

May 30, 2002

Senator Joseph L. Dunn  
Chair, Select Committee to Investigate Price  
Manipulation of the Wholesale Energy Market  
State Capital Building, Room 2080  
Sacramento, CA 95814

Senator Bill Morrow  
Vice Chair, Select Committee to Investigate Price  
Manipulation of the Wholesale Energy Market  
State Capital Building, Room 4048  
Sacramento, CA 95814

Dear Senator Dunn and Senator Morrow:

Michael Kahn and Terry Winter have asked that I respond to your letter of May 23, 2002. As Mr. Kahn advised in his May 24 letter to you, the ISO Board of Governors has formed a Special Committee to oversee review of the matters you have raised and is engaging an independent investigator to conduct a further inquiry. Nonetheless, we wanted your Committee to have the benefit of this initial response while the Board's Special Committee performs its work.

Before addressing your specific questions, some general remarks are in order. Please find enclosed a preliminary report which presents the details of the operational situation confronting the ISO during the November 16, 2001 weekend. It demonstrates, among other things, that the ISO did not request CERS to submit "load in excess of its demand." Nowhere in the recorded conversation did ISO use the words "fictitious" load. The "load" that ISO needed CERS to serve was real.

The fact that CERS may have scheduled in the forward market sufficient energy to meet the net short *projected* by the Investor Owned Utilities is not relevant to whether the ISO needed additional generation available in real time to meet anticipated system needs and reserve requirements. CERS' procurement of power might have been in excess of load as forecast by CERS or the IOUs; it was not in excess of identified system and area grid needs forecast by the ISO. Indeed, ISO data shows that CERS' procurement to serve load was consistently over or under actual load requirements through November 2001 and that there was no material difference in scheduled versus actual load over the November 16 weekend as compared to earlier or later time periods that month. CERS' need to sell off over-procured power is not an event in any way unique to the November 16 weekend. Importantly, the concern over the November 16 weekend was not simply with the total number of megawatts procured to serve load in the state as a whole, but included the locational requirements of the megawatts serving load; this is because the transmission outage that

occurred that weekend very nearly divided the state into two isolated operating areas, each of which required sufficient generation within its boundaries to serve and balance its own load. Again, these issues are described in more detail in the enclosed interim report.

With respect to your specific questions, we respond as follows:

Question 1: “Who in management was aware of this incident or, more generally, of this behavior.”

Response: Messrs. Alaywan, McIntosh and Bibb who participated in the November 14 telephone conference with CERS are each Directors and so are members of ISO management. In addition, I, as ISO Vice President – Grid Operations, was generally aware of the Path 26 outage described in the report. More generally, ISO management is keenly aware that it is the ISO’s responsibility per state law and Federal Tariff to take appropriate steps to ensure the reliable operation of the transmission grid in accordance with reliability criteria issued by the Western Electricity Coordinating Council. ISO management is also aware that the ISO is authorized by its Tariff to obtain resources or services outside of the ISO markets to ensure reliability where, in the ISO’s judgment, it is prudent to do so.

Question 2: “On April 4, 2002, after discovery of the telephone conversation between and [sic] ISO trader and an Enron trader, Mr. Winter was asked to ‘explain . . . in writing the circumstances of this call and any other similar calls in which the ISO participated.’ The Committee received no response. Does ISO believe the behavior detailed in the November 14, 2001 conference call to be substantially different than the July 3, 2001 incident. If so, why?”

Response: First, the assertion that the Committee “has received no response” to its inquiry is simply not the case. As the Committee is aware, the ISO engaged the law firm of Fenwick & West to investigate the July 3 incident. That firm, and particularly its senior partner John Fox, has provided numerous reports to the Committee regarding the results of that investigation. A letter from Mr. Fox dated May 30, 2002, detailing repeated and continuous communication (including written documentation) with the Committee’s Chairman and staff concerning, among other things, the status of the investigation, is enclosed. It is our understanding, as reflected in Mr. Fox’s letter, that he informed the Committee that his final report would be available shortly and that the Committee indicated no difficulty with the time frame in which Mr. Fox was working.

Second, there is no resemblance whatsoever between the July 3 incident and the arrangements requested on November 14, 2001. In the July 3 telephone conversation, an ISO employee contacted Enron and requested that a bid be placed at a specific price into the Hour Ahead auction for Replacement Reserves, a form of Ancillary Services. The purpose of the request – in the employee’s mind – was to set a high market clearing price, which he believed would punish and/or deter what he saw as gaming activities by certain other market participants. That conduct is prohibited by the Tariff and the ISO’s Code of Conduct; such unilateral action is not permitted to address “gaming” activities. By contrast, the ISO’s ability to arrange for specific generating resources to be available to meet reliability criteria is specifically authorized (indeed, required) by the Tariff. The requirement for a creditworthy counterparty to back that arrangement was ordered by FERC. Any purported economic dislocation to the markets would have been a result of a physical

equipment outage of a key portion of the transmission grid, not a manipulation of the market. This is more fully explained in the interim report.

Question 3. “If the ISO believes the July 3, 2001 incident and the November 14, 2001 to be substantially similar, why was it not disclosed to the committee . . . . Jim Detmers testified before the committee at the November 13, 2001 hearing that ‘section 2351 at [sic] the ISO tariff does have it specified that if the ISO is forecasting a deficiency on the grid . . . we have the ability of going out and making bilateral arrangements . . . .’ The behavior specified in the November 14, 2001 call with CERS does not represent this kind of action. If the ISO was employing other means of procuring power, or having power procured in order to avoid or address a potential deficiency on the grid, why did ISO not disclose this behavior to the committee?”

Response: In answer to the first part of the question, the July 3 and November 14 events are not similar in any respect (see response to Question 2). With respect to the Committee’s remarks concerning my November 13, 2001 testimony to the Committee, the November 14 telephone request to CERS was, in fact, an exercise of the ISO’s authority pursuant to the Tariff section which I incompletely referenced in my testimony as “2351.” (The full citation is Section 2.3.5.1.5.) Its application is discussed more fully in the enclosed interim report.

Question 4. “Does ISO believe this behavior falls within the rules of its Tariff? ISO board chairman Michael Kahn indicated in Tuesday’s press release that ISO believes the behavior ‘does not indicate wrongful conduct or manipulation of the ISO’s markets.’ The committee would like an explanation of this conclusion in light of the pending investigation.”

Response: Yes, the ISO’s request to CERS reflected in the November 14, 2001 telephone transcript is within the rules of the Tariff, specifically, Section 2.3.5.1.5. The interim report elaborates. The ISO believes that its initial assessment as set forth in the Tuesday press release is fully justified by the facts outlined in the enclosed report. Nonetheless, the ISO Board has taken the additional step of appointing a Special Committee to confirm the facts. This Committee will continue this investigation and will report its findings to your Committee.

Question 5. “Please provide the committee with all documents, including memoranda, emails and handwritten notes that discuss this behavior as a strategy or policy of the ISO.”

Response: To the extent that the reference to “this behavior as a strategy” means an alleged ISO request for a “fictitious load” schedule, the ISO has not discovered any instances of such a “strategy” being employed by the ISO, and thus is not aware of responsive documents. Documents gathered to date reflecting the system conditions that required the ISO’s November 14, 2001 request of CERS over the weekend beginning Friday, November 16, 2001, accompany the enclosed report. To the extent that media reports have alluded to other allegedly improper conduct by ISO employees, the ISO Board Chairman in his May 24, 2002, letter to the Committee requested that any such evidence held by the Committee be made available to the Special Committee so that it can investigate. The comments released by or attributed to CERS and Mirant are too vague to enable the ISO to conduct a meaningful inquiry.

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Question 6. “Please provide the committee with all relevant documents for every instance in which this strategy was undertaken, including a complete list of the entities ISO asked to participate in this behavior, the amount of energy involved, the times and dates of these requests, the cost of the energy purchased, and whether or not the energy was used or resold.”

Response: To the extent that the reference to “this strategy” means an alleged ISO request for a “fictitious load” schedule, the ISO has not discovered any instances of such a “strategy” being employed by the ISO, and thus has no other information responsive to this request. As noted above, the ISO Board has requested that the Committee make available to it any other evidence of allegedly improper conduct so that it may be thoroughly investigated.

Question 7. “We reiterate our request that the ISO board waives its attorney-client privilege. Please provide the committee with ISO’s response to this request.”

Response: To the best of our knowledge, the ISO had not received a request from this Committee, prior to the receipt of the May 23, 2002, letter, for a waiver of the attorney-client privilege. The ISO Board intends to address this request in the context of the investigation undertaken by its Special Committee.

Please note that this response and the enclosed report are both preliminary. Two of the participants in the November 14 discussion were traveling out of the country as this response was prepared. The ISO will supplement this response if necessary upon their return.

In closing, we would like to suggest that, in the future, should you have reason to question any of the activities of the ISO, you should feel free to contact us for a briefing.

Sincerely,

Jim Detmers  
Vice President, Grid Operations

Enclosures

Cc: ISO Board of Governors  
Senator Debra Bowen  
Senator Wesley Chesbro  
Senator Martha Escutia  
Senator Maurice Johannessen  
Senator Sheila Kuehl  
Senator Byron Sher  
Hon. John Burton  
Hon. Herbert Wesson  
Governor Gray Davis  
Attorney General William Lockyer