabilize prices. But suppliers are unlikely to sign contracts at reasonable prices unless the federal regulators impose a firm price cap.

The federal commission's reluctance to act against crippling price spikes leaves California in a difficult position. Right now California consumers are trapped in an endless game of blame shifting between state and federal regulators. The best way out would be for some higher authority — perhaps the Energy Department — to step in and appoint a professional, nonpolitical, non-special-interest market repair team. When the repairs are done, we can test drive the market again. But next time, a little caution might be a good thing.

Steven Stoft, a senior research fellow at the University of California Energy Institute, is author of the forthcoming "Power System Economics."