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POLICY BRIEF

The Governor's Energy Proposal:

An Independent Analysis

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March 2001

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Executive Summary

Governor Gary Locke has crafted a legislative proposal designed to respond to the ongoing crisis in the availability of energy in Washington state. He correctly identifies the problem, namely increased demand in the face of static supply, but offers little in the way of long-term solutions to address this problem. What he proposes for this very sick patient are band-aids, such as increasing conservation among state agencies, tax breaks to encourage questionable power sources, such as wind and solar, and minor efforts to encourage more electricity production. The governor's program lacks two important things.

· First, it reveals an unwillingness to accept that in the near-term there is no

quick fix possible and some pain will be felt.

· Second, the plan lacks a commitment to create a supply and demand interaction

within a true market economy for energy. This would address the source of the

problem and create a long term solution. The governor's plan does not even

address the reasons supply has not kept up with demand.

In a nutshell, we are suffering through an energy crisis as a result of government actions executed by a blind faith in central government planning and a failure to respond in an increase in demand. The way out of this problem is for government to get out of the way and let private actions take hold.

I. Introduction[1]

Washington state faces a long-term crisis in energy production and transmission. Many assume California's woes are isolated to California and caused by that state's disastrous regulatory environment (to call the California legislature's restructuring of the energy industry "deregulation" is tragically inaccurate). That environment exacerbated and raised to extreme levels the consequences of a larger problem which Washington state also faces: Rising energy demand, but static energy supply.

Governor Gary Locke has proposed what he is calling a "package of measures" to provide "enough energy for Washington." This study will show that while the governor

correctly identifies some of the causes for this growing crisis, he misses others and his proposed "package" offers little near-term relief. The governor's plan does not address the fundamental underlying problem of the state's energy system, is distracted by unrelated policy proposals and would not achieve its stated goals even if fully implemented. What emerges from the plan offers little more than the band-aide approach taken by President Jimmy Carter in an earlier energy crisis. The Locke plan does not take the bold approach needed to address the root causes of the energy shortage.

II. The Energy Crisis

Fortunately Washington does not yet currently face rolling blackouts, as does California. Our state does face the threat of shortages and brownouts this summer, and the reality of marginally higher prices. The following section lists the reasons the governor has identified as the causes for the present energy situation, along with a brief policy discussion of each:

Low rainfall. Rainfall is indeed down in Washington state this year and dam levels are low. The Grand Coulee Dam is normally at about 1,265 feet elevation at the start of most years, but this year was at 1,240 feet. That's the equivalent of fifteen medium-sized nuclear power plants of generating capacity that just isn't there.[2] The Bonneville Power Administration (BPA) generates 45% of the region's power and over 90% of that comes from hydropower. But past years have seen low rainfall without jeopardizing power supplies. Must we now accept that if rainfall over just a few months is two-thirds of a normal year, we'll run out of power? Is it really an issue? Could the BPA spill more water over dams to generate power even now? What is the impact of the biological opinion of the Endangered Species Act (ESA), which restricts the water the BPA may spill over dams for power generation in the winter so that salmon can migrate more easily in the spring? What impact does the ESA have on the power market by forcing BPA to buy from outside suppliers to make up for this water not spilled in the winter? Rather than recognize these as important issues to be investigated, the governor's plan addresses none of these questions.

Rising power demand. The governor correctly identifies half the real problem. Demand is rising rapidly. In the past decade Washington state's power consumption has increased 24%.[3] Economic growth is a good thing. It is a sign of a long-term boom in Washington that has taken the state, perhaps permanently, out of the ranks of economic backwaters and made it a vibrant and exciting place in which to live and work. Demand for energy can certainly be influenced and no doubt reduced, but the plan provides no rational way for this to happen. There is no incentive to encourage the right behavior here.

California's "turbulent energy market." The governor refers to "a market damaged by California's failed deregulation." This view reflects an inaccurate understanding of regulatory changes in California. First, there was no deregulation – just an ill-advised change in existing regulations. Second, California's woes are rooted in the same problem as Washington's: increasing demand in the face of static supply. Yes, California's woes have forced up spot electricity prices from producers in other states, which has in turn

increased prices to Washington suppliers, such as BPA. But the fact that BPA has to go to these sources in the first place is the issue, not what price they have to pay when they go to them. Western state leaders, including Washington's, are blaming out-of- state suppliers for price gouging on the spot market. This is akin to drilling holes in the bottom of a boat and then putting to sea, and later criticizing the Coast Guard for the price they charge to rescue you when you sank.

Lack of new generating capacity to serve the new economy. Here the governor correctly identifies the other half of the problem, although his plan does not address why we have this problem or fully explain why it is a problem. First, the new economy itself is not to blame. Population in Washington state has skyrocketed in the last ten years, increasing by more than 21%, adding one million new residents. More people use more power, whether there's a new economy or not. On the former point, the plan ignores the source of the problem – a failure to plan ahead and a regulatory environment that lacks normal market incentives to induce corrective behavior in consumers, suppliers and investors. Current regulations are absolutely punishing when it comes to navigating a regulatory maze required to bring new power facilities on line. Evidence of this was provided by the February 2001 rejection by the state Energy Facility Site Evaluation – in the midst of an energy shortage – of the new 660-megawatt natural gas plant at Sumas. The Council cited, among other things, concern over "greenhouse gas emissions."[4] The proposed Sumas plant would use some of the cleanest technology available today and would produce enough energy to almost serve a city the size of Seattle.
Over the last ten years, as mentioned, Washington's power consumption has increased 24%, while generating capacity rose only 4%.[5] The story has been repeated in every Western state, creating a problem of immense magnitude. Nevada had the highest growth rate of any state during this period, yet added no new energy generating capacity.

IV. Governor Locke's Program

While the governor has accurately identified a few of the causes of Washington's energy crisis, his program for dealing with the crisis falls short of adequately dealing with those causes. His proposal breaks into six areas:

1. Conservation. Encourage limited conservation, primarily within state government.

2. Generate more power. Provide extremely limited tax breaks to a handful of entities that might produce more power, while forcing them to meet strict employment and pollution guidelines.

3. Rate-reductions. Subsidize usage of energy by the poor.

4. Alternative sources. Encourage wind, solar and biomass fuel energy sources.

5. Blame suppliers. Investigate supposed price gouging by suppliers.

6. Defend the status quo and call for more regulation. Keep all current regulations and add federal price caps.

V. Analysis of Governor Locke's Program

1. Conservation. While conservation is certainly useful as far as it goes, and is unobjectionable to all, it will have little impact as proposed in the governor's plan. Conservation is nothing more than reduced demand, and the plan ignores the only real way to get it in meaningful amounts: Allow prices to rise to real market levels. In San Diego last summer usage dropped 9% with price hikes caused by one of the hottest summers on record and the first glimmer of the disaster California lawmakers had wrought with their new regulations on the power industry. But state lawmakers succumbed to political pressure and capped rates at their pre-hike levels. Predictably, usage shot right back to where it was before. Merely encouraging people to cut back is not going to have nearly the effect of allowing the market to naturally reduce demand with higher prices. Nor do civic calls for conservation signal to suppliers a market where increasing supplies might be a wise business decision – only increasing prices can do that.

This program for conversation is mostly ineffective. The primary measure calls for conservation in government buildings. An audit of state buildings is useful to encourage conservation, but will not have much substantial effect. State and local government accounts for only 6.7% of Washington employment.[6] Typically commercial use of energy accounts for a third of total usage. So even the mandated 10% reduction in power use in state buildings through better window caulking, weather stripping and other measures, would only reduce state energy use by at most one quarter of one percent. Even is fully implemented, much of this proposal would have no immediate effect, because it mostly applies to state buildings that have yet to be built.

The rest of the actions here promise similar results: tax exemptions for buying fluorescent bulbs and energy-efficient washing machines, forcing utilities to advertise conservation to their customers, and other measures that promise no long-term benefit and do not to address the root causes of the problem.

2. Generate more power. This part of the plan is called "Encouraging New Electrical Generation." The governor proposes tax breaks for entities that produce power using solar, wind or biomass fuel (landfill gases) and to upgrade current facilities so they can operate at greater capacity. Encouraging existing power plants to upgrade makes sense and would be effective in increasing the state's overall energy supplies. Many stringent environmental regulations artificially limit power production and easing some of these would significantly increase power generation in a matter of weeks.

The proposed tax break for alternative sources, though, is flawed because our state gets the bulk of its energy from hydro, nuclear, coal and other sources. Less than 1% of current power supplies come from solar and wind power. Energy from biomass sources is negligible. Wind and solar technologies are nowhere near mature enough to meet any

significant portion of our energy needs. Other proposals, such as allowing the Tacoma steam plant to breach pollution guidelines for 30 days by burning asphalt waste and other "dirty" sources if it "pays the pollution back later," also do nothing to address long-term needs. Similarly, no long-term benefit can come from the governor's offer to allow utilities and companies to use temporary diesel generators for 30 days if they, too, "pay back" the pollution later. Finally, the plan offers a muddled tax break to companies that generate their own electricity, but only if they guarantee they will not reduce their workforce for five years! And even then the tax break would not take effect until 2004.

3. Rate reductions. Public assistance to low-income families to help pay their heating bills may be necessary, but the governor should not present this as any kind of solution to the energy crisis. Subsidies neither increase energy sources nor encourage consumer conservation, in fact they would have the opposite effect. Including low-income heating subsidies in a major energy package may make sense but should not let us obscure the deeper problems that should be addressed in that package.

4. Alternative sources. We have already pointed out that the bulk of the governor's efforts to produce more electricity are centered on incentives, through tax breaks, for wind and solar power. He goes a step further by making it a centerpiece of his message to utilities that they must "diversify" their power sources and invest in solar and wind power. If some utilities choose to invest in this direction, they should certainly be allowed to do so. But the government cannot mandate how industries should behave, in this case by requiring an investment in wind and solar power. At present and for the foreseeable future these technologies are simply not capable of meeting our demands. More to the point, though: Countless examples such as Japan, Inc. and the Soviet Union abundantly prove that central planning fails. The government cannot dictate what technologies should and shouldn't be used. The governor's plan must instead find ways to free utilities and energy producers to experiment in a true market environment, with the best technology winning on the basis of proving itself for customers. Many customers, as in Pennsylvania right now, may very well choose greener technologies, even if the price is slightly higher.

5. Blame suppliers. The proposal would authorize $100,000 to hire expert witnesses to help Attorney General Christine Gregoire prosecute any power company executive accused of illegally price gouging. This sort of distraction is worse than an opportunity cost. It is dangerous because the energy crisis is an extremely complex issue. If the governor says the problem is caused by price gouging, even without proof, then many people will believe him. This may eliminate the political support for real solutions and distract elected leaders on a witch-hunt that will only scare off future suppliers and make the present crisis worse. Threatening energy producers with prosecution is not an energy policy, and to do so without clear evidence is irresponsible.

6. Defend the status quo and call for more regulation. The plan demands that Washington continue to pay for BPA power at cost while other states pay market rates, and it calls for federal price caps on wholesale prices. In addition, it asks other government bodies in

other states and at the federal level to implement more regulation of the California market.

This is a typical central planner's response to a problem created by the inevitable failures of previous planning: Impose more planning. Government caused this problem by preventing the development of a free market in energy. To impose more government regulation, price caps, etc. would only make the situation worse. The Northwest has an energy crisis independent of California's. Demand here has risen an order of magnitude faster than supply over the last ten years. Government planners did not see that coming and without a market in place to react to the changes as they occurred, a crisis was inevitable. To call for a return to the days of more regulation, or for expanding current regulation is not effective.

VI. Policy Guidelines for Effective Solutions

The legislature and the governor have an opportunity to work toward effective solutions to Washington's long-term energy needs. This is a complex situation that has no "silver bullet" solution. In many cases there is a need for deeper investigation into the issues before remedial action can be taken.

At a minimum the state should take the following policy steps:

Allow prices to immediately rise in a predictable, gradual fashion so that consumers can reduce their demand based on their own priorities. If there is real hardship for some truly needy citizens, then private and public assistance in those cases can be pursued. But this must be limited to the truly needy who represent a tiny fraction of consumers. As with any product in shortage, prices must be allowed to rise for consumers to get the signals they need to determine how to adjust their behavior.

Determine whether rules governing water usage for generating power at dams can be relaxed and still provide enough water to help salmon. BPA is now generating 10% less power solely to comply with salmon restoration rules.

Eliminate the barriers imposed by regulations and benefitless pollution controls for building new power plants. It is particularly vexing that Washington regulators can cite concerns about global warming when they deny production increases. There is no legal requirement that this action be taken and the subject itself is still heatedly debated among scientists (note that the United States never signed the Kyoto Proposal on global warming).

Eliminate regulatory barriers for traditional power sources, such as hydro, natural gas and fossil fuel plants, not just for alternative sources like wind power.

Encourage a true market in energy by convening a task force to look into:

Allowing BPA to charge market prices;

Eliminating rules that dictate industry structure;

Speeding up plans to allow consumers a choice of energy supplier;

Enacting laws that encourage the development of power exchanges and clearinghouses.

Speed up building of power plants. There are encouraging signs the legislature will act to remove some of the barriers to new energy production. In an improvement on Locke's

plan both parties have plans for expediting approval of new plants. The Democrat plan, though, is flawed because new plants would have to be gas-fired or fueled by alternative energy sources such as wind and solar. Gas-fired plants are more expensive than other plants such as hydro and diesel, which are out of favor with environmentalists. The Republican plan includes expedited approval for all types of plants, including hydro and nuclear, and thus is an improvement. The Republican plan also wisely proposes bypassing the state Energy Facility Site Evaluation Council (EFSEC), which determines, or more often blocks, where plant can be built. Only one plant permitted by the Council has been built in the last 31 years. The Democrat plan includes a positive measure, which would allow utilities to build plants without a public vote, removing a 1981 overreaction to the WPPSS fiasco.

VII. Conclusion

Energy is like any other commodity and is subject to the economic laws of supply and demand. Only a properly functioning market can ensure a reliable, correctly priced product over the long-term. As we have seen, central government planning has never worked in any country for long. It is precisely such central planning, through which regulators and elected leaders often ignore the natural constraints of supply and demand that got us in this situation. At its root this problem arose because policymakers failed to predict and plan for future consumption and lacked faith in a free market to provide the product (energy) at a reasonable price and in reasonable quantities.

Governor Locke's plan correctly identifies some of the root problems of Washington's energy crisis, but then proposes measures that would have little effect, even if all were fully implemented at once, and often are not directed at the root issues. The legislature should consider implementing some of the policy guidelines outlined above that address the long-term energy needs of our state.