# Is price gouging really the problem?

## By Frank A. Wolak

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Many sellers of wholesale electricity in the California have been accused of price gouging. The word has been relentlessly bandied about, but what exactly is price gouging, and is it against the law for a firm to engage in this activity?

If it is not illegal for a firm to charge extremely high prices, then why has so much attention been focused on these actions by generators? The answers to these questions reveal a fundamental flaw in the current process for restructuring wholesale electricity markets throughout the United States.

U.S. antitrust law does not formally define price gouging. According to the common use of this term, if a seller charges a price significantly higher than the cost of producing the product including, of course, a reasonable return on the capital invested, then the seller is price gouging. The seller would counter that this price was chosen to maximize his profits given the market demand and supply decisions of his competitors.

By setting a profit-maximizing price, the seller is earning the highest possible return on the money his shareholders invested in the company. Sellers who do not set profit-maximizing prices find that investors sell the shares of their stock and purchase shares of those companies that do set profit-maximizing prices. This sequence of events is the natural result of investors looking for the highest possible return on their investment.

Firms that are able to raise the market price through their unilateral actions are said to possess market power. The unilateral exercise of market power is not illegal under U.S. antitrust law. However, the exercise of market power through coordinated action among firms is illegal. Therefore, bidding extremely high prices or refusing to sell output in order to drive up the market price is not illegal under U.S. antitrust law as long as this behavior is not the result of coordinated actions by firms in the market.

Even though the unilateral exercise of market power is not illegal, electricity prices that result from the unilateral exercise of market power are illegal. The Federal Power Act requires that the Federal Energy Regulatory Commission, the government agency that regulates wholesale electricity price throughout the United States, set just and reasonable prices for wholesale electricity. FERC has determined that wholesale electricity prices that reflect the exercise of unilateral market power are not just and reasonable.

The Federal Power Act also requires FERC to order refunds for any overpayments that result from consumers buying electricity at these illegal prices. Suppose consumers paid $300 per megawatt-hour (MWh) for electricity and this price was the result of the unilateral exercise of market by at least one market participant, who in this case was bid substantially in excess of the full cost of producing the electricity. If in the absence of this exercise of market power, the market price would be $40/MWh, then FERC is required by the Federal Power Act to order a refund of $260/MWh for each MWh of energy sold at $300/MWh.

FERC's process for enforcing the Federal Power Act in California and other regions where firms receive market prices for their electricity implies the following perverse logic. A generator engaged in an activity that is not illegal -- the unilateral exercise of market power -- causes a market outcome that is illegal -- unjust and unreasonable prices. Moreover, this generator must pay refunds on sales made at these illegal prices even though the actions that produced these prices are not illegal.

Moreover, FERC's methodology requires the firm to act against its own self-interest. As described above, the unilateral exercise of market power by a firm is equivalent to it using all legal means available to entice shareholders to purchase shares of its stock. Firms doing their best to meet their responsibility to shareholders results in illegal market outcomes. It is now easy to see why the unilateral exercise of market power by firms in the California electricity market -- what many observers have called price gouging -- went on for so long without any action from FERC to halt this activity.

Clearly, this situation is the result of very poor public policy design and would not have occurred if the federal government had passed legislation that set out a framework for the formation of wholesale electricity markets. Instead, this process was undertaken on a piecemeal basis by the FERC despite its statutory mandate to set just and reasonable wholesale electricity prices.

As California has learned over the past year, the markets can set prices vastly in excess of just and reasonable levels even if no market participant is engaged in any illegal activity. However, these prices can impose enormous harm to consumers and to a state's economy. The citizens of California and the United States need a more clearly thought out policy for restructuring wholesale electricity markets.

A policy that asks firms not to maximize their own profits, but imposes no financial penalties on firms that do maximize their profits, will always lead to electricity prices that reflect the exercise of all available unilateral market power. It is only a matter of time before conditions in another market in the United States align to make electricity prices that reflect all available unilateral market power exceed of the cost of producing this electricity by a substantial margin.

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