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WHY WHOLESALE PRICE CAPS ON ELECTRICITY WON'T SOLVE CALIFORNIA'S ENERGY WOES

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California's well-publicized energy problems could get much worse if some Members of the U.S. Senate have their way. They are advancing legislation that would require the federal government to limit how much wholesale energy prices could increase. In a state where rising prices are perhaps the only factor discouraging ever higher energy demand, placing caps on energy prices would be a recipe for more and sharper shortages.

In 1996, California passed a badly flawed utility deregulation scheme. The botched implementation of this plan, coupled with regulations that discourage the construction of new power plants, produced rolling blackouts and higher prices. Power supply across the state could fail to meet demand by as much as 5,000 megawatts this summer—enough to darken 500,000 homes.

Liberals are trying to blame the Bush Administration for California's self-inflicted energy fiasco. California Governor Gray Davis (D) and U.S. Senators Dianne Feinstein (D) and Barbara Boxer (D) are demanding a bailout through government controls on power prices. In April, the Federal Energy Regulatory Commission (FERC) issued an order limiting wholesale prices during power emergencies. Now public officials are pressuring FERC to expand this order. But government intervention did not and cannot solve California's energy crisis. Politicians should stop trying to manipulate energy prices and allow the market to set prices so that consumers will benefit from a long-term supply of reliable and affordable energy.

Who's to Blame for California's Shortages. As political columnist Robert Samuelson noted in *The Washington Post* on June 13, "the root cause of California's electricity problem is simple: Demand outran supply." In a free market, this imbalance is automatically addressed through changing prices. Prices rise when demand for a product exceeds its supply. These higher prices, in turn, create an incentive for producers to generate more of the product or for consumers to reduce their purchases. Balance is restored because supply grew to meet demand or high prices reduced consumption. In the electricity market, as prices increase, either individual and business consumers restrain their consumption or new electricity supply enters the marketplace until prices begin to fall.

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Unfortunately, Governor Davis decided to defy the law of supply and demand by constraining, through law, the ability of electricity utilities to increase retail prices. Meanwhile, FERC deregulated wholesale electricity prices, which reacted to market forces by rising as demand increased. Stuck between the rock of the governor's controls on retail

rates and the hard canon of supply and demand in wholesale electricity markets, California's two largest utilities bore the brunt of the price differential and promptly became insolvent.

Now, instead of accepting responsibility for their foolish public policy, Governor Davis and some shortsighted Members of Congress are seeking to expand it through "price mitigation." Although a less politically explosive term than "price controls," price mitigation still constitutes government intervention in the marketplace. In fact, many of these Members are urging FERC to expand its April order limiting wholesale prices in California during power emergencies (when reserves dip below 7 percent) to apply during all hours. They also want to extend its restrictions to 11 other states in the Western Systems Coordination Council.

Why Price Controls Are the Wrong Solution. While many might think that price controls are a nice, practical solution to California's energy problems, government-imposed price caps do not work. In fact, they generally prolong the problem by inhibiting the necessary role prices play in markets as the visible measure of supply and demand. That prices must remain unfettered by government controls for markets to work efficiently is economic canon beyond political ideology. As Robert Litan of the Brookings Institution recently noted, "Ninety-five percent of economists would say that price controls are always dumb or that there should be a very strong presumption against price controls. They lead to artificial scarcity and then perpetuate it."

The nationwide price controls on oil imposed by President Richard Nixon in the 1970s provide a precedent. As with the current crisis, the objective of those price controls was to ensure adequate supply of petroleum products (particularly gas) at reasonable rates by constraining price increases. Not surprisingly, the artificially low prices for gas failed to curtail consumption; they also removed incentives for producers to increase supply through less efficient (and therefore more expensive) means of production or by expanding capacity through investment. History demonstrates that this centralized price and allocation regulatory system led to long gas lines and other problems.

The value of history is that it can keep policymakers from repeating prior mistakes. Many in Congress, however, refuse to learn from experience. Instead, they are poised to exacerbate supply shortages for short-term political popularity—a self-indulgent strategy that is doomed to a long-term policy failure and that will be harmful for consumers.

Conclusion. If FERC imposes wholesale price controls on electricity, it will merely be repeating the errors of Governor Davis and other shortsighted politicians whose ill-considered strategy led to California's current crisis. Fixed consumer prices on electricity undermined the impact that increased prices would have had on consumption. It also drove two California electricity utilities into bankruptcy when they could not pass their increased costs on to consumers. This bad decision-making made new investment in the power sector unprofitable, especially when combined with excessive regulation.

California should serve as a lesson that partial deregulation cannot work. Intervening in California and Western states' wholesale electricity markets, whether by price caps or price mitigation, does nothing to solve the supply–demand imbalance and will only make matters worse. Members of Congress should remember the lessons of the 1970s and resist the temptation to do what is politically expedient. Instead, they should let the market operate freely. The U.S. House Appropriations Committee has taken a step in the right direction by opposing an amendment to the fiscal year 2001 supplemental spending bill to impose price caps on wholesale markets in California. The Senate should act responsibly and follow that lead.

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