Statement of Alfred E. Kahn
before the
Committee on Governmental Affairs
United States Senate
Senator Lieberman, Chairman
June 13, 2001

I trust it will be helpful to the Committee if I frame this statement as an answer to the—in a sense—personal question: How and why could I, who have played a leading role in the deregulation of airlines, surface transportation and telecommunications, have joined some other economists in calling for the imposition of regulatory caps on wholesale electric rates in California?

This background of experience, will, I trust make it relatively easy for me to tread a judicious path between the deplorably ideological arguments and restatements of preconceptions that have characterized far too much of the public discussion of this issue—arguments between ideologues of the Right and Left, Greens and Browns, "liberal" Populists and Conservative "Realists." (I had at first effort attempted to supply adjectives suitable respectively to each of these groups, and think it worth reporting to the Committee that I find characterizations such as "ideological," "self-righteous," "indignant," "scornfully dismissive," "arrogant," "supercilious" seem to apply equally to all of them.

Since I have in this instance joined in what the eminent economist, William Safire, has characterized as

> the demagogic call for energy 'price caps,' always politically satisfying at first—populist interference with the markets' self-correction that would lead to worse shortages and rationing, to inflation and wage control.[1]

I express the hope that commentators such as these will be at least partially satisfied that the sybarites of California and the politicians and militant consumer advocates who promised them the benefits of free markets without the risks are already being sufficiently rewarded for their opportunism. In a sense, the only substantial difference between us is their evidently greater

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[1] "What to Remember," *New York Times*, May 28, 2001, p. A11.

willingness to see retribution fall not just on the actual perpetrators but on the millions of innocents while generators—a number of whom, some responsible, non-populist economists have concluded contributed to their good fortune by withholding supplies at critical junctures—reap billions of dollars of economically superfluous profits.

Since the letter that I signed elicited the immediate response, from the President on downward, demonstrating a firm command of the first week of Economics 101, that caps would not only do nothing to solve the fundamental imbalance of supply and demand but by interfering with the elasticity response on both sides and particularly by discouraging the expansion of capacity, exacerbate the problem, I can respond most efficiently in the form of a few propositions from Economics 101.1:

> In the presence of extreme inelasticities of both demand and supply and in the presence of extreme shortages, such as have characterized California at times of peak demand, unregulated markets don't work very well.[2]
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> True, the elasticity response of demand has been prevented by the ridiculously extended freeze in charges to residential customers, followed by grudgingly inadequate increases; but since the extreme shortages, producing 10- and 20-fold increases in wholesale prices, have taken the form of extreme spikes at particular times and places, and the overwhelming majority of customers do not have meters permitting them to be charged on a real-time basis, it has not been possible to elicit efficient demand responses, and the result has of course been severe blackouts. It is a truism that blackouts have occurred because most retail rates have not been free to increase to whatever extent necessary to prevent them. What is frightening to contemplate is the extent of that "extent."
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> As against the minimal contribution of 10-fold increases in prices to an improved balance of supply and demand in such circumstances must surely be weighed not merely the income distributional consequences of such price explosions but the adverse macroeconomic consequences of generators extracting hundreds—indeed thousands—of dollars a year from every inhabitant of the state, much as of the three-fold explosions in the prices of crude oil nationally in 1973 and 1979-80.
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> The spectacular historical instances of price controls doing more harm than good—cited eagerly by opponents of our present initiative—by interfering with the expansion of supply—notably the controls on prices of crude oil and natural gas in the 1960s and '70s—have been ones in which regulation held prices below short- and long-term marginal production or opportunity costs. The caps advocated here

[2] Even the explosion of California's wholesale prices has not prevented severe blackouts. Of course, that was because most retail rates were not free to increase to whatever extent necessary to prevent them. What is frightening to contemplate is the extent of that "extent."

would decidedly not hold them below the costs of additional supply. That cost-based price ceilings are not inevitably in conflict with economic expansions of supply is amply attested by the experience of the electric industry, to choose an example at random, during the entire half-century, 1945-95. If the literature agrees on anything about that experience, it is that cost-based regulation, as traditionally practiced, encouraged the goldplating of service and the very excess capacity that seemed to promise such enormous benefits to consumers during the past decade if rates were deregulated.

There seems good reason to believe that the explosions of wholesale prices has not been a phenomenon of pure competition alone, but have reflected the not-necessarily-collusive or antitrust-law-violative withholdings of capacity at peak times, in order to lever up the market-clearing prices—a process that Professors Joskow and Borenstein have documented.

In such circumstances, Economics 101.33 tells us, ceilings may actually result in expansions of offerings: there is no benefit in withholding supply in those circumstances, only sacrificed profits.

Interference with the fundamentally required correctives—of expanded capacity, on the one side, and conservation, on the other—would of course be severely counterproductive. But where those supply-and-demand responses inevitably take time—to cite the most relevant example, at least a couple of years before the additional generating capacity is likely to come on the market—any discouragements can readily be prevented by making the price caps (a) designedly temporary, automatically sunsetting within, say, two to three years, and/or (b) inapplicable to new capacity coming on line.

So much for elementary economics.