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LAWRENCE KUDLOW, co-host:

There are conflicting stories as to what sparked last week's big blackout. We'll leave it to the experts to sort out the immediate reasons for the crisis, but the underlying causes are evident. As President Bush said, 'The delivery system is old and antiquated,' and as Energy Secretary Spencer Abraham commented yesterday, 'Electricity rates need to be sufficient to incentivize the building of new transmission.' We're also going to need some reliable transmission standards, and that means a role for federal regulation, too. Oops. Hate to say it, but sometimes free market pricing does require some federal coordination, if for no other reason than safety and soundness of our power-driven economy.

So let's get some thoughts from our two guests; Fred Smith, founder and president of the Competitive Enterprise Institute, a public interest group, and Dr. Robert Michaels is professor of economics at Cal State University in Fullerton. He's also an adjunct scholar at the Cato Institute and the

National Center for Policy Analysis.

Welcome, gentlemen. That's a big--big agenda, so Mr. Michaels--Dr. Michaels, I better start with you; you wear so many hats. Now I don't want you and Fred to read me out of the free market movement...

Dr. ROBERT MICHAELS (PhD, Economics Professor, California State University):  
Right.

KUDLOW: ...but it just--it just occu--I know, I heard that giggle, Fred--but it just occurs to me that we may not be able to wait three years for some FERC reliability standards. I'm not talking about economic regulation here; I'm talking more, I think, about safety regulation. So what do you think about President Bush's position on that subject?

Dr. MICHAELS: For reliability standards, the real questions you've got to be worried about is: What do you really intend to win by getting it to Washington, and why do you expect that having enforceable sanctions is going to matter? It's entirely possible that self-regulation would have some

virtues.

Think of some things about the governance at stock exchanges; but more than that, when people--when things go to Washington, they often go to the least common denominator. There may be some utilities that feel they can safely reduce their safety practices, their reliability practices if, in fact, it goes to Washington.

KUDLOW: All right. Well, I didn't expect to win too big on that. And, Fred Smith, let me come to you on this very same point so you can take a whack at me. Go ahead; right here (points to chin).

Mr. FRED SMITH (President, Competitive Enterprise Institute): Right.

KUDLOW: The point I want to make is, Vice President Cheney made this very point in his energy report--I guess it's been out about two years--and it is also true regarding the self-regulation of stock exchanges that we have learned that the rule of law must be enforced. Now I understand people are going to try to take advantage of this, but where do you come out on this issue of national enforcement standards, national reliability standards, which seems to have broken down in this latest crisis?

Mr. SMITH: Larry, no one tried to bring these systems down. The grids that went down were harmed dramatically by this; they suffered reputation and so on. The problem is, without competition you're not allowed to charge the rates that allow you to, as you point out, incentivize the system. You're not allowed to invest in the technologies that allow you to upgrade the quality, the reliability, of your system. And those are not artifacts of the market; those are artifact of the fact that we have vulcanized our electrical system with a Public Utility Holding Company Act, which has fragmented America's electricity grid, not by market forces, but by delivered decisions of an earlier Congress in the 1930s, and by the fact that we've regionally monopolized every one of our electricity grids so that there is nobody there to compete with them.

Repeal PUHCA--basically, a rep--a--a--declare electricity an interstate commodity good, so anyone can sell electricity to anyone; they can get it to reduce the rate of regulation controls over the grids and watch 1,000 flowers bloom.

We saw it when we deregulated generation. Generation is a lot healthier than it was 10 years ago, but we only regulated one-half of an integrated electricity network. Reg--deregulate the other half and the problem will soon be over.

KUDLOW: Well, all right. I agree with deregulating the--the utility holding company. Actually, I agree with everything you just said. I'm coming off the floor now from these original shots.

You're right. We--we actually had guests--stock market guests earlier in the show who said there may be a surplus now of generated power because the transmission thing doesn't work, so it's kind of a mismatch. Fred, who's the biggest--who's the biggest clog, or monkey wrench, in the system with respect to proper transmission rates and rate of return for--for capital investment?

Mr. SMITH: Well, there's two. The primary one is the public--the state public utility commissioners who have created through, I would think, a slight violation of interstate commerce clause--state governments can't say you can only have one supermarket in an area, but they can say you can only have one regional electricity company. We ought to open that up. I think that is a role of the federal government, to declare that electricity's a--a commodity and has a right of interstate commerce commission. But also we need to recognize that we started down this road very intelligently. We deregulated generation, as your analyst earlier said. We've got more generation over the last decade...

KUDLOW: Hmm.

Mr. SMITH: ...than anyone anticipated. We did nothing on the transmission side, and, duh, we got no transmission grid. A massive increase in the production of electricity matching the demand for electricity hits a rigid regulated system and we get congestion. Congestion in the electrical system is called blackouts. And now we're going to turn it over to a group who knows how to handle congestion? The federal government's management of the grids in the airline area--wonderful congestion management there. The government's management of the highway systems of America? Maybe in New York, but in most of America congestion is a fact of life in government-managed systems.

KUDLOW: All right. Fred Smith, ever the admirer of federal regulatory policies. And I want to come back to Dr. Robert Michaels on California and

other issues, but first, we've got to take a brief transmission break here to make some money for our show. More on Power Politics in a moment when KUDLOW

& CRAMER returns. I hope you stay with us.

(Announcements)

KUDLOW: Here we're talking about power politics with Professor Robert Michaels of Cal State University and the Center--National Center for Policy Analysis. We've also got Fred Smith of the Competitive Enterprise Institute. It's a delightful conversation, whereupon I have been cast as the liberal.

Let me go right to Mr. Michaels--Dr. Michaels. What do you do with this NIMBY argument--not in my back yard--or as House Majority Leader Tom BeLay--Tom DeLay called it, 'a banana,' meaning--Let's see, how did he describe this? Absolutely no building--building nothing anywhere. What do you do with that if no one wants to put in transmission systems, transmission lines? Don't you need some federal help to get this going and--and solve the problem of the insufficient supply of transmission grid?

Dr. MICHAELS: I'm about to become the token leftist on this show, but--which I'm not in real life--but this has gotten completely out of hand. Basically, the industry is run under the Federal Power Act of 1935, and the Federal Power Act was written in a period just like the Holding Company Act, when we were looking at small utilities that were self-contained, very little power crossed state lines, and it was plausible that you would give state governments the authority overseeing transmission. The industry is totally different nowadays, and it still is operating with the state regulated transmission system.

KUDLOW: Hmm.

Dr. MICHAELS: You are seeing everything that you would expect to see, because transmission grids are not like pipes with valves you can shut off. Transmission makes electricity flow like water. It's a whole system. The electrons don't respect state lines. If you're going to have a free market in electricity you are going to have to have access to highways, and the sad news is that this is a different industry.

The right scope of government--federal government is going to depend on exactly what it's being called on to do. Now you are being called on to run--or at least see to it that power flows freely over very, very large regional grids. This is an authority which--you can make a real good case--has to be taken away from the states, and it's an authority in which the states are not willing to give up.

A very telling thing happened a couple of days ago at the National Governors' Conference. It was Saturday. Lights were still off in parts of the Northeast. The governors all went behind closed doors and unanimously declared that they had no intention of giving up state authority overseeing transmission.

KUDLOW: Don't you love it? Don't you love it? Right in the smack of--listen, I'm so glad to hear you now. I'm not lonely.

Mr. SMITH: Well...

KUDLOW: Now, Fred Smith, you've only got--we've only got a little bit left, but I want to add to that. A lot of accounts in the newspapers that the Southern Company--which is a fine company, I'm not disparaging them--but politically they're in there trying to stop exactly the kind of national and regional coordination that Dr. Michaels described. What do you do with that, Fred? Sometimes...

Mr. SMITH: Well--well...

KUDLOW: ...the markets need a little push from Uncle Sam.

Mr. SMITH: But before we rush in and assume government is going to push in the right direction, then push us over the cliff, government, as I mentioned--management of con--of grids has been pretty abysmal. We have plenty of federally created right of ways already: the interstate highway systems, the waterway systems. Why don't we authorize those to be used for grids before we start seizing private property?

Secondarily, the NIMBY problem is largely political. In your little area, Attorney General Blumenthal was all passionate about the risks associated with activating that power cable that goes from Connecticut down to Long Island--and would have been helpful in the last crisis. So don't rush in with

more political--don't just...

KUDLOW: I just--just have to say, with respect to Mr. Blumenthal, if it moves, tax it; if it moves, regulate it; and if it moves, sue it, so you're on to something there, Fred.

We're going to give you--you didn't finish your thought. We've got to take another quick break, then we're going to come back with our energetic guests in a moment. I'm not so liberal after all. Please stay with us.

(Announcements)

KUDLOW: Tomorrow on KUDLOW & CRAMER, Interior Secretary Gale Norton joins us to talk about opening up the East Rockies to natural gas drilling. Plus, is Uncle Sam spending way too much of our taxpayer money? Of course. That's tomorrow.

Right now, however, some final thoughts on fixing our power problems with Fred Smith and Robert Michaels.

Now, Fred, you know, I am totally opposed to any price regulation and any rate regulation; totally, totally opposed. But I want to posit this conundrum to you: Re--regional--these regional transmission organizations could conceivably work. And their--the lights did not go out in Pennsylvania, and I guess parts of New Jersey and so forth, because they had a pretty good little regional operation. What do you make of that?

Mr. SMITH: I read The Wall Street Journal today, too, Larry, but I--but I also read The Financial Times over the weekend who--the British understand markets apparently better even than our own Wall Street Journal. They called for more markets not less. Look, people do not want their grids to go down. If they're incentivized to build and to try to persuade people to give them right of way--but remember, an awful lot of the reliability is not going to come by more wires in the sky or in the ground, it's going to come about by technologies that allow us to hold these networks more reliably together, that respond with smart grid technologies to the stupid regulations we've had to date.

KUDLOW: All right.

Mr. SMITH: Legalize the flow of electricity. You don't have to get--you don't have to solve market problems...

KUDLOW: Robert Michaels, last--last word. California--10 seconds, any improvement in the regulatory environment in California, heaven forbid?

Dr. MICHAELS: Oh no. It's even going to get worse. Just wait till the recall, and don't trust Arnold either.

KUDLOW: All right. Also in today's FT, Amity Shlaes compared Warren Buffett to Herbert Hoover. I kind of love that.

Anyway, kids, you're terrific. I appreciate your coming on. That's it for tonight's program of KUDLOW & CRAMER. Thank you very much for watching.

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