

# New England Capacity Market Agreement

## Introduction

In the first seven years since the generation, delivery, purchase, and sale of wholesale electricity was restructured from monopoly utilities into competitive markets, New England has made significant progress developing its electricity infrastructure and competitive wholesale markets. Competition in the electricity industry has resulted in a reliable, economical, and environmentally friendly power system. New England's wholesale electricity prices, after adjustment for fuel costs, have declined by 5.7 percent from 2000 to 2004, and the lights stayed on throughout most of New England during the Northeast Blackout of 2003.

Despite this progress, challenges remain. The region faces a significant threat to the reliability of its power system. While electricity use continues to grow, investment in new supply has slowed down because the current capacity market has not been sending the right economic signals to encourage new plant and demand response development. As a result, ISO New England estimates that, as early as 2008, the region may not have enough supply to meet its electricity needs on the hottest days of the year. These conditions, as well other factors, mean wholesale prices will likely begin to rise in the next few years.

In 2003, the Federal Energy Regulatory Commission charged ISO New England with developing a market to address the reliability issue threatening New England. Since that time, the ISO has been working to address New England's electricity needs and has recently reached an agreement with other New England stakeholders, including a majority of the New England states, on a market structure to address these needs.

## Key Elements of Agreement

The settlement agreement proposes a competitive market structure to sustain a reliable electricity system. The stakeholders worked from a proposal developed by all six New England states to create an auction-based Forward Capacity Market (FCM) with a provision that fully compensates those resources that will be available during times when energy is most needed. Since payments will not be made under the FCM until three years after the first auction, the parties agreed to a transition payment mechanism that will encourage the development of new conservation and efficiency programs, emergency generators, and new capacity - while allowing continued operation and maintenance of existing power resources.

The FCM will complement the current energy market and provide incentives to attract new power plants, new conservation and energy efficiency programs, and maintain the reliable operation of existing power plants. The results of this settlement proposal will achieve what the ISO has been working towards for some time – a complete set of wholesale markets that ensure power system reliability in New England by attracting investment in new and existing power resources at a fair market cost.

## Forward Capacity Market

In keeping with the market proposed by the states, under the settlement, power resources commit to be available to provide power roughly three years in advance of when the power is needed. This allows time for new resources to be developed and built. The FCM is designed so that the market price will be set by the lowest priced new capacity that meets the region's needs for electricity.

To begin the process, the ISO, with input from regional stakeholders, determines the amount of resources needed to meet the future reliability needs of the region. The ISO will then conduct an auction for the purchase and sale of the wholesale power resources needed to meet demand and power system reliability three years in advance. By way of illustration, if the first auction were conducted in 2007, it would set the price for the resources needed in 2010; the resources would not be paid until 2010 for being available to provide capacity at that time.

#### **Performance Incentive to Ensure Reliability**

Power resources that win in the auction must be available to serve New England's power grid when consumers most need electricity. If a resource does not perform when called on upon by ISO New England, it will lose a significant percentage of its monthly FCM payment. The possibility of not obtaining full payment should encourage resources to be available at the times when electricity demand is high. This feature should help address reliability concerns raised by the ISO, the states, and the Attorneys General during the 2004 Cold Snap when many generators did not produce needed electricity.

#### **Transition Mechanism to Ensure Near-Term Reliability**

Payments under the FCM will not be made until three years after the first FCM auction, so steps must be taken to ensure power system reliability in the interim. Recognizing this, the parties agreed on a transition payment mechanism that will provide incremental capacity payments to existing power resources. Each year the payment increases slightly until the auction commitment year (2010 in the example above) to ensure that resources are maintained and operational until FCM payments begin. Consistent with the ISO's strong principle that units should only be paid for performance, transition payments are also reduced based on the generator's history of being available at times of peak demand.

#### **Integration of Energy and Capacity Markets Prevent Double Recovery**

FCM payments will be reduced when prices in the energy market go above a certain level, which usually occurs when electricity demand is high. This "Peak Energy Rent" deduction has two functions. First, it prevents over collection from two separate markets (energy and capacity). Second, it encourages a resource to produce electricity during periods of high demand conditions. Why? Because a resource that isn't producing electricity during these time periods is still subject to the FCM payment deduction. This provision helps reduce overall wholesale costs of electricity.

#### **Projected Costs**

Electric reliability comes at a cost. The market must provide the right incentives to keep existing power resources available and encourage investment in new resources to meet future consumer needs. It is anticipated that during the transition period, costs will be less than the Locational Installed Capacity Market (LICAP) would likely have been during that same period.

Actual costs under the FCM structure will be market based. Therefore, these costs cannot be determined given the difficulty of accurately estimating future costs for resources needed three years from now and beyond. Although the parties cannot estimate future market costs, some agreed upon price limits for payments to existing generators in the first year of the auction will range from \$4.50-\$10.50 per kw-month. This is to ensure that prices to consumers do not go too high because, without this mechanism, prices could reach \$15 kw-mo.

Although the agreement is expected to become effective June 1, 2006, transition payments will only start in December, 2006. States can take action now to manage wholesale costs. Namely, the states can foster conservation and efficiency programs and implement retail rate designs to reduce electricity use, which help decrease wholesale prices by slowing down the growth in demand and the need for new resources. The states can also encourage local utilities to protect against any short-term fluctuations in wholesale costs through long-term contracting for power supplies, which help stabilize wholesale prices over time.