

*This memo is preliminary in nature and subject to revision and review. Any views expressed are not necessarily those of the Federal Reserve Bank of Boston or the Federal Reserve System.*

To: Lynn Browne, Executive Vice President  
From: Carrie Conaway, Deputy Director  
Re: Update on forward capacity markets  
Date: January 3, 2007

You recently requested an update to my recent memo on progress in developing the region's forward capacity markets for wholesale electricity. You should be aware of several significant developments since I wrote that memo this past summer.

- The continuing controversy around the new forward capacity markets has focused primarily on the transition payments: the mechanism the settlement developed to transition the market into the auction. Maine remains particularly opposed to the transition payments, arguing that the state is being penalized for having implemented deregulation more effectively than other states and that the cost of the transition to Maine—estimated at about \$300 million over four years—is too large. In response, ISO notes that the transition payments are similar to a mechanism Maine itself proposed as an alternative to LICAP several years ago, and that Maine can sell excess power to other states to recoup the new costs.
- On October 31, FERC issued two orders that together cleared the way for the transition to the forward capacity market. The first order denied a request to rehear FERC's earlier approval of the settlement, while the second approved changes to existing tariffs that were needed to implement the transitional payments. In doing so, FERC stated that while it "may not consider the transition payments ideal as a single market design element, when considered as part of the larger settlement agreement...they serve as a reasonable transitory mechanism that enables the New England region to shift to the forward capacity market" (*Foster Electric Report* 11/8/06).
- On November 2, ISO New England began accepting "show of interest" applications for its first forward capacity auction. Applications will be accepted through at least December 31. ISO will review the applications by October 31, 2007, and the first auction will occur in February 2008.
- In its *Regional System Plan 2006*, released in late October, ISO New England reported that generation companies have announced plans for at least 4,000 megawatts of new capacity to be built in New England. CEO Gordon van Welie attributed this increase to the greater certainty of return provided by the new forward capacity market. He cautioned, however, that this new generation is only proposed, not actually built, and that many new generation projects in the

region have run into problems in later approvals phases.

- Meanwhile, the Maine Public Utility Commission has issued two draft reports looking at the costs and benefits of Maine’s withdrawing from the regional power system. These reports evaluate three possible scenarios: operating as an “electricity island” that does not trade Maine’s electricity outside the state; operating as a stand-alone transmission organization; and aligning Maine’s electricity grid with that of Canada’s Maritime Provinces.
  - **Electricity island:** According to the MPUC report, this approach offers net savings of \$325 million—\$225 million from annual energy costs and \$100 million from reduced capacity costs. The savings mainly come from the fact that Maine generates more electricity than it uses; if it did not need to generate that electricity to supply the rest of the region, costs would be lower. The state would also avoid the cost of having to contribute to transmission improvements that mainly benefit the rest of the region. There are costs associated with this approach, as well, as Maine would have to absorb some costs now covered by the ISO, but these were estimated to be smaller than the savings.
    - The report “acknowledged that the electrical island approach is probably impractical, but stands as a baseline for measuring Maine’s options” (*Power Markets Week* 11/13/06).
    - MPUC noted that if electricity prices dropped significantly, these savings would evaporate, as some generators might go out of business and it would become more difficult to attract new investment.
    - In addition, the study was disputed by NEPOOL (a regional association of generators, transmission suppliers, distributors, and end-users) because “it assumes Maine’s competitive generators will remain on the ‘island,’ when in fact they will exercise their ability to sell power into other states if it benefits them economically.” (*Power Markets Week* 11/13/06)
  - **Stand-alone transmission organization:** The costs and benefits of this approach are difficult to quantify, as it depends on the cost of transmission tariffs and other trading rules that would need to be negotiated between Maine and the ISO.
  - **Aligning with Canada:** This approach offers both pros and cons, and its costs are still unclear.
    - “Load and supply growth for Maine and the Maritimes appears to be in concert. Combining the regions into a market might create modest improvements in supply and peak load diversity.” (*Power Markets Week* 11/27/06)
    - But “the equilibrium may not persist. The Maritimes may need new supply more quickly than Maine, which would add to Maine’s costs. ... For Maine, the economic danger is that Maritime demand could grow to the point where it soaks up Maine’s capacity surplus, causing ME/CAN to rely on expensive imports from New England or Quebec.” (*Power Markets Week* 11/27/06)

- Regulatory differences between the two systems would also have to be reconciled.

The Maine Public Utility Commission says its intent in issuing these reports was not to advocate for any one particular solution, but to spur public debate on the issues. The Commission plans to report on its options to the Maine Legislature in January.

## Sources

*The Energy Daily*. “FERC defends New England capacity payments.” November 2, 2006.

*Foster Electric Report*. “FERC approves tariff revisions for implementing a forward capacity market in New England, denies rehearing of order approving the new market.” November 8, 2006.

*Global Power Report*. “ISO New England begins accepting applications for its first forward capacity market auction.” November 9, 2006.

*Power Market Today*. “ISO-NE planning report targets need for new coal, nuclear generation.” October 30, 2006.

*Power Markets Week*. “Maine examines pluses, minuses of forming interwoven system with Canadian Maritimes.” November 27, 2006.

*Power Markets Week*. “No Maine is an island...or can it go alone? Idea of cost savings for state called unrealistic.” November 13, 2006.