Kathryn J. Jackson, Chair
Board of Directors

January 16, 2014

Ladies and Gentlemen:

On behalf of the entire ISO New England board, we appreciate your January 10th letter and the concerns you have raised. The Forward Capacity Market ("FCM") and Pay For Performance ("PFP") have been controversial from their inceptions, and fully understanding stakeholder perspectives is critical for both management and the board in making very difficult decisions on the ISO's course of action.

To fully explain our decision on your request, we believe it is necessary to provide our perspective on the need for capacity markets and PFP. The FCM settlement was reached when circumstances were very different than today. New England had no capacity market and, nationwide, capacity markets were in their infancy. The older oil and coal units operated regularly and there were significant concerns about increasing natural gas prices. Renewable resource integration had not begun in any meaningful way. Resource performance had been improving since industry restructuring. Under those circumstances, the ISO and New England stakeholders forged a compromise that provided capacity revenues to the region's resources, but did not closely link those revenues to the performance of those resources.

Since FCM was implemented, however, things have markedly changed. Abundant natural gas from the Marcellus region has become the cheapest fossil fuel. Pipeline capacity into New England from the west cannot come close to supporting operation of gas generators in all load conditions. The oil and coal plants, despite being built as base load and intermediate units, have become uneconomic and are effectively being operated as peaking resources. Owners of four major generating stations and a variety of smaller resources have announced the retirement of roughly four thousand megawatts of capacity over the next three years. Renewable and demand-side resources are being deployed at an increasing pace and are a major objective of the region's policymakers. And, most importantly, while average resource performance has been declining and we have experienced some "near misses" because of performance issues, the poorest performing resources continue to be paid essentially their entire capacity payments.

Beginning over three years ago in recognition of the changing landscape in the region, the ISO, working together with its stakeholders, identified five strategic risks facing New England's electricity system: resource performance and flexibility, increased reliance on natural gas capacity, retirement of fossil-fired generators, integration of a greater level of variable resources, and non-transmission alternatives. While the region developed a consensus around these risks, the rapidity of change has surprised many and consensus has not been achieved on solutions to these risks.

In an effort to address the first four of the strategic risks, the ISO issued the initial white paper on PFP in October, 2012. This began a stakeholder process that spanned roughly fourteen months. During this process, in addition to the numerous NEPOOL committee meetings, we have met with the NEPOOL Participants on three separate occasions, and individual board members have had many other conversations with stakeholders regarding FCM and PFP. We have met with the state regulators from each of the New England states to discuss our collective concerns. Throughout this process, we hope that management and the Board have effectively communicated the objective in redesigning FCM – to address the region's strategic risks by providing the incentives for investments in reliability by both existing and new resources. We believe that this objective requires appropriate and coordinated incentives in both the energy and capacity markets.

It is our perspective that in the early stages of the stakeholder process, an energy-only market was discussed as an alternative to PFP that could meet our objective; we are not aware of any other workable alternatives that were presented. However, both the ISO and stakeholders rejected the energy-only approach for two reasons – such a market would be highly volatile and the very high energy prices that would be needed to induce investment in reliability are untenable. Therefore, the ISO proceeded with PFP, making significant modifications to address legitimate stakeholder concerns. To assure that there are no fatal flaws in the proposal, both the internal and external market monitors and other experts have reviewed the design. Furthermore, management has met with representatives of the financial community, who also supported the design.

On December 19th, after the NEPOOL votes failing to support PFP and supporting the alternative NRG proposal, the board met to discuss the possible jump ball filing. We agreed that the NEPOOL Alternative (which provides a $500 increase in scarcity prices and a very low risk capacity payment) will not address the region's strategic risks and cannot achieve the objective of providing reliability through efficient markets. Indeed, we recognized that the two proposals reflect differing visions of how the markets should work. Under the NEPOOL alternative, all resources will be paid a base capacity payment that entails relatively little risk and will provide support to owners of every resource with relatively little variation based upon performance. On the other hand, PFP will closely link payments and performance.

We provide this background to explain why the board has decided to move forward with PFP. First, we believe that the fast-changing circumstances in the region require action now. Resource retirements, declining performance, lack of gas transportation and inadequate alternatives to gas-only generation all necessitate increased investment in reliability – whether that is dual fuel, firmed gas supply through LNG purchases or other actions, improved maintenance practices, or new resources that can provide energy or reserves when needed. The region will need new resources over the next few years and only with a well-defined capacity product and a market that sends clear price signals based on actual performance will New England garner the investments needed for reliability.

Second, we do not believe, as your letter suggests, that the combination of a downward sloping demand curve and better price formation in the capacity market will address the risks facing the region. Both of these changes will stabilize prices for the region's resources, but these changes provide no assurance that the money collected will be invested appropriately to give consumers the reliability for which they are paying. Merely procuring nameplate capacity without strong incentives to ensure resource performance in times of shortage is an empty package for consumers – and we are concerned that we will never achieve the objective of resource adequacy and reliable performance through the wholesale markets. Similarly, while we fully support the region's commitment to further pricing enhancements in the energy market, we have seen no evidence that such changes alone can incent appropriate new entry to replace retiring resources, investments in dual fuel or LNG, existing resource investment in improved performance, or the flexibility to support the region's ever-growing desire for variable energy resources.

Where we most strongly disagree with your letter is the assertion that "there is significant doubt as to whether "Performance Incentives" can ever accomplish the goals set out by ISO-NE." PFP is a standard market design that functions very well in many markets for many products. The Analysis Group performed detailed analysis showing that PFP will cause the capacity market to select more reliable resources, and that resources will have strong incentives to invest in reliability (e.g. dual fuel capability). To our knowledge, there is no analysis showing how the NEPOOL alternative will address the risks facing the region.

While we appreciate and share your concerns that litigation is costly and time consuming, and will potentially distract us from other projects, our view is that New England is at a crossroads on capacity market design. We have all worked very hard to find a consensus solution, but our basic disagreement over the fundamental goals of capacity markets needs to be resolved. Put simply, FERC must decide if the region is paying just for resources or, instead, is paying for resources that provide reliability to consumers. The ISO will put forward its best case in support of PFP and we are sure that each of you will do the same and explain how other alternatives can address the risks facing the region. With clear explanations on all sides of the debate, the FERC will be well-positioned to decide the fundamental questions to be presented in a timely fashion.

Again, we want to thank you all for your letter, your hard and thoughtful work on the region's most difficult issues and your sincere concern that we all continue to work together as we face major industry change.

Sincerely,

Kathryn J. Jackson, Board Chair

Gordon van Welie, Chief Executive Officer