



Memorandum

To: Finance Committee
From: William J. Regan, Jr., Chief Financial Officer
Philip Leiber, Treasurer & Director of Financial Planning
cc: Board of Governors, ISO Officers
Date: June 8, 2005
Re: *Investment Policy Modifications*

This memorandum requires a Committee recommendation and Board action.

EXECUTIVE SUMMARY

This memorandum outlines and requests approval of certain proposed changes to the ISO Investment Policy (Investment Policy or Policy). In 1999, Management developed and the Board approved an Investment Policy for ISO Corporate Funds. The policy was developed to reflect the conservative investment objectives of the ISO (safety of principal, liquidity and earnings). Management also initiated and presented the results of a benchmarking study to support various aspects of the policy at that time. This included a study of investment policies at other entities in the industry (municipal utilities, the Investor Owned Utilities, and other ISOs).

Management proposes certain modifications to the policy, none of which represent a departure from the objectives noted above. The changes are of four types: (A) those necessitated by the agreements related to the 2004 bond offering; (B) clarifications; (C) authorized investments; and (D) policy/administrative. The proposed changes are discussed below and are specifically shown in **Attachment 1**, which contains a redlined and clean version of the revised investment policy. The changes noted in **Attachment 1** are cross-referenced to the list outlined in the discussion section below.

Management requested Board approval of changes to the Investment Policy at the February 2005 Board meeting. The Board deferred action on the changes, and requested that Management address an additional issue, relating to the risk of loss for market participant funds invested by the ISO. This issue has been addressed in this memorandum. Further, the Board requested the view of an independent expert with respect to the proposed changes and the investment policy overall. Moody's Investor Services has reviewed the proposed policy and advised "[the proposed policy]...meets a strong standard and would be cited as a positive in Cal ISO's credit rating."

Management recommends that the Committee recommend Board approval of the proposed changes to the ISO's Investment Policy.

Moved,

That the Finance Committee of the ISO Governing Board (Finance Committee) recommends that the ISO Governing Board approve the proposed amendments to the ISO's Investment Policy, as those proposed changes are outlined in the memorandum, and related attachments, to the Finance Committee dated June 7, 2005.

DISCUSSION

As noted above, the proposed changes to the Investment Policy fall into four categories. Each category, and the proposed changes that fall into those categories is discussed below. Except where noted, these items are unchanged from the February 2005 Board memo.

A. Clarifications

The first two items are clarifications related to CAISO's December 2004 bonds that were issued to provide funding for MRTU and other capital projects.

1. The existing policy prohibits investments in "derivative securities", but notes that the interest rate swap that serves as a hedge on the ISO's bonds is not a prohibited investment. That reference is currently specific to the interest rate swap for the ISO's 1998 bonds (which were refinanced in 2000 with the same swap being kept in place with counterparty JPMorgan.) The ISO proposes to strike the specific reference to the 1998 bonds and replace it with "interest rate swap agreements related to ISO debt, as approved by the Board of Governors." As noted in the presentations to the Board on November 10 and December 3, 2004, Management indicated that it would procure an interest rate swap agreement covering 60% of the outstanding principal of the 2004 bonds. The ISO executed a swap agreement with JPMorgan on December 16 for that amount, 60% of the \$124,100,000 bonds issued, or \$74,460,000.
2. The ISO proposes to make specific reference in the Investment Policy to investments procured with 2004 bond proceeds. These investments are detailed in the "Other Permitted Investments Section" of the revised Investment Policy. The ISO sought the advice of JPMorgan and pricing-agent Gibbs Consulting on appropriate investments for the 2004 bond related funds. Based on their advice, the ISO conducted a competitive bidding process on December 16th to procure investments for the 2004 bond's project fund, debt service reserve fund ("DSRF") and bond fund.
 - The ISO solicited bids for our \$109,959,614 project fund for either a flexible Guaranteed Investment Contract ("GIC") or flexible repurchase agreement (no bids for this product were received). Based on the submissions, the ISO selected a GIC for the bond project fund. The selected GIC will provide a significantly higher yield than the alternative, while maintaining the highest-level of security for the ISO. The investment provider is FSA, a "AAA" rated bond insurance company. Management notes that the ISO investment policy provides that GICs should comprise not more than 45% of the total portfolio. This limitation was not exceeded, but subsequent changes in the ISO investment portfolio could result in a breach of this limitation (if the size of the overall portfolio decreases, this investment will comprise a larger percentage of the total, perhaps in excess of the 45%). The ISO proposes a change to the Policy to clarify the intent of the dollar limitation restrictions in Item 10 below.

- The ISO procured a forward delivery agreement/forward purchase agreement for the DSRF in the amount of \$12,410,000 with Morgan Stanley & Co. and a like agreement for the bond fund with JPMorgan (the bond fund holds the monthly principal payments made by the ISO until the bonds are retired on February 1 of 2006-2010). The bond fund contained no funding as of year-end, as the account holds monthly principal payments to be made by the ISO beginning on February 1, 2005. These investments are permitted under the existing policy as “Repurchase Agreements”, and listing these investments is intended as a clarification of this.

Other clarifications address ambiguities or past changes to the ISO organization.

3. The Investment Policy makes reference to the ISO “Chief Financial Officer and Treasurer”. Since the year 2000, these have been separate positions. Therefore, the proposed revisions to the Investment Policy reflect this change. In addition, Management proposes to also clarify and expand upon the identified responsibilities of the CFO.
4. Management proposes three other minor items: *[Updated from February 2005 Memorandum]*
 - a) Strike language referring to swaps of investments—while this use of the term “swaps” refers to “changes in investments” it is confusing as the term “swap” is also an investment type specifically addressed elsewhere (investments in derivative securities are prohibited other than as specifically permitted for interest rate swaps on bonds approved by the Board.); and
 - b) Amend the sentence related to “portfolio holding limits” in the general section of the policy as separate limits are specified for types of investments in the policy.
 - c) Use the precise reference for rating agencies such as Moody’s / Standard & Poors / Fitch / Dominion, which are referred to by the Securities and Exchange Commission as “nationally recognized statistical rating organizations” or “NRSRO”s.

B. Authorized Investments

5. *[Updated from February 2005 Memorandum-previously classified as a “clarification”]*
Management proposes to change the heading of a group of authorized investments from “Tax Exempt Obligations” to “Municipal and State Obligations / Tax-Exempt Obligations”. The content of these sections will remain unchanged. The proposed change reflects the fact that some state and municipal obligations are taxable for certain investors. The proposed title change for this section better describes the list of potential investments in this area. As a 501(c)3 not-for-profit entity, interest received by the California ISO is not taxable.
6. Management proposes to modify the section related to “Mutual Funds-Debt Only” to limit permissible bond fund investments and to permit more flexibility to invest in high-quality money market funds.
 - a. Management proposes to limit investments in certain debt-related mutual funds to not more than 25% of the ISO’s portfolio. Currently, unlimited investments are permitted in bond funds investing in obligations backed by the full faith and credit of the United States. This could permit significant investments in funds holding longer-term government bonds that might face significant fluctuations in principal due to changes in interest rates. While the ISO has not invested in such funds,

Management believes it warranted to limit investments in debt-related funds to those with a short to medium-term investment focus to avoid such risk.

- b. Management proposes to add a new section to the Policy entitled "Money Market Funds" to permit investment in high-quality money market funds without regard to dollar limitations. Money market fund investments are currently included in the "Mutual Funds" provision discussed in the prior paragraph. The existing 45% limitation on debt-related mutual funds other than those holding U.S. backed obligations is eliminated with respect to such high-quality money market funds¹. Money market funds hold a diversified portfolio of high credit quality short-term investments and are subject to significant restrictions as to eligible investments under SEC regulations. Because of these factors and the very limited potential for any losses associated with such funds, Management considers such a limitation unnecessary. The very limited additional risk is warranted by the higher yields that such money market funds offer over money-funds that invest solely in U.S. government backed obligations, which are permissible in unlimited amounts under the existing Policy.

7. Management proposes to address the issue of investments related to "market" funds.

- a. A provision will be added to the Policy indicating that "market" funds will be invested only in high-quality money market mutual funds (as defined in the revised Policy). Although Market funds are not explicitly addressed in the existing Investment Policy, the ISO has invested in such funds, consistent with the proposed Policy, i.e., the ISO has only invested in "high-quality money market funds". However, Management does propose two exceptions to the "high-quality money fund" rule. First, as the ISO at times maintains investment accounts with funds from a single-entity (such as a collateral account), if that entity requests or authorizes an investment in another investment product permissible under the ISO Investment Policy, pursuant to the proposed changes the ISO can agree to such an investment at its discretion and with the approval of the ISO CEO or CFO. Second, the proposed changes permit market related funds that may ultimately be distributable to multiple market participants to be invested in a "AAA" rated U.S. Government Treasury or Agency Security of an appropriate maturity upon approval of the ISO CFO and CEO.
- b. **[Updated from February 2005 Memorandum]** As requested at the February 2005 Board meeting, Management reviewed the issue of risk of loss of market participant funds invested by the ISO. The CAISO Tariff currently does not specifically address this matter, but does provide for a negligence standard related to liability for ISO conduct. For the avoidance of uncertainty on this matter, Management proposes to modify the ISO Tariff to indicate that Market

¹ "High quality money market funds" are defined as a money fund that:

- (A) Is limited to investments in US Treasury and Agency securities or;
- (B) Meets the following criteria: (i) seeks to maintain a stable share price of \$1.00. (ii) invests in only "eligible securities" as defined by Rule 2a-7 of the Investment Company Act of 1940 (which among other restrictions permits only securities with remaining maturities of 397 calendar days or less.) (iii) purchases only "first-tier securities" (per Rule 2a-7) that present minimal credit risk. (iv) is a fund approved by the National Association of Insurance Commissioners (NAIC) as a permitted investment. (v) has minimum fund assets of \$2 billion.

References:

1. Investment Company Act of 1940 is located here: <http://www.law.uc.edu/CCL/InvCoRIs/rule2a-7.html>.
2. As an indication of the safety of principal of money market funds, only one of the thousands of available money market funds has ever failed to maintain the \$1.00 stable share price, resulting in a loss to investors. "In 1994 an institutional money fund, Community Bankers U.S. Government Money Market Fund, liquidated at 94 cents a share due to extensive derivatives-related holdings."

Participants will bear any risk of loss of principal and/or interest on funds held and invested by the ISO on behalf of Market Participants.

8. Management proposes certain changes and additions to the section entitled "Commercial Paper (C.P.) Medium Term Corporate Notes, and Asset-Backed Securities". **[Updated from February 2005 Memorandum]**
 - a. First, Management proposes to clarify that the 5-year limitation on maturities shall begin at the time of purchase of the security by the ISO. For example, the ISO could purchase a 10-year bond in the secondary market if there were five years or less until the bond matured.
 - b. In addition, the proposed changes clarify that the five-year limitation shall not prohibit the ISO from investing in certain securities that may have a longer ultimate maturity than five years, but which are effectively short-term securities. Certain investments known as variable rate demand obligations or auction rate securities have weekly or monthly interest rate reset periods and may have an ultimate maturity of greater than five years, but are appropriately treated as a short-term investments by the ISO, as they will not fluctuate in value due to changes in interest rates given the periodic interest rate reset feature. Accordingly, a reference is made to permit investments in "Variable Rate Demand Obligations" and "Auction Rate Securities".
9. Management proposes to include a provision to explicitly list agreements related to the ISO's Series 2000 bonds, and to exclude these from any dollar limitations noted elsewhere in the Investment Policy. Two such investments are noted in the "Other Permitted Investments Section" of the revised Investment Policy.
 - a. First, like the investments purchased for the Series 2004A/B bonds, Management is currently exploring the purchase of a forward delivery agreement/forward purchase agreement for the bond fund on the existing Series 2000ABC bonds. This would provide a higher yield on such funds versus the current investment of a treasury money market held by the bond trustee. If such an investment is purchased, it would extend until 2009, when the Series 2000 bonds are retired, Under such an arrangement, the trustee would hold the monthly principal payments deposited by the ISO until April 1 of each year, and then use such funds to retire the scheduled debt.
 - b. Second, in connection with the Series 2000 bonds and a swap restructuring, the ISO purchased a Guaranteed Investment Contract with JPMorganChase Bank on June 1, 2000 in the amount of \$2,823,000. The interest earnings on this investment are accounted for as offset to ISO bond interest expense.

C. Policy / Administrative

10. **[Updated from February 2005 Memorandum]** Management proposes to expand the "Exceptions" section of the Investment Policy to permit waivers to limitations in the Policy upon written consent of the ISO Finance Committee Chair or the Chair of the ISO Governing Board. The existing exception method (by CEO approval) for dollar limits to investments is also further tightened, and requires ISO Finance Committee Chair approval and subsequent notice to the ISO Governing Board.
11. Management proposes to clarify that the effectiveness of the percentage of portfolio limitations for specific types of investments is "as of the date of the purchase of the investment". The purpose of this

change is to prevent having to rebalance the portfolio and liquidate investments just because of a decrease in the overall size of the portfolio to avoid a subsequent violation of a dollar limitation.

12. Management proposes certain changes that are necessary to acknowledge the increasing participation of financial institutions in the energy markets and the fact that the ISO may, from time to time, have or enter into financial relationships with affiliates of market participants. Two instances of this exist at present:
 - a) Deutsche Bank serves as Trustee for the ISO's Series 2000 and 2004 bonds, and the ISO has investments in a Treasury money market fund entitled "Deutsche Bank Institutional Treasury Money Market Fund". An affiliate of this company, "DB Energy Trading" became a certified Scheduling Coordinator on January 21, 2005.
 - b) In December 2004, the ISO held a competitive bidding process for investments related to the 2004 bonds (see item 2, above). Morgan Stanley Capital Services Inc. / Morgan Stanley & Co. Incorporated was the successful bidder, and the ISO procured a forward delivery investment agreement from this firm. A related firm, Morgan Stanley Capital Group, Inc. has been a certified Scheduling Coordinator since May 2001. Management proposes to add language to permit such investments with affiliates of market participants, but have attempted to narrowly tailor such language to appropriately reflect the need for ISO independence from market participants

Upon approval of the proposed changes to the Policy, Management intends to periodically review the Investment Policy to ensure that it continues to satisfy the ISO needs and those of its Market Participants.

MANAGEMENT RECOMMENDATION

For the reasons outlined above, Management recommends that the Committee recommend that the Board approve the proposed changes to the ISO's Investment Policy.

Moved,

That the Finance Committee of the ISO Governing Board (Finance Committee) recommends that the ISO Governing Board approve the proposed amendments to the ISO's Investment Policy, as those proposed changes are outlined in the memorandum, and related attachments, to the Finance Committee dated June 7, 2005.