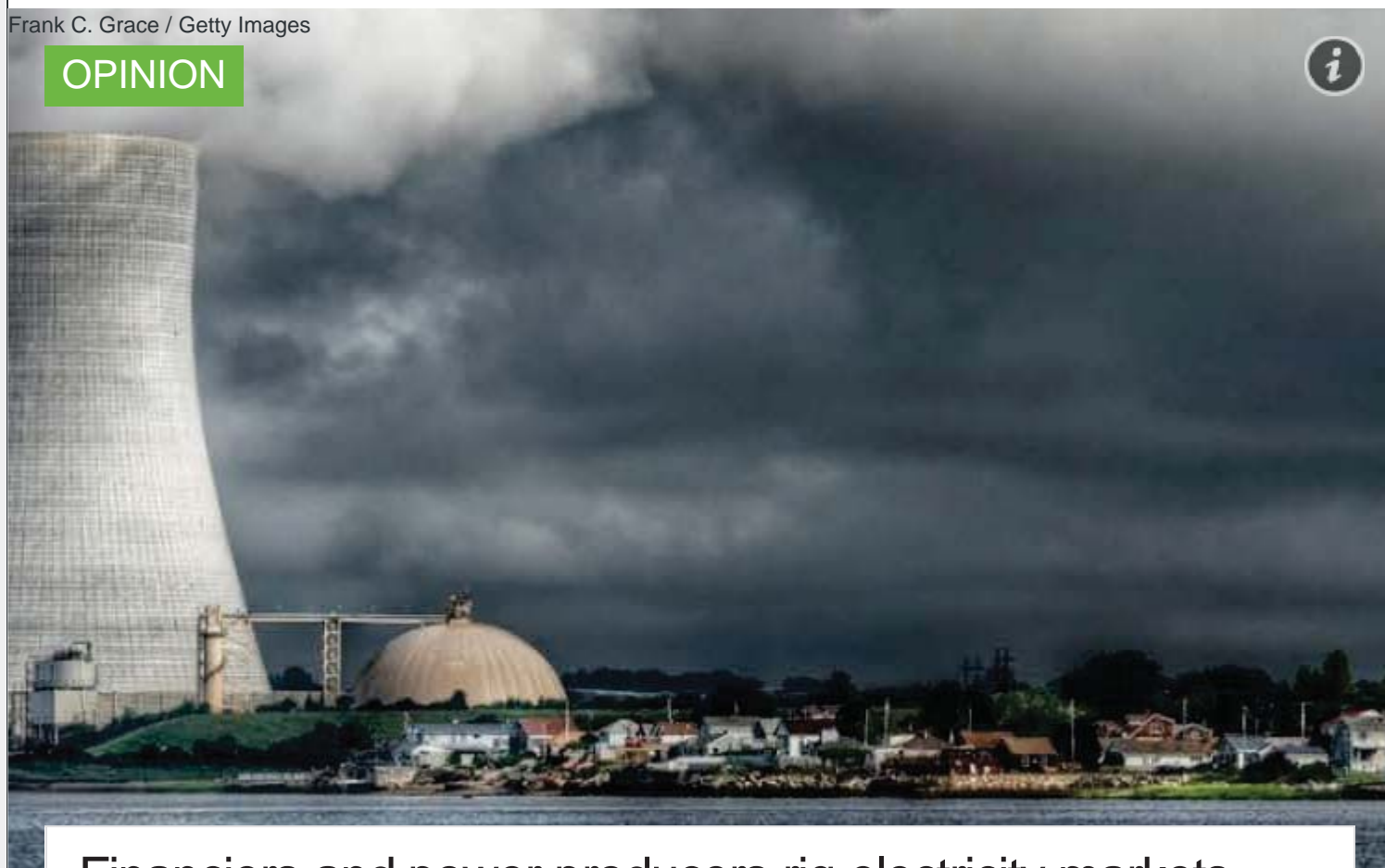


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OPINION



Financiers and power producers rig electricity markets

Sleepy regulators in New England allow consumers to be robbed of billions of dollars

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by **David Cay Johnston** -  [@DavidCayJ](#)

For decades Wall Street financial engineers, teaming up with electric power producers, have gamed wholesale electricity auctions to earn bigger profits than either a regulated utility or a competitive market would yield. This month they made a major advance in their campaign to get rich by subtly draining your wallet. Yet every major news organization ignored this.

This latest development took place in New England, which already has America's most expensive electricity. February's electricity auction saw the annual cost to customers rise to \$4 billion, up from about \$3 billion in last year's auction and less than \$2 billion in the 2013 auction. That \$4 billion figure would have been much higher but for a rule capping prices.

By the way, that \$4 billion is not for the electricity, which costs extra. The \$4 billion price tag is for capacity payments made to owners just for promising to run their power plants in 2018 and '19.

If that sounds bizarre, it's because it is. It is comparable to government taxing us to pay auto dealers to keep enough cars and trucks on their lots to satisfy expected future demand.

Half the states also have auctions that set the price of electricity for periods ranging from a year down to a few minutes. The other half still rely on traditional rate regulation, which has its own problems.

If there is abundant capacity to produce power at peak periods, such as hot summer afternoons, then prices will not rise much, if at all. But if there is barely enough power to meet demand, then prices rise significantly. And if capacity is just 1 percent less than demand, the wholesale price soars.

In these auctions every producer gets the top price even if most bid far less. These are known as clearing price auctions, in which the highest bidder sets the price for all suppliers.

Plants fueled by uranium and coal must run flat out all the time, so their owners may offer power for free or for a penny per unit. But if the last generating plant needed to meet market demand bids \$1,000, that is what everyone gets, even those offering to give electricity away.

In theory, high prices send a signal to investors to put more money into building new power plants. In practice, these high prices send a different signal: Close a few key existing power plants, build few new ones and watch profits soar. Because costs do not rise in tandem with prices, superhigh prices such as \$1,000 per unit make for exceptionally fat profits. Of course, that means a heavy drain on customers, be they homeowners or factories.

The New England price hikes stem in large part from the 2013 purchase of a fleet of power plants by former Goldman Sachs energy traders operating as Energy Capital Partners. Just weeks after buying the plants, they announced plans to shut down the biggest one, [Brayton Point](#), as I wrote last May. Last summer the partners arranged to sell the entire fleet to Dynegy, a Houston firm that pioneered extracting huge profits from electricity auctions.

Energy Capital Partners claimed Brayton Point was not economical — a necessary claim under the electricity market rules to justify closing a plant. Yet in a call to stock analysts this week, Dynegy's chief financial officer, Clint Freeland, talked about "how profitable Brayton Point is during the winter."

The investment website Market Realist listed some "key advantages" of Dynegy's acquiring the New England plants and closing Brayton Point. That will create a "[generation shortfall](#)," which in turn "will give Dynegy superior pricing power."

Would you destroy a \$12.9 million power plant if it would make you \$500 million?

That is not how electricity markets are supposed to work. The guiding legal and economic principle is that both profits and prices must be just and reasonable. Competitive bids are supposed to set prices, not the market power of producers.

Key to meeting that just-and-reasonable standard is robust competition among many suppliers, which need to keep their plants running to cover costs and earn a profit. But as Zacks Research advised clients last summer, "in a deregulated electricity business, utility companies are consolidating." The fewer bidders, the easier it is to manipulate auction results and jack up prices.

Bob Flexon, Dynegy's CEO, repeatedly told securities analysts this week about how plant closings and rules that allow it to withhold its Midwest power plants from auctions are "positive," by which he meant profitable. His tape-recorded comments ought to draw intense interest from any regulators concerned with how companies subvert competitive markets.

"The key years here are '16, '17 and '18, when you have all the plant retirements," Flexon said, connecting the plant closures to an expected bump up in prices for electricity.

A Dynegy presentation suggests that the near tripling of New England capacity auction payments to \$4 billion will produce half a billion dollars of increased revenue for the company. A disclosure document indicates the plant was purchased for just \$12.9 million. Would you destroy a \$12.9 million power plant if it would make you \$500 million? The

market rules, however, are supposed to prevent such price gouging.

Flexon also made a remark that suggests collusive bidding practices are back in California, though I am sure his publicists and lawyers will find a way to explain away his words.

“The first round bid you always [take with] a grain of salt,” he said. With “second round bids, we had a much more limited group that we elected to work with” he said, using language that suggests coordinated bidding, which defeats the whole point of the auction and is illegal. He said Dynegy stuck with that group until the final round of bids, which produced results that “didn’t look like the opening round bids. They were quite different.”

Robert McCullough, an Oregon utility economist known for busting industry myths, says gaming of electricity markets is easy and lucrative, as long as regulators look the other way.

“With perfect competition, you always bid your marginal cost — as the economist Alfred Marshall was pointing more than a hundred years ago,” McCullough said. “However, when your market share is sufficiently high that you have the potential to set the market price, it is in your interest to raise your price above marginal cost, even though you will lose some of your market share” because one or more of your fleet of power plants will produce no electricity and thus not collect any money.

“This gets even better when you can buy someone else’s plant and shut it down,” McCullough added, because the reduced capacity means higher prices. Combined with the savings from not operating the shuttered plant, the result is much bigger profits.

“Clearly, the story is that you could not buy the other New England power plants unless you committed to Brayton Point’s closure,” he explained. “This is part of the nudge, nudge, wink, wink of mergers and acquisitions” in which federal and market regulators look the other way with regard to electricity auctions.

For every wink, dear consumer, you will pay dearly. I will explain further next week.

David Cay Johnston, an investigative reporter who won a Pulitzer Prize while at The New York Times, teaches business, tax and property law of the ancient world at the Syracuse University College of Law. He is the best-selling author of [“Perfectly Legal,”](#) [“Free Lunch”](#) and [“The Fine Print”](#) and editor of the new anthology [“Divided: The Perils of Our Growing Inequality.”](#)

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