This week, Standard and Poor's reported that the U.S. electric power industry is staggering under the worst credit crunch it has seen since the Depression. Billions of dollars of debt will have to be refinanced soon and there's little cause for optimism. But why should we be surprised? The past decade of the business has been a case study on the perils of limiting competition and distorting market incentives.

Foremost among the recent burnouts was, of course, the plight in California. But the crisis is not one of energy; it is a crisis in bad market design.

Remember when Ma Bell would not let you connect any telephone except hers? The theory was that, "in your interest," Ma had to protect the integrity and reliability of the network. This is the crux of the California energy crisis, and a pattern repeated in the Midwest, South and East in the summers of 1998 to 2001.

The legacy of regulation is to average everything. A porch light left burning in the daytime is given the same priority for energy as people riding in elevators. Relief for the utility companies will not be had in the political arena: The only way out now is to begin to rationalize costs in a way that naturally affects customers' behavior.

The typical consumer does not know how much she has purchased and what it will cost her until the end of the month when she gets her bill. If she should go to the trouble of looking at her meter at 3 p.m. on a hot summer day with the air conditioning on high, and the clothes dryer cranking away, she will note that the little monitoring wheels are spinning much faster than when she inspects it at 3 a.m. in the morning.

Conduct the following mental experiment in the airline and hotel examples: Imagine that a flat average cost price is charged independent of day of week, holidays and season. Presto, there would be a shortage of airplane seats and accommodation rooms at all peak demand times, more airplanes and more hotels would have to be built and this extra capacity would be idle at all other times. All customers able and willing to consume more off-peak, if they could save money, would be forced to help pay for the idle capacity caused by the peak users.

Some well-meaning officials have suggested that the California experience shows that the energy crisis is here to stay, and that we need more supplies of energy because you cannot get more for less -- shades of the bogus energy crisis of the 1970s! Hardly. The market will determine whether we need more energy supplies after retail competition has filled in some of the idle capacity intervals.

Others have blamed the crisis on California market rules that limited the use of long-term contracting for power. But long-term contracting is just another form of averaging the cost over time. You must begin with a deregulated retail market, a robust and well-structured two-sided spot market for wholesale power, and then allow people to engage in whatever financial arrangements derived from that spot market that best suits their circumstances.

The regulation of electrical utilities began about 85 years ago as, one-by-one, the states moved to grant each local area an exclusive franchise monopoly to serve its local electricity customers. For most of that history the industry had neither the technology nor the competitive motivation to implement demand responsive pricing. This is not rocket science.

The irony of it all is that in California the "obligation to serve" at a fixed average price could not even be implemented at times of severe stress because the unresponsive demand exceeded energy supply, and the shortfall was met by rolling blackouts that stranded people in elevators.
When peak demand strains supplies, because the reservoirs are low and/or the temperature is high, the wholesale price paid by the distributors in California (and earlier in other states) substantially exceeded the fixed regulated price at which the power was resold to customers. During the week of June 26 the wholesale spot price in California leaped as high as $1.10 per kwh, but the power purchased was resold to customers at around $0.11 - 0.12 per kwh.

That's called buying high and selling low, and if it persists, bankruptcy is inevitable.

How can this be happening in the long-arrived electronic age of cheap sophisticated switching, sensing and control devices capable of selective programmed interruption of power flows to particular circuits and appliances, conditional upon almost anything: time of day, price, temperature?

The way to reduce these huge losses in this environment is by selling less to customers by offering a discount if they consume less. But the idea of making more money by selling less power is a way of thinking that does not come naturally to an industry conditioned by the "obligation to serve." According to press reports, California utilities lost some $14 billion trying to avoid blackouts. A minuscule fraction of this sum would have disciplined prices and avoided the blackouts.

The key policy need is to remove restrictions on the entry of competing retail energy suppliers. If a company is cooking microchips, there is no way that it can afford interruption, but a household may be perfectly willing to run a clothes dryer when the prices are lower. Some may be willing to pay a market determined premium to satisfy all their demand; others may be willing to pay no such premium and be freely interrupted to always get the lowest available prices; still others will fall in between these extremes.

What we do not need is a new one-size-fits-all decree from the top -- the kind of policy that created the problem in the first place.

The nice thing is that technology is already available, or on the near horizon, that can make consumer demand as responsive to prices as consumers choose to make it when exposed to the reality of time-variable supply cost. In turn, a change in the pattern of investment in generator types will be encouraged. The need for peak plants that sit idle for most days of the year will be reduced. There will also be an increase in investment in smaller, cheaper power plants located near the end-use consumer. Power losses in transmission and distribution will be decreased, peak transmission constraints will be reduced (important given political opposition to new power lines), and the more efficient pattern of consumption over time will lower carbon and nitrogen emissions.

Until this policy is implemented, no one can say whether we have, or will ever have, an energy crisis.

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Mr. Smith, a professor at George Mason University, is a recipient of the 2002 Nobel Prize in Economics. Stephen Rassenti and Bart Wilson contributed to the research for this essay.

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(See related letter: "Letters to the Editor: Selling Electricity Is Easy; Then Comes the Hard Part" -- WSJ Oct. 23, 2002)

(See related letter: "Letters to the Editor: Power Market Pluralism With \`Forward Contracts\" -- WSJ Nov. 6, 2002)