

California Is Giving Electricity Deregulation a Bad Name

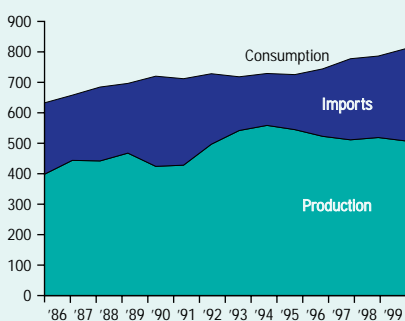
Since mid-2000, California has experienced a considerable number of problems with its electricity market, including fluctuating prices and shortages. Many people associate these problems with the restructuring of the California electricity market that took place nearly three years ago, and some have proposed that California return to the rate-based regulation that characterized the market prior to the restructuring. The problems with the California electricity market are the result of several factors—none of which should be associated with free markets.

For years, the state of California slowed the development of new electricity generation facilities within its borders for environmental reasons. Electric utilities, fearing they would be unable to recover their costs as the state moved away from rate-based regulation, stopped trying to build new generation facilities.¹ The imposition of price caps on retail electricity prices under the state's restructuring plan has further deterred the development of new generation facilities. Consequently, the growing demand for electric power in the state has been met through increased imports of electricity delivered through a national grid (*Chart 1*).

Chart 1

California Electricity Consumption and Imports Growing

Trillion British thermal units



SOURCES: Energy Information Administration; author's estimates.

As part of its electricity restructuring plan, the state of California created a nonprofit entity known as an independent system operator.² The California Independent System Operator (Cal-ISO) has the job of operating about 75 percent of the California electricity grid. It is also responsible for making the market for California electricity. Like any market maker, Cal-ISO's job is to ensure that the California market for electricity clears—in many cases buying electricity from independent generators and selling it to utilities and businesses. The restructuring plan discouraged private market-making organizations such as Enron from participating.

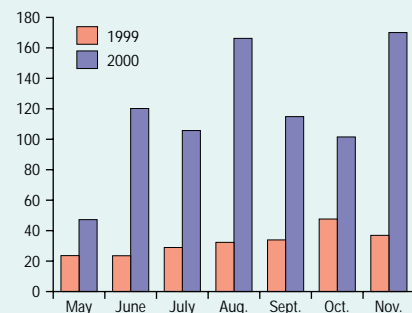
Because California imports much of its electricity, Cal-ISO and the state's utilities both turned to traditional sources outside the state for the additional electricity necessary to serve their customers. In 2000, some of these producers refused to sell electricity to Cal-ISO without a letter of credit because the ISO has no assets. Cal-ISO asked some of the local utilities it serves to provide such letters and was turned down because price caps had impaired the creditworthiness of the utilities, which were paying more for some sources of electricity than they were allowed to charge for it.³ In addition, some traditional sources from which California imported electric power lacked the capacity that California sought. Consequently, California's electricity imports fell short of meeting growing demand.

Although the wholesale prices of electricity in California rose sharply in 2000 (*Chart 2*), price caps (imposed as part of the original restructuring plan) prevented allocation of suddenly scarce electricity from being based on price, and a shortage of electric power materialized. In response, the state government established mandatory allocations that curtailed nonessential electricity use, and rolling blackouts were imposed throughout the state. In early December, the state began working toward lifting price caps on electric power.

Chart 2

Average Wholesale Unconstrained Market-Clearing Price for Electricity in California

Dollars per megawatt-hour



SOURCES: California Energy Commission; California Power Exchange Corp.

Although lifting the price caps is a step toward a freer market, doing so does not resolve the basic problems—that the state lacks sufficient generating capacity and the market-making organization at the heart of the California restructuring scheme was created without the economic resources to make a market. The state of California is now finding it necessary to guarantee Cal-ISO's contracts to purchase electricity from outside the state. The experience with restructuring in California provides an example of how not to deregulate electricity markets rather than a reason not to deregulate.

—Stephen Brown

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Notes

¹ For more information, see Berenson, Alex (2000), "California on Edge of Failing to Meet Electricity Needs," *The New York Times*, Final ed., August 3, p. A1 (online), and Shlaes, Amity (2000), "A Revolution Fails to Bring Power to the People: California's Experiment in Deregulating Electricity Has Run into Trouble, but the State's Politicians Should Keep the Faith," *Financial Times (London)*, London ed., August 22, p. 17 (online).

² For more information, see Hollis, Sheila S. (2000), *Electric Industry Restructuring in Review*, Duane, Morris & Heckscher LLP, Washington, D.C., report.

³ See Hollis (2000) and Economic Insight, Inc. (2000), "Excerpts from the Energy Market Report," December 14, online at www.econ.com.