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Deregulation Caused the Great Blackout of 2003?

It Just Ain't So!

As I sat in New York during the blackout, I wondered who would succeed at producing the first predictable polemics blaming "deregulation." Every crisis unsurprisingly is used to further the agendas of anyone remotely concerned. Every interest group claimed that had its agenda been accepted the crisis could have been avoided. The Northeast power outage followed true to form. Blaming deregulation apparently began while my power was still out.

Blaming anything may be totally wrong. However electricity is generated and transmitted, a complex system must exist. Nothing can be made foolproof, and it will be unclear, at least until the investigations cease, whether the causes were readily predictable and easily corrected, according to a cost criterion. The possibility remains that the blackout could not have been prevented.

Even if a prevention strategy were available, the failure to adopt it is not clearly due to neglect of the many alternatives that might have been adopted. What is involved is a long-standing crisis in electric power that the so-called deregulation process sought to remedy. To the extent the effort failed, it was precisely because deregulation was a fraudulent description.

The situation has a long history. In the early decades of the twentieth century, the electric-power industry urged the states to institute regulation. The system worked to the satisfaction of companies, customers, and the regulators until the early 1970s. Stable fuel prices and improved technology allowed selling prices to fall (from 2.71 cents per kilowatt hour in 1926 to 1.59 cents in 1970) despite inflation.

The 1970s brought the unhappy combination of rising fuel costs, soaring construction costs, lessened technical progress, and increased environmental requirements. Suddenly, the regulators had the new task of adjusting to upward pressures on rates. They acted with, at best, equivocation and, at worst, with disastrous expedients. Several states, notably New York and California, saw non-utility generation as a miracle cure and pressured utilities to sign long-term contracts based on the expectation of continued energy price rises. A further problem was that the utilities had embarked on expensive expansion programs, much but not all nuclear. A growth slowdown produced by rising rates and the spurt in construction costs made these expansions expensive and premature. These plants and the contracts for non-utility generation became severe burdens when energy prices softened.

Utilities naturally sought reversal. Some proclaimed that they had lived under a regulatory compact that could and should be restored. Others sought whatever relief they could find. In several states, major initiatives were undertaken. The details differed greatly. The main common feature was that generation of electricity was freed from wholesale price regulation. Generally, a further step was a phased removal of regulated rates to final consumers. A third step in some states was to require divestiture of generating capacity. New York required total divesting; California confined the sell-off to fossil-fuel plants within the state.

Several critical points emerge. First, not all states instituted such changes. Second, those imposing restructuring each adopted a unique approach. Third and most critically, the liberation was limited. The guts of the California crisis, for example, was simply that uncontrolled wholesale prices soared in response to rising natural gas prices, and retail prices were not allowed to rise in response. (The charges of manipulation will

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probably prove wildly exaggerated.) More critically, the transmission system was not included in the restructuring process. The only initiative was the Federal Energy Regulatory Commission's (FERC) ultimate decision that independent regional transmission companies were the proper response.

Central Plan versus Market

The debate on what to do involves both the classic question of plan versus market and how the market should be organized. Thus Robert Kuttner's fanciful discussion in the *New York Times* of August 16 postulates that what is needed is formal energy plans submitted to the states and ratified by appropriate rate settings. This is incorrect as both diagnosis of need and description of history.

Kuttner's article begins correctly but irrelevantly, noting that planning, coordination, and incentives are needed to ensure efficient supply of electricity. However, this is true of *every* commodity. The world economy nevertheless produces most commodities without any *central* plans, and somehow enough investment occurs to preclude significant shifts in supply-demand balances. Contrary to common statements about electricity, nothing about it inherently prevents adequate investment as long as prices are set in the market. The amounts are no vaster than in other heavy industry, and uncontrolled prices would be adequate to recoup costs.

It also is utter fiction that, as Kuttner alleges, plan ratification by regulators was the method used to ensure adequate electric-power investment in the face of price control. As it happens, the states that employed systematic state energy plans were California and New York. The California approach was for a massive state agency to formulate extensive reports notorious for their enthusiasm at discouraging expansion. The New York state utilities submitted annual plans to the state, and similar inaction prevailed. Kuttner's basic error is to blame deregulation for the failure to remove price controls that eliminated the incentives for investment in transmission.

Kuttner precedes this claim with another whopper and irrelevance. He spins a fanciful tale that the new un-integrated industry is prone to massive price manipulation. Elementary economics makes clear that a well-structured market cannot be manipulated. To the extent that the opportunistic charges against California generating and natural-gas pipeline companies are substantiated, the manipulation was possible only because of flaws in the government-imposed restructuring.

Kuttner's second criticism of deregulation was that economic transmission of electricity is limited by physics. This is true but does not preclude the systematic maintenance of massive flows over the distances in which exchange is economic. Moreover, the move to an almost national grid long antedates the regulatory initiatives of the past few years.

However, the issue of the optimal organization of private electric-power companies remains. In a classic 1937 article, Nobel laureate Ronald Coase noted that vertical integration (the combination of successive steps in the supply process) improved coordination, but might strain the capabilities of top management. Specialists on the subject long raised questions about the optimum in electric power. At one extreme, the concept of "superpower" has had proponents since at least the 1920s. The idea is for power companies to continue the traditionally standard practice of simultaneously generating, transmitting, and distributing electricity, but to merge companies so that they supplied much larger regions. At the other extreme, it was suggested that integration, if ever needed, was no longer required. The truth remains to be proven, and one of the defects of imposed restructuring is that it establishes a new structure on the basis of regulatory judgment rather than market tests.

In short, once again the interventionists blame limited changes in regulation for the impacts of continued regulation.

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The FTC Gets in Its Licks

by George C. Leef

The freedom of Americans to peacefully manage their own affairs has been shrinking for many decades, as government officials find more and more reasons to tell us what things we must do and what things we may not do. The pettiness of it all is wonderfully demonstrated in a recent decision by the agency that supposedly acts as a protector of the consumer: the Federal Trade Commission (FTC).

The FTC has legal power to block business mergers that it decides might "lessen competition." Recently, the management of Dreyer's Inc., a firm that makes ice cream, concluded a deal with the international food giant Nestlé, under which Nestlé would purchase Dreyer's stock and wind up with majority control of the firm. Dreyer's shareholders approved the transaction, only 0.1 percent of the shares being voted against. But it isn't enough just to have a willing buyer and a willing seller in modern America. You also have to play "Captain, may I?" with government officialdom. In March, the FTC announced its opposition to the merger. If Nestlé and Dreyer's want to merge, they will have to fight it out with the FTC in court.

Here are the pertinent facts. There is a huge market for ice cream and similar frozen desserts (like Eskimo Pies). A small part of that market consists of what the FTC calls "superpremium" ice cream—very rich and costly brands such as Häagen-Dazs, Ben & Jerry's, and Godiva. The FTC contends that 98 percent of the "superpremium market" is "controlled" by three large manufacturers: Nestlé, Dreyer's, and Unilever. If two of those three were allowed to merge, the result would be "greater concentration" in the industry, which the FTC invariably assumes to mean less competition and therefore harm to consumers. The director of the FTC's Bureau of Competition, Joe Simons, said, "This merger, as structured, would likely raise prices and reduce choice for consumers. The market for superpremium ice cream is already highly concentrated and this deal will reduce the number of significant competitors from three to two."

This is the classic approach of antitrusters: define markets with absurd narrowness and then assume that any reduction in the number of competitors is an "injury to competition" necessitating their intervention. It's all done to help those of us who can't resist an occasional bowl of ice cream. I cheerfully admit to being one of those people, and would be quite pleased to see the FTC stop pretending to do me favors.

First, the "superpremium ice cream market" is nonsense. There is nothing unique about Häagen-Dazs, Dreamery, Ben & Jerry's, or any of the other brands. They cost more per ounce and have a higher butterfat content, but still it's just ice cream. Dreyer's

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