



Overview: The Capacity Settlement Agreement

The settlement agreement does three things:

- Eliminates LICAP, the Locational Installed Capacity market proposed by ISO New England
- In its place, establishes a Forward Capacity Market (FCM)
- Provides a mechanism of fixed transition payments to maintain reliability until the Forward Capacity Market is fully functional

Why is any change necessary?

Everyone agrees the current capacity market is flawed. At a FERC hearing in September, all parties testified that a change in the capacity market structure was needed.

- Today's capacity market price is near zero when there is surplus, but will be very high once there is not enough capacity in the region (likely by 2008 or 2009)
- This situation exposes consumers and suppliers to highly volatile prices, provides no price signals to develop new capacity until it is too late, and prevents generators and demand response providers from earning enough to cover their costs
- Areas with shortages see the same near-zero price as areas with surplus, so there is no incentive to build new generation (or keep existing generation available) where it is most needed

How is the settlement agreement different from LICAP, and how will it help consumers?

- The settlement agreement completely discards the proposed LICAP market design, which was strongly opposed by representatives of all six states because it would cost too much and that it wouldn't ensure new development.
- Under the settlement agreement, the core of the forward capacity market which replaces LICAP is a Forward Capacity Auction (FCA). The FCA will create binding commitments to bring new capacity into the region and to keep existing capacity available.
- The region will hold an auction each year to buy the capacity it needs for the year beginning three years in the future. This lead time will make it possible for new projects to compete, avoiding the risk of market power abuse by existing power plants.

- When a generating plant or demand-side resource is selected in the auction, it will assume the obligation to provide reliable power to New England:

Payments to generators are performance-based. An owner of a generating unit that is not available during periods of system stress will lose a substantial portion of its capacity payment.

On-time completion of new projects. New plants that fail to begin commercial operation on time will pay substantial penalties.

Prices subject to strict monitoring. Generators' energy prices will be subject to strict market monitoring, as they are today.

- LICAP during the interim period (through May 2010) would have cost the average New England consumer over 1.8 cents per kilowatt-hour, over \$9 per household per month.¹ Under the settlement, the average monthly cost is under \$5, reducing costs to consumers by \$4.3 billion during this period.²

Why are there transition payments?

The FCA mechanism will take some time to fully design and implement, and then there is a three-year period until the winning bids are obligated to deliver power. Transition payments will ensure that there is reliable power while this new system is put in place, by:

- **Deferring retirement of necessary plants.** The transition payments of the settlement agreement will avoid premature retirements of necessary plants, and are less costly than the “reliability must run” contracts to keep them operating under the current system.
- **Attracting imports.** Absent transition payments, capacity prices in neighboring regions would likely be higher than those in New England, thus reducing needed imports and potentially leading to reliability problems in the region.
- **Promoting investment in energy efficiency, demand response, and renewable energy for a cleaner environment.** Transition payments can help pay the costs of environmentally friendly alternatives such as energy efficiency measures, load controls, and renewable energy resources.

For more details, see NEPGA Fact Sheet No. 7, *What Is Contained in the Capacity Settlement Agreement?*

¹ Assuming average usage of 500 kWh per New England household per month .

² These figures assume costs per kWh are borne equally across all rate classes. They do not include changed costs associated with Reliability Must-Run (“RMR”) contracts that cover costs of particular generators needed for system reliability. Average costs and savings per household vary from state to state.