

Recharging Electricity Deregulation

Reviewed by George C. Leef

ELECTRIC CHOICES: Deregulation and the Future of Electric Power

Edited by Andrew N. Kleit

242 pages; Independent Institute and

Rowman & Littlefield, 2007

For many people living in the northeast, August 14, 2003 was a day nearly as memorable as September 11 or (for those old enough), the day President Kennedy was shot. August 14, 2003 was the day of the great blackout that spread from Ohio to New York and beyond. Millions of people were trapped in high-rise buildings without air conditioning or elevators, and when they finally reached street level they had no efficient way of getting home. For a seemingly minor glitch in the electric grid, the costs were enormous.

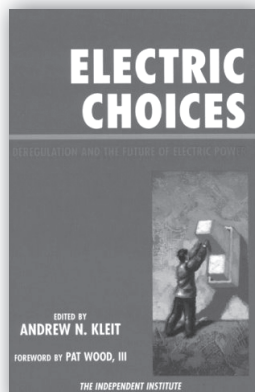
Electric power is one of our oldest regulated industries. As we have learned from public choice theory and numerous studies of the economics of regulation, there are good reasons to believe that regulation is more apt to be a source of trouble for consumers than a cure for supposed market failures. Most readers of this magazine probably harbor the suspicion that the market for electricity could use a stiff dose of market competition.

Electric Choices, edited by Andrew Kleit, professor of energy and environmental economics at Penn State, is a book that brings together 10 papers by energy market experts. Cumulatively, the contributions make a strong case that our electric power industry could be significantly more consumer-friendly, reliable, and

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efficient if it were guided more by the invisible hand of the market than the all-too-visible and usually clumsy hand of state and federal regulation.

POOR DECISIONMAKING Pat Wood III, former chairman of the Federal Energy Regulatory Commission, sets the tone in his foreword, arguing that it is time that the last of our great monopolies enter the bracing world of market competition. Wood writes:



We do not yet know how to create real competition in the transmission portion of the energy sector. Deregulation is still worthwhile, however, because in energy, the network (pipelines, powerlines, and other components of the distribution infrastructure) accounts for no more than one-fourth of the end-user's energy bill. The rest of the bill reflects

the costs of the competing commodity that moves over the network.

If we were to abandon our old regulatory model and restructure the electric power market, what benefits could consumers expect? The book's essays give the reader a comprehensive look at our electrical generation and transmission systems, with special emphasis on the inefficiencies of state and federal regulation.

Andrew Kleit points out that our traditional regulatory framework, which is based on the twin non-market notions that investors should be guaranteed a "reasonable" rate of return and that consumers should be guaranteed fixed and "reasonable" prices, leads to poor decisionmaking. "In a restructured electric sector," Kleit argues, "with wholesale power sales deregulated, investments in power plants are just as risky as investments in any other nonregulated sector

of the economy. If we have another round of overly expensive power plants with limited demand for their products, it will be investors who pay." Deregulation would thus spur sounder investment decisions and, because of the abandonment of rate-of-return regulation, give electric utilities the same incentives to minimize costs as exist in other industries. And deregulation on the consumer side would also be beneficial: "Since the cost of power fluctuates wildly during the day, the chance to offer differential pricing presents the opportunity for large efficiency gains," Kleit states.

In their co-written chapter "Can Electric Restructuring Survive?" Kleit and his Penn State colleague Timothy Conside compare the disastrously political "restructuring" of the electricity industry in California in the late 1990s with the far more successful experience in Pennsylvania. Although the authors do not regard the Pennsylvania effort as ideal, it did take some important steps in allowing power to be sold on either a spot or long-term basis as purchasers prefer, and it also allowed consumers the freedom to do business with suppliers other than their local distribution company. California, on the other hand, made a complete mess of things with its rate caps and requirement that all electric suppliers buy their power on the California Exchange spot market, thereby making it impossible for firms to protect themselves against price risk through futures contracts. Consequently, California power companies were losing almost 10 cents on every kilowatt-hour they sold in the latter half of 2000. That was short-sighted political meddling of the worst kind and consumers paid the price when power shortages ravaged the state soon afterward.

Prof. Lynne Kiesling of Northwestern examines the history and effects of retail price regulation in her chapter, "The Role of Retail Pricing in Electricity Restructuring." She contends that the focus we have long had on setting rates so as to recover utility costs is the obstacle to the advantages of market-based retail pricing. Kiesling explains that allowing mar-

ket pricing “gives consumers incentives to manage their own energy costs and helps bring aggregate supply and aggregate demand into balance at levels that do not exhibit prices as high or as volatile as in the absence of demand response.” She points out that current regulations do not give consumers a choice as to the amount of financial insurance (against price fluctuations) and physical insurance (against supply instability) that they might desire. Every consumer gets a lot of price insurance from rate regulation, but Kiesling argues that many businesses would rather contract so as to guard

consumer benefits in the market if we permit freedom of contract to trump the knee-jerk assumption that monopoly is bad. Relieving transmission congestion would be well worth it, in Hogan’s view.

A particularly thought-provoking chapter is “The Role of Distributed Energy Resources in a Restructured Power Grid,” by David Dismukes of Louisiana State University. The question Dismukes explores is this: What if a substantial number of consumers were able to generate some or most of their own power? In what he calls a “great paradigm shift,” technology is making it possible for firms to invest in distributed energy resources (DER), by which Dismukes means generation, storage, and demand-side devices connected to the

There are possibilities for a brighter future if we can break through the inertia that protects the status quo.


power grid below the bulk power transmission system. Devices such as micro-turbines, fuel cells, wind turbines, photovoltaics, and flywheels can, under the right circumstances, be efficient energy producers. (Dismukes is not arguing for the subsidization of “alternative energy sources” as many politicians do, but only suggests that they can be profitable investments.) “Widespread use of DER technologies,” he writes, “could mitigate congestion in transmission lines, help to control price fluctuations and provide greater stability to the electricity grid.” Because DER investors will want access to the electric grid not only to buy power, but

sometimes to sell it, if we are to get the full benefit of these intriguing technologies, we will need to make adjustments in our regulatory framework.

What is the obstacle to such changes? Kiesling’s answer is inertia. The main actors in this political drama all have status quo bias. The utilities are, for the most part, content with the cocoon that the current regulatory regime gives them, just as regulated airlines and trucking companies were happy with their cozy worlds prior to deregulation in their industries. The regulators themselves fear a free-market environment that would give them little or nothing to do. Consumers could be a force for change, but most of them have never thought about the prospects for improvement if economic freedom were unleashed in the market for electricity.

In his chapter “Market-based Transmission Investments and Competitive Electricity Markets,” William Hogan of Harvard University considers the possibility of another sort of unbundling — generation and transmission. Unlike Pat Wood, Hogan believes that transmission markets can be competitive and that entry into transmission markets would be enhanced by allowing owners of new transmission investments to restrict access across their lines and capture monopoly profits. Hogan foresees

power grid below the bulk power transmission system. Devices such as micro-turbines, fuel cells, wind turbines, photovoltaics, and flywheels can, under the right circumstances, be efficient energy producers. (Dismukes is not arguing for the subsidization of “alternative energy sources” as many politicians do, but only suggests that they can be profitable investments.) “Widespread use of DER technologies,” he writes, “could mitigate congestion in transmission lines, help to control price fluctuations and provide greater stability to the electricity grid.” Because DER investors will want access to the electric grid not only to buy power, but sometimes to sell it, if we are to get the full benefit of these intriguing technologies, we will need to make adjustments in our regulatory framework.

CONCLUSION This review covers only the tip of the iceberg in a book packed with insights into the problems with our current mode of electricity regulation and the possibilities for a brighter future if we can break through the inertia that protects the status quo. Since that inertia is at least partly rooted in the fact that few people have ever considered the benefits we would derive from an electricity market with far less government control, Professor Kleit’s eye-opening book is extremely welcome. 

Freaking Out

Reviewed by
Richard L. Gordon

ECO-FREAKS: Environmentalism Is Hazardous for Your Health!

By John Berlau

250 pages; Nashville, Tenn.: Nelson Current, 2006

Even people who sympathize with the environmental movement worry about the current proliferation of environmental groups. It puts pressure on both existing and new groups to differentiate themselves by devising fresh concerns and launching new crusades — and exposing themselves to refutations or overreaches that can embarrass the broader environmental movement.

In his new book *Eco-Freaks*, John L. Berlau of the Competitive Enterprise Institute provides such refutations. He seizes on five thrusts of the environmental movement: Rachel Carson’s *Silent Spring* attack on the pesticide DDT, opposition to asbestos use, efforts to reduce automobile use and fuel consumption and expand the use of transit, opposition to logging on federal land, and the campaign against dams. In three of those cases, Berlau uses major catastrophes of the early 21st century as his pegs; he attributes the rapid collapse of the World Trade Center towers to the failure to use asbestos in their construction, and he links the Katrina disaster in New Orleans to city residents’ limited access to cars and environmental opposition to the construction of floodgates.

Berlau’s chapter on opposition to the use of pesticides like DDT is the longest in the book. He presents a solid chronological review of the subject. Criticism of Carson has become a standard part of the literature, but Berlau’s effort stands out as a fuller treatment than others that I have encountered. He nicely presents the history of DDT’s development as part of the push to solve serious threats to the U.S. military in World War II, details

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how Carson misrepresented the environmental problems associated with DDT, and extends the discussion of health threats from inadequately controlled insects far beyond that of the standard example of the malaria threat.

The asbestos chapter nicely shifts from the World Trade Center case to what it typifies. Asbestos is by far the most effective fire-retardant available. The material does present hazards, but those are hazards to workers in mining and installation who can control the risk, just as many other industries can control risk. As with DDT, Berlau nicely extends prior discussions in this chapter. Of particular interest is his treatment of why asbestos was not used in the World Trade Center. The key was lobbying by a purported expert with a falsified résumé.

His automobile chapter moves from the problems of the car-less in New Orleans to the reduction in auto safety produced by federal regulation of vehicle fuel efficiency standards. Berlau may exaggerate the role that improved urban transit and the return of streetcars in New Orleans played in limiting access of that city's poor to cars, but his criticism of fuel efficiency standards follows the extensive technical literature on the undesirability of the policy.

Berlau's discussion of forest management opens by noting President Ronald Reagan's much-ridiculed (but nonetheless true) statement that forests are a source of air pollution. He uses that pollution as an argument for more intensive management of government forests, either through logging or other means. With a nod to libertarians, he notes the legitimate question of whether extensive federal ownership of land is desirable, but he argues that, if government ownership cannot be curtailed, then government should allow logging. The chapter also criticizes policies allowing dangerous proliferation of wildlife such as the deer that now run rampant and cause many accidents. As with the other chapters I have already discussed, the chapter on forests is a summary of extensive writings on the issue.

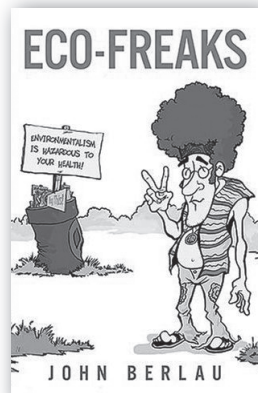
Berlau's chapter on the campaign

against dams is a straight-forward discussion of why opposition to dams is overdone. A large part of the discussion reviews how environmentalist objections precluded construction of more effective barriers to flood waters in the New Orleans area. He also notes other aspects of federal water project policies. The chapter's tacit premise is that, given the acceptance of interventionism inherent in environmentalism, those projects should have proceeded. This leaves for others the libertarian objections to government involvement in such activities.

Berlau opens the book with an introduction that explains the inspiration of the work and outlines the content. He

concludes the book with a long discussion of environmental extremists, followed by a brief statement of general principles for better policy, the essence of which is that the effects on humanity should be central to environmental policymaking.

The book, to a large extent, explores issues familiar to observers of environmentalism. Berlau covers the subjects lucidly and, in most cases, quite fully, and the documentation is well done. The biggest criticism I have of the book is its failure to indicate clearly the extent to which Berlau's examples of extremism are representative of the broader environmental movement or just isolated excesses. Other efforts, such as Lomborg's *The Skeptical Environmentalist*, argue that exaggeration is endemic; I concur. Nevertheless, Berlau is a readable treatment of some interesting overreaches. **R**



Healing an Ailing Market

Reviewed by Sherry Glied

THE CURE: How Capitalism Can Save American Health Care

By David Gratzter

325 pages; New York, N.Y.:

Encounter Books, 2006

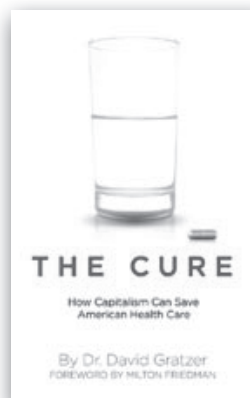
After a hiatus of a dozen years, health care reform is back on the U.S. policy agenda. Health care systems are enormous, technologically and institutionally complex organizations that simultaneously pursue multiple, conflicting goals. These fundamental characteristics guarantee that there is no unique ideal configuration of a health care system.

The unequivocal impossibility of a perfect health care system helps explain the wide and ever-changing variety of models that exist around the developed world. In this context, the policymaking community is

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particularly well-served by reasoned critiques that point out the weaknesses of popular models and by innovative market-oriented ideas that will push debate in new directions. David Gratzter's new book, *The Cure*, is a welcome addition on both fronts.

Gratzter's book stands out from the current crop of health care titles because of its strong comparative focus and its emphasis on the role of system design in promoting medical progress. Gratzter, a Canadian psychiatrist, has observed the practice of medicine in both Canada and the United States. His book, well-written and replete with colorful anecdotes, draws on his experiences in both countries, as well as on a broad range of research in health care economics and health service delivery.



STIFLED MARKET The book's principal thesis is that government meddling — through the favorable tax treatment of employer-sponsored insurance, promo-

tion of health maintenance organizations, mandates on the content of health insurance coverage, federal regulation of drugs, and the Medicaid and Medicare public insurance programs — stifles the operation of the health care market. Gratzer provides a measured assessment of these governmental interventions, emphasizing their weaknesses and the distortions they cause, but acknowledging their contributions and strengths. For example, Gratzner nicely documents how HMOs did succeed in lowering costs without diminishing quality, while criticizing this approach for its paternalistic vision of health care service delivery.

Gratzer's proposals for change similarly offer realistic institutional options that promote market ideals. Like Milton Friedman and many others, he suggests moving from our current employer-based system to an individual-based system. In the course of describing such a system, however, he subtly moves from a purely voluntary, individual health insurance market — a type of market that is conceptually elegant but that has never existed for any length of time anywhere — to a proposal similar to the very successful model now offered to federal employees — one that could readily be implemented within today's health care system. He extends this proposal to encompass the Medicare program, but recognizes that the high risks manifested by this population probably require additional government intervention in the form of risk adjustment.


One disappointing element in the book is its failure to fully confront the supply side of the health care market. In both Canada and the United States, governments have handed over control of the health care system to service providers, deferring to providers' technical expertise. This abdication has allowed providers to collectively determine how many physicians will be trained, the extent (quite limited in both countries) to which non-physician providers will be able to compete with physicians, and how scarce resources, such as hospital beds, will be allocated. Predictably, providers have used this authority to keep the supply of competitors as low as possible, to maintain their own prices as high as possible, and to provide service of idiosyncratic quality. Patients, in both countries, have become accustomed to

rude service, long waits, and very limited information about product quality. This acquiescence to standards that would be intolerable in any other context is especially striking because, as Gratzner emphasizes, patients have little incentive to consider the fiscal costs of medical care in their decisionmaking. Patients not only pay the financial consequences associated with insulation from medical prices, they do not even get to enjoy expense account-quality health care as they do so!

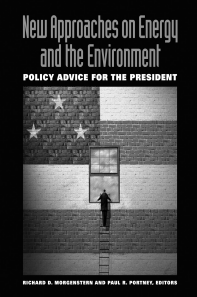
MANAGE IF NOT CURE The title of Gratzner's book seems the mark more of an overzealous publisher than of the more cautious author. Thanks to advances in modern medicine well-documented here, many diseases can be completely cured. The frequent mistake in health policy-

making is to believe that the myriad malfunctions in the delivery and distribution of medical services care that arise from the functioning of the health care system similarly admit a cure. They do not. Too many inconsistent imperatives make it impossible to erase all the symptoms that afflict the health care system at once.

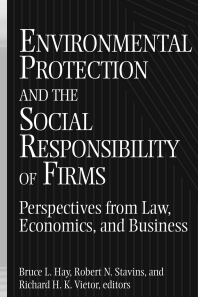
But perceptive counsel of the sort Gratzner offers can at least help make it easier to endure this chronically distressing condition. The book includes a long list of market-oriented, decentralizing, consumer-oriented innovations that are being incorporated in a variety of health care systems around the world. In content, if not in its title, Gratzner's book suggests that this kind of incremental progress is what we should be looking for in health care system reform. **R**



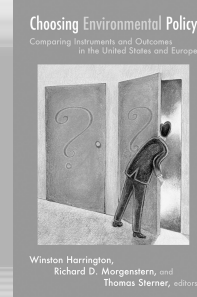
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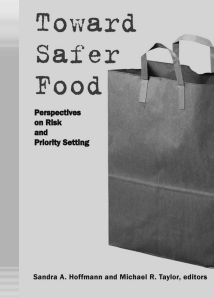
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