

BIG DOGS EAT FIRST

THE FALSE ECONOMICS OF ELECTRICITY DEREGULATION

An Interview with Dr. Eugene P. Coyle, Energy Economist, November 28, 2001*

DB: Electric deregulation has failed in California. The cost to the people as electricity consumers and taxpayers will be in the tens of billions. You told us this would happen. In 1994 you counseled the Los Angeles Department of Water and Power and the California Public Utilities Commission to steer clear of deregulation. [1] You published an article in 1995, which demonstrated how unregulated players would game the system. [2] I recorded your strong arguments against deregulation in my 1996 book, [3] which you repeated to the Wall Street Journal the next year. [4] How did you know that deregulation would fail?

EPC: The generation of electricity is a natural monopoly in the sense that a competitive commodity market won't let the producers cover costs. If they don't fix prices they will go broke. To protect the public interest, we need either public ownership or re-regulation.

DB: Your approach to the problem is not a common one among economists. How did you get interested in electricity?

EPC: As a member of the International Brotherhood of Boilermakers I worked on a couple of power plants being built in New

Jersey. I studied economics in college and then went through jet fighter school and later helicopter school in the USAF.

After the service, and some commercial flying, I worked on Wall Street, for Brown Brothers Harriman & Company, a powerful private bank. My job, focused on utilities, was to pick stocks that would go up. The bank's clients owned a lot of stock in utilities, so the CEOs were happy to see me. Later I went to grad school in economics.

DB: So you talked with the CEOs of utility companies around the United States?

EPC: Yes. Because our clients were important shareholders, the officers were quite frank with me. I learned a lot about their strategic thinking at that time.

My dissertation, THE THEORY OF INVESTMENT OF THE REGULATED FIRM, a theoretical work on how regulated utilities behave, came from the insights I got then.

DB: When you finished your Ph.D. at Boston College, where did you go to work?

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EPC: What I learned at my first teaching job is really an important part of my education. I taught at Emmanuel College, a Catholic women's college in Boston. I had just learned the same theory that every other micro-econ student learns. I loved the elegance of the theory, despite the fact that I'd seen a lot of the world and knew the theory didn't have much relevance to the economy. But that kind of economics was all I had been taught, all I knew.

I started teaching these very bright women what I had been taught. I was drawing the same curves on the blackboard that every other economist still draws. After a few weeks of class the students -- this was at the time of the Vietnam War and the Civil Rights struggles -- the students said, "We are not willing to listen to this stuff. We want to learn about the economy." Students were very militant around Boston in those days and I was in big trouble. I said, "Well, gee, this is all I know." Me with a Ph.D.! And the students very generously said, "Well, if that's all you know, you can do that; but let's see if we can learn something about the economy too." And so I embarked on learning economics. My dissertation was an attempt to move in the right direction, but without those women I might never have broken away from the economics-without-content still taught in every economics department.

DB: Were you always going to pursue the subject of utilities?

EPC: No. My dissertation was really in economic theory -- in the context of electric power. I thought of myself as a micro-economic theorist. When the first oil crisis hit electricity prices shot up. So I went to work for a grassroots group called TURN, which represented utility consumers. My work on the first California rate case of that era, in 1974 and '75, was the economics part of getting the CPUC to adopt what are now called "Baseline rates." I quickly became well known around the U.S., and that launched my consulting career.

DB: You recently wrote a fascinating study called PRICE DISCRIMINATION, ELECTRONIC REDLINING AND PRICE FIXING IN DEREGULATED ELECTRIC POWER. [5] You say that electric deregulation can't work for small businesses and residential consumers. Can you explain why?

EPC: The industry has a cost structure that makes profits impossible if you sell electricity as a commodity. The up-front cost of building a big power plant is hundreds of millions of dollars. Once you've laid out that kind of money, you have to first sell as much as possible at high prices. Then, to keep the plant running full tilt, you sell at lower prices to everybody else. By selling all the output possible -- we call it running at a high capacity factor -- you can spread the fixed costs of the plant over the maximum number of kilowatt-hours. In order to make money you have to discriminate -- charge high prices to

captive customers in order to offset the low prices you charge the remaining customers.

That is what the airlines do -- sell high-priced tickets to business customers and then fill the plane with leisure travelers for whatever they will pay. Even a few dollars is better than getting nothing from an empty seat

Some pharmaceutical companies now offer to "discriminate" on prices in order to save their monopoly patents. Drug companies spend a lot on research, but the actual manufacture of a pill costs almost nothing. Bristol-Myers Squibb, for example, sells an annual supply of the AIDS drug Zerit for \$3,589 in the United States and \$54 a year in South Africa. Combivir, an AIDS cocktail, costs \$7093 per year in the U.S. and only \$293 in South Africa, whose government dictated those lower prices to deal with the public health emergency posed by the AIDS virus. I testified about the necessity of government regulation of the price of electricity in Brasilia last May, at the invitation of the Brazil's National Congress. [6]

DB: I want to be sure I understand you. Tie this back to electricity for me.

EPC: You can't make money in a commodity business. Nobody wants to sell their product as a commodity. If electricity is unregulated, then selling it as a commodity will result in losses unless, of course, the producers collude on pricing or

merge into such a small number of companies that they can set prices without illegal collusion. Even then, they will also have to price-discriminate among customers, just like the airlines.

DB: Okay, but with the airlines small customers get the breaks. Why doesn't that happen in electricity?

EPC With the airlines, business customers have to make the trip, and don't want to be stuck on the road over the weekend. That's why the airlines require a Saturday night stay for cheap tickets. Leisure travelers will fly if the price is attractive. They can always choose to drive or to stay home.

In electricity it's the other way around. Electricity is a necessity for the small business and residential customers; they are captive customers with limited options. The big customers -- such as oil refineries -- have some options, such as switching fuels, or building their own power plants. So the small customers will be gouged and the big customers will get the low prices. This is driven by cost structure and by what economists call the customers' elasticity of demand.

DB: So you are saying that no matter what else restructuring does, small business and residential customers are going to be hurt?

EPC: There is no way around it. To be profitable they will have to discriminate, and the targets will be

customers without alternatives. The cost structure of airlines, pharmaceuticals and electric power requires monopoly or what is, in effect, collusion, in order to keep prices up.

DB: The experience of California in the last year and a half seems to indicate that there is something dreadfully wrong with restructuring. Besides high prices we have had blackouts. How would you fix that?

EPC: Electricity is an industry, which has to be regulated in some way. In addition to price gouging, for an industry providing an essential public service, we must deal with issues of reliability and safety. The market neither ensures that there will be enough generating capacity to serve the public nor does it deliver clean energy. Safety is compromised by the job cuts we've seen under deregulation. For reliability, cleaner power, and safety, this industry has to be planned.

DB: Don't unregulated businesses plan?

EPC: Of course they do, but in the interest of the owners, not the public. It is in the owners' collective interest to be short of capacity, to keep prices high. But that means lower reliability.

DB: Most economists seem to be in favor of deregulation. They believe in the market and think it will fix everything, not just electricity. Isn't that the conventional wisdom among the big name economists? Are they

paid off by people who hope to make a fortune from deregulated electricity?

EPC: It is actually much worse than that. Of course there is a lot of money to be made by consulting for those pushing deregulation, but the problem is much more profound than that. Economists are trained to believe only one thing, which is that if you let the market set the price, everybody will be better off.

The problem is deeply entrenched in the universities, where the belief in the market is passed on despite the obvious flaws that we see every day. Poverty, pollution, homelessness, racial discrimination, and lower pay for women are all evidence that the market gives us neither efficiency nor justice. Economists are trained to believe that we can assume those problems are not related to the economy.

This summer there was a paper given at Jackson Hole, Wyoming, where all the highest muckety-mucks of finance and economics gather every year to discuss the world's problems. Two of the biggest names in economics wrote a paper together where they said the market does a magnificent job of producing economic welfare. [7] They put in parenthesis "(if the initial distribution of wealth is satisfactory)." That is a mighty big "if." We know most of the wealth in this country is concentrated in very few hands, and that many have little or nothing in terms of assets. Many families have negative

net worth, and even people who own their homes might owe more on credit cards than the equity in the house. But economists assume that we all are on a par. Then they can show, with equations and graphs, that the market "works."

That Jackson Hole paper is just a handy example. It is more than you usually get in plain language from an economist. But economists make many more assumptions that also fly in the face of reality. And those assumptions are key to their beliefs.

DB: I hear rumors about some of the star economists getting \$5,000 for a speech at a luncheon, and up to \$800 an hour for consulting. Don't you think that influences them?

EPC: Well, all the big consulting money comes from the big players. But I think there is a more important problem with economists. Most of them will say the market works better than public regulation, public planning, or public control. They are taught that, and in turn teach the next generation.

DB: If the economics is so wrong, why aren't they challenged?

EPC: They are. Some really big names have come out with serious challenges over the years -- John Maynard Keynes, John Maurice Clark, some real purists out of the University of Chicago. It doesn't make a dent. It is partly the same problem that I had when my students challenged me -- I didn't know what

else to say. But the biggest thing is that the economics departments in our leading universities -- and all the ones with less prestige that follow along -- the departments drive out dissent. They only teach one school of economics, what is called "marginalism" or "neo-classical" economics.

There is currently a big student revolt in France, which has the government looking at what is taught in economics. It is spreading to other countries. Twenty-seven Ph.D. candidates at Cambridge University in England wrote a letter demanding a wider view of the world. The fact that the students wrote anonymously says a lot about the state of things. These students are demanding a new economics, which they very aptly call "Post-Autistic Economics." [8]

DB: Well, if big name economists point out the flaws, as you are claiming, why don't the flaws get corrected? Why do we have to have One Market Under God [9], to use the title of the recent book by Thomas Frank?

EPC: I read a very clear explanation of that recently in the latest "Post-Autistic Economics" newsletter. Someone was quoted as saying that economists keep two sets of books. One set is for students, journalists, and legislators where the economists talk about perfect competition and the glories of the market. The other set is used when they are challenged, and they say, "Yes, we know there are flaws in the analysis, but we are

writing articles about all that." They are continuously giving bad advice but then claim that in their "rigorous scholarship" they get it right.

DB: The cost structure of electric power is the key to how your analysis differs from the economists who adore the God of the market. Is that right?

EPC: Yes, it is a key part of it. On Wall Street people look at actual industries and how they operate. Economists look at curves and think about how companies would operate if only they conformed to the curves. If you looked at the real economy you could have seen the California price fixing coming, though most economists seemed surprised when it unfolded in 2000.

DB: You foretold it in an article in 1995, where you asked if the FBI would have to regulate the California power exchange. [10] Are you the first person to see the importance of cost structure?

EPC: Hell No! I'm just echoing a century of famous economists who have understood this.

DB: Who are they if they are so famous?

EPC: You went to Yale University didn't you? We can go back to an economist who became the president of Yale University in the early part of the 20th Century, A. T. Hadley. He saw the problem but saw unregulated monopoly as the

solution. There were others before him, but he was the most prominent American addressing this. In the 1920s John Maurice Clark of Columbia University, and a leading economist, wrote a very well known book, *Studies in the Economics of Overhead Costs*. I mentioned Keynes earlier. In my own monograph I cited Lester Telser of the University of Chicago and a bunch of economists following him who are active right now. And then I mentioned before a paper given at Jackson Hole this year. That was by Larry Summers, former Secretary of the Treasury and now the President of Harvard and Brad DeLong of UC Berkeley. It's amusing that the President of Yale discovered overhead cost in 1896 and the President of Harvard re-discovered it in 2001.

DB: Why isn't this taught in the universities?

EPC: The main reason is that it cuts the legs right out from under worship of the market. It smashes the idol in the temple.

DB: Go back to that Jackson Hole paper you've mentioned a couple of times. Was that about electric power?

EPC: Summers and DeLong, the authors, described in the paper what people are calling "the new natural monopolies," with a stress on the word "new." They advocate that industries like pharmaceuticals and software need a monopoly via patents or copyrights to be profitable. They are correct in that and it is the

cost structure of drug and software companies that they rely on for the conclusion. But that's the same cost structure, which is the reason for the old natural monopolies -- like electric power. But to answer your question, no, they never mention electric power.

DB: Let's talk about public ownership for a minute. I had a discussion on KPFA with Severin Borenstein, Director of the University of California Energy Institute. And I brought up the fact that in 1998 the 18 public power entities in Northern California sold electricity for an average price of 7.64 cents per kilowatt-hour. The PG&E Co. sold electricity at 9.29 cents per kilowatt-hour. I asked Professor Borenstein "Do you study this phenomenon? Do you study the fact that public power entities, which are democratically governed, actually deliver power for a lower price? And do you work that into your theoretical model?"

And he replied, "We don't study that."

A month or two later, in the spring of 2001, he gave a talk at the California Public Utilities Commission. He was asked the same questions and once again he said it wasn't something his Institute studied, and that perhaps this was a discussion for another time.

I'm wondering how we break into this closed system with what we are calling our "new" paradigm, which is really as old as the hills? Do you have any suggestions?

EPC: The solution is political. People have got to run grassroots campaigns, all over the country, to either get regulation back in place or form new public power utilities. To do both really. It is time for people to express what they want -- cheap, clean, reliable electricity -- and take steps to get what they want.

A note about the interviewer: Dan Berman is employed as a utilities analyst with the Office of Ratepayer Advocates of the California Public Utilities Commission, where he serves as a certified shop steward of Local 1000 of the Services Employees International Union. In his spare time he edits www.publicpowernow.org, an on-line magazine. The views Berman expresses here are his alone and do not necessarily represent the views and positions of his employer.

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[1] Coyle, Eugene, "Remarks to the Los Angeles City Council" [in Regard to Electricity Deregulation] March 3, 1994; Coyle, Eugene, "Testimony before the

California Public Utilities Commission, regarding I. 94-04-032, Order Institute Rulemaking on the Commission's Proposed Policies Governing Restructuring California's Electric Services Industry and Reforming Regulation," July 1, 1994, esp. p. 785.

[2] Coyle, Eugene, "Who Will Regulate PoolCo -- the FBI?", Public Utilities Fortnightly, March 15, 1995, op. cit.

[3] Who Owns the Sun? (Co-authored with John T. O'Connor), Chelsea Green Publishing Co., White River Junction, Vermont, 1996, pp. 219, 221, 307.

[4] Kranhold, Kathryn, "Consumer Group Reverses Course on Electricity Law," Wall Street Journal, August 20, 1997, p. CA1.

[5] Coyle, Eugene P., Price Discrimination, Electronic Redlining, and Price Fixing in Deregulated Electric Power, Report prepared for the American Public Power Association, January 2000, 114 pp. available at <www.publicpowernow.org>

[6] Coyle, Eugene P., "The California Electricity Crisis, Energy, and the Environment," (Testimony before the Committee on Mines and Energy, Chamber of Deputies, National Congress of Brazil, Brasilia), May 25, 2001, available at <www.publicpowernow.org>

[7] Summers, Lawrence H. and J. Bradford DeLong, "The 'New' Economy: Background,

Questions, and Speculations," ("Conference Draft -- Not Final"), August 31, 2001, 59 pp., presented at Jackson Hole, Wyoming.

[8] See the Post-autistics Economics newsletter at <www.paecon.net>

[9] Frank, Thomas, One Market Under God: extreme capitalism, market populism and the end of economic democracy, Doubleday, NY, 2000.

[10] Coyle, Eugene, Public Utilities Fortnightly, op. cit.