

Memorandum

To: ISO Finance Committee
From: William J. Regan, Jr., Chief Financial Officer
Philip Leiber, Treasurer & Director of Financial Planning
cc: Board of Governors, ISO Officers
Date: March 1, 2007
Re: *2006 Investment Compliance Report*

This memorandum is for information only. No Board action is required.

Executive Summary

The ISO Investment Policy (**Attachment 1**) provides that the Chief Financial Officer is to submit an annual report on ISO investments to the Board of Governors that is to contain:

- *A list identifying the type of investment, issuer, date of maturity, par and dollar amount invested on all securities. The market value and source of the market value information will also be provided.*
- *A statement that the portfolio is in compliance with the Investment Policy or manner in which the portfolio is not in compliance.*

Attachment 2 contains the annual investment report as of December 31, 2006, and a statement that the portfolio is in compliance with the Investment Policy.

Discussion of Portfolio Composition and Performance

CAISO's corporate investment portfolio is comprised of two types of funds:

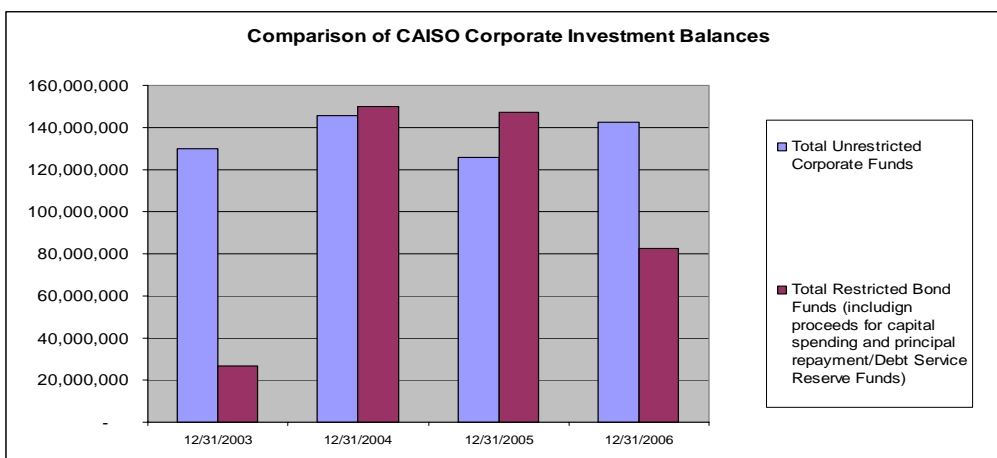
1. **Operations related funds (Unrestricted).** **Attachment 2a** shows the value of the Operations Related/Unrestricted funds at \$142,773,143, or 63% of the total portfolio. These funds are available for general corporate use (though not all are available for current use), and include the following:
 - **Operating Reserve Funds:** the Operating Reserve is defined in the CAISO Tariff, with a targeted funding level of not less than 15% of the O&M budget, or about \$22 million. When the 2007 GMC rates were set on December 15, 2006, the Operating Reserve balance was forecast to exceed that level by \$25.2 million as of December 31 2006.

- Funds received from GMC and other revenues that will be disbursed for routine CAISO expenditures (accounts payable as of December 31, 2006 is approximately \$31 million [unaudited])
- Cash related to other obligations: Significant items include Amendment 33 fines and interest to ultimately be refunded to market participants (approximately \$45.3 million [unaudited]), Transmission Studies Deposits (\$2.1 million) and other longer-term CAISO obligations including post-retirement medical liability (approximately \$8.3 million [unaudited], a portion of which is to be imminently transferred to the recently established CAISO VEBA Trust).
- Remaining funds relate to differences between actual the year-end operating reserve balance and forecast and various working capital accounts.

2. **Series 2000 / Series 2004 Restricted Bond Related Funds.** Attachment 2b shows the value of the Operations Related/Unrestricted funds at \$82,831,734, or 37% of the total portfolio. The bond related funds include bond repayment accounts for monthly principal & interest deposits, a debt-service reserve fund, miscellaneous accounts, and the remaining project funds of approximately \$18 million from the 2004 bond issuance, which is anticipated to be fully spent by April 2007, when the new 2007 bond proceeds are to be available.

The funds are invested in a variety of short-term, and some medium-term financial instruments as authorized by the Investment Policy. CAISO's conservative Investment Policy has investment objectives of (1) safety of principal, (2) liquidity and (3) earnings. Investments of the bond-related funds are further limited to permissible investments authorized by the bond indentures. Attachment 2 contains the statement that the portfolio is in compliance with the investment limitations set forth in CAISO's investment policy adopted by the Board in June 2005. Attachment 2c provides a listing of investments by asset class for the entire CAISO investment portfolio (unrestricted and restricted funds).

CAISO's recorded interest earnings in 2006 were \$5.7 million for the Operating Related (unrestricted) funds and \$3.2 million on the bond related funds. These amounts compare to \$4.5 million and \$4.1 million, respectively, for 2005. Interest rates increased in 2006 compared with 2005, which contributed to the higher earnings on the Operating Related (unrestricted) funds. Interest earnings decreased on the bond related funds as the size of the bond construction fund decreased as the funds were spent on the MRTU program and other capital expenditures during 2006. Further, the interest rates on most of the restricted bond funds were unchanged from 2005 to 2006, as the interest rates were locked-in at the time of issuance of the 2004 bonds.



In last year's investment report to the Board, CAISO's Treasury department expressed its intent to procure investment management software in 2006 to improve the efficiency of necessary portfolio accounting and compliance activities and to facilitate enhanced investment performance reporting. This software was procured and implemented during late 2006. For 2007 and future years, this software package, JPMorgan Sympro, will provide investment performance reporting that will be included in future Board reports. However, such performance reports are unavailable for 2006 as the software was implemented during the year and a full year of activity is necessary to provide meaningful performance figures.

We look forward to addressing any questions of the Board regarding CAISO's investment portfolio.