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Power politics hurts consumers - SEVERIN BORENSTEIN.

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Last week's massive power cut in eastern America and Canada has reignited the debate over electricity deregulation. In fact, the blackout seems to be unrelated to deregulation: the power went out in deregulated New York but not in nearby Pennsylvania or Massachusetts, two of the pioneering states in electricity deregulation. It now appears that the power failure began in Ohio and spread through Michigan, two states that have dipped no more than a toe into deregulation waters.

Since California's electricity crisis in 2000-2001, the debate over electricity deregulation has become increasingly polarised. Many US politicians are now vehemently opposed to deregulation, while others continue to favour it, albeit less vocally. Unfortunately, few of these people really know what deregulation means in the electricity industry.

In reality, there are no deregulated markets. Even in such "deregulated" US industries as aviation, telecommunications, petrol and natural gas, states and the federal government make rules about how companies operate, how they set prices and where they can sell their goods and services. And "deregulated" wholesale markets in electricity remain more regulated than those in other industries. In electricity, the real issue is not whether deregulation is good or bad, but the areas in which market incentives can be harnessed in a way that will benefit consumers. Such a nuanced view does not make for good television sound-bites but it makes for better public policy.

Electricity deregulation started in the 1980s when several US utilities began buying power via a competitive bidding process, rather than building their own capacity as their needs expanded.

Though not without problems, these first steps towards using market incentives have generally lowered prices for consumers. Competitive procurement is now widely used by regulated utilities and is advocated by some opponents of deregulation.

In the 1990s, there were increasing calls for the power companies to drop the utility role in generation entirely and instead purchase power for customers in a competitive wholesale market.

Some wholesale power markets, however, have not turned out to be competitive: California is the most extreme example of market incentives in generation that have raised prices and contributed to power shortages.

From these experiences we are learning how market incentives in wholesale electricity markets may still benefit consumers; but it has turned out to be much more challenging than advocates of deregulation foresaw.

We have not come far in understanding how market incentives might improve the process of constructing new transmission lines, the critical link between electricity generation and the customer. A new line in one part of the grid affects power flows over every other part, producing both costs and benefits that are not incurred by the owner of the new line. As a result, market incentives may not be strong enough to produce new lines where they are needed.

That is why transmission investment is best managed under strict government regulation and a long-term planning process. Thoughtful regulation is likely to be of greater benefit to consumers than market incentives. In this area, markets may not produce the best outcomes. Unfortunately, in the rush towards deregulation, US regulators have neglected their responsibility to ensure the reliability of electricity transmission.

With all the focus on the incentives of suppliers, the US has largely overlooked the potential benefits from economic incentives on the demand side. While wholesale prices change every hour, the rates paid even by large industrial customers change only once or twice a day; and those rate schedules are fixed for months at a time. Retail prices do not reflect the real time supply/demand balance or wholesale price.

In the most extensive real time pricing programme for large industrial customers, Georgia Power has demonstrated that allowing retail prices to change hourly can significantly lower peak demand, thereby reducing both power costs and the need to build additional generating units.

With today's computer technology, real time retail pricing also holds great promise in helping grid operators balance demand and supply to cope with grid emergencies, such as the one that occurred last week.

The potential gains from reducing regulation are not a question of ideology but of careful economic and public policy analysis. Some markets benefit consumers most when they are under intense government scrutiny, while others are stifled by such regulation, providing greater benefits when operated with less intervention.

Policymakers pursuing the public good should avoid simplistic political positions for or against deregulation. Instead, they should focus on the real challenge: determining where and how deregulation can benefit consumers.

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