California Independent
System Operator Corporation

Memorandum

To: ISO Board of Governors

From: Yakout Mansour, President and Chief Executive Officer

Date: October 20, 2008

Re: CEO Report

This memorandum does not require Board action.

Since my last report it seems that events in the global financial markets and their impact on the economy have in one way or another affected everyone, including the California Independent System Operator Corporation (ISO). As a result we have been closely monitoring the investments of the ISO and the financial condition of our market participants, which indeed we discussed with you at length during a special Board meeting early on in the current crisis. We will continue to oversee developments at this heightened level for as long as these conditions persist. Nonetheless, business here and elsewhere continues and there are a number of items I would like to bring to your attention at this time, some of which are related to these recent events but most of which are simply part of our normal course of business.

1. FINANCIAL HIGHLIGHTS

a) Financial Condition of ISO and Market Participants. Clearly recent conditions in the financial markets have caused major changes in the way organizations manage their finances and the ISO is no exception. The first step was for us to review all investments made pursuant to our investment policy, which even though by all standards is conservative, there is always some risk in making decisions to prioritize safety of principal, liquidity, and return in accordance with the policy. The majority of the ISO's investment portfolio has been invested in high quality money market funds, and we have seen no declines in the value of our funds. For funds that are not immediately needed, the ISO has invested a portion of funds in a diversified portfolio of highly rated corporate and government agency bonds to provide some stability of interest earnings and a higher return than is available in money market funds. The ISO's total investment portfolio has declined only about 2% in value and as a result we currently are seeing some unrealized losses; however, if we hold these bonds to maturity we should expect no losses. In any event we will continue to closely monitor our investments and take actions as appropriate. We have also commenced a review of the investment policy with the assistance of an outside expert and, while we believe the policy is fundamentally sound, we intend to bring the policy with any appropriate revisions to the Board in December.

September and October have also been challenging times for a number of our market participants and related entities. In September, we decertified Lehman Brothers Commodity Services as a scheduling coordinator, after they failed to post additional collateral to support their potential obligations. We have also closely monitored and requested collateral to support the obligations of other market participants, and at this time do not anticipate any losses related to Lehman Brothers Commodity Services or other market participants.

b) Recent Fixed Rate Bond Offering. First I would like to thank the Board for supporting management in reaching the recent decision to refinance our existing debt and issue new debt at a fixed rate. In total the ISO issued about $200 million in fixed rate bonds just last June. From where we now stand, the decision to move to traditional fixed rate bonds has been validated, as variable rate debt has continued to face the same challenges seen earlier in the year that prompted our examination of our debt structure. In so doing I would also like to thank our Chief Financial Officer, Phil Leiber, for his dedication and thoughtfulness in exploring all possible options and identifying the benefits of a fixed rate financing.

2. MRTU READINESS

Program Update. In response to the Board resolution of the last meeting, I am pleased to report that the ISO readiness is well on track for filing our sixty day certification of readiness on December 1, 2008 with the Federal Energy Regulatory Commission (FERC), and go-live on the February 1, 2009 planned date. The Board will hear the full details as part of this meeting's agenda.

In this regard, there are few points I would like to clarify:

1. It is unrealistic to expect performance from the simulation similar to the production environment. What we wanted to know from the simulation is the connectivity of the market to the ISO systems, test the performance of the functionalities in analyzing the test cases and produce results as expected, understand the results as to how bidding and scheduling behavior affect congestion mitigation prices and training. In doing so, the process required daily tweaking and manual interventions to produce a valid hypothetical case for simulation which takes time to set the cases and resolve inaccuracies in the bids, load forecasts, simulation environment limitation, and operator actions. That often resulted in periods where the results were late but the engines performed as expected. No matter how long we stretch the simulation and testing period for, we have reached a limit to what we can further in value from simulation. Indeed, we are comfortable and confident in the technology as it stands in performing what it is supposed to do.

2. No matter how much we do and resolve in simulation, we are sure that we will have glitches when we go live from time to time. The key is to have a strong level of understanding and the skills to deal with the issues as they arise. When I reported to the Board in the past on the delay of readiness, it was primarily because of my assessment that we have not reached that level of competence. Today, I am finding the vendor/ISO team diagnosing the issues and resolving them virtually on the spot and significantly more effectively than few months ago. Therefore, my confidence in being able to deal with the issues after we go-live is high.

3. Locational marginal pricing is introduced to send strong signals of congestion cost to influence scheduling and bidding behavior. High nodal prices are not necessarily indicative of something wrong as long as we understand how one can schedule resources to reduce them. We have seen indications from market participants that when they see high prices it is indicative of something wrong. On this front, we have seen high prices in simulation the source of which can be attributed to a physically explainable and acceptable reason, mathematically correct but not reasonably acceptable reason, or a software bugs that need to be fixed. The latter is either already fixed or on its way of being fixed at the time of writing this report. The former only needed explanation but left alone while the middle is the subject of mitigation policy that is also presented to you in the agenda.

Overall, we stand committed to the timeline established by the Board and do not see value to extending the testing and simulation timeline beyond that based on what we see today.

3. MARKET & INFRASTRUCTURE DEVELOPMENT

a) Generator Interconnection Procedure Reform (GIPR). We are very pleased to report that on September 26, 2008 the FERC conditionally approved with only minor clarifications our filing to reform the generator interconnection process. As a consequence we have already begun implementation of the reformed process. We expect the 78 serial group projects (representing approximately 21,000 MW, of which approximately 12,500 MW represent renewable resources) to have their studies completed by the end of this year and their interconnection agreements completed early in 2009. In addition, approximately 230 new study agreements have been sent to those projects identified to be part of the initial transition cluster (representing approximately 70,500 MW, of which approximately 55,000 MW represent renewable resources). These study agreements are required to be signed by the interconnection customers and returned with the required increased deposits to the ISO no later than November 25th, 2008. Studies for the initial transition cluster projects are expected to start December 1, 2008 on schedule. This is a major milestone in our continued efforts to clear the backlog of the existing queue, and as a result support the efforts of load serving entities to meet the renewable portfolio standard requirements. Assuming durations based on the process timelines as approved by FERC, we anticipate the initial transition cluster will complete the process within two years, a timeframe unthinkable under the previous serial study approach. In addition we estimate that the time to clear the existing ISO queue backlog for interconnection requests will be reduced from about four to five years under the previous serial study process to about two years under the new cluster study process. As always we will continue to monitor this process reform to assess whether the expected benefits are realized and to make adjustments as appropriate to improve our performance.

b) Integrated-Balancing Authority Areas (IBAA). After a long stakeholder process to resolve issues related to the import and export of power at interties that are highly integrated with other balancing authority areas the ISO filed its proposal with FERC requesting the approval of a modeling and pricing approach that specifically eliminated incentives for schedules at the interties that would otherwise adversely impact ISO load. On September 19, 2008 the FERC issued an order conditionally accepting our proposal in all significant respects. Most importantly the order confirmed the concerns raised all along by the ISO and emphasized the fact that impacted external entities have a clear option to obtain a pricing arrangement that better reflects the value of their external resources. On compliance to the FERC order, the ISO will be including in its tariff the specific data required and stands ready willing and able to negotiate any such agreements with any entity impacted by these rules.

I want to take this opportunity to invite the concerned parties to work with us on improving the modeling of their parts of the grid to allow all of us to visualize the grid better and allocate cost fairly for the benefit of all of us. As I said before, and the Commission confirmed, absent that we have no option but to proceed with the approach approved by this Board and the Commission.

c) Pacific Gas and Electric Company (PG&E) Recabling Project. On October 14, 2008 PG&E informed the ISO by letter that it had approved a capital expenditure of $114.0 million in system maintenance expenditures for the San Francisco 115 kV recabling project. The project will mitigate the risk of equipment failures and service interruptions associated with aging underground cables, which could last from one to twelve months, depending on the severity of the failure. The project will upgrade 17.5 miles of the most critical existing underground transmission cables in San Francisco with higher capacity cables. The project costs more than $50 million but does not require Board approval because it is part of PG&E's ongoing obligation under the Transmission Control Agreement. This agreement between PG&E and the ISO imposes a duty of care on transmission owners to maintain transmission facilities in accordance with good utility practice as well as to satisfy applicable reliability criteria and other ISO performance standards established under the agreement. Transmission system maintenance projects do not come to the Board for approval but management chose to inform the Board in this case because of the cost of the project and to express our general support of such measures to maintain and upgrade critical aging infrastructure.

4. OPERATIONS

a) Conditions and Forecasts. At this time we can definitively state that summer conditions will not return until next year. However, at the same time this is the fire season for Southern California and indeed we recently saw significant Santa Anna winds with several major fires that had the potential to impact the power grid. In addition to the tragic consequences as a result of these fires, they at times threatened the Southwest Power Link and the South of Songs transmission corridor. We understand as a result that SDGE implemented the first phase of their new fire procedure which, during certain conditions, allows them to eliminate re-closures on certain 69 kV lines in areas prone to high winds in an attempt to reduce the chance of utility ignition.

Concurrently, we have begun in earnest our winter preparedness activities. Fall maintenance season is in full swing and the challenges of shoulder month outages combined with variable weather led to a warning declaration on October 8th as blown weather forecasts, maintenance constrained import capabilities, and a series of generation forced outages combined to cut heavily into reserve margins. October/November maintenance is critical to prepare units and transmission lines for the winter season. Transmission capability will be critical this winter season as very low hydro output levels in Northern California will shift that region from net exporter to net importer as the temperatures drop. In addition, and perhaps more important this year than in recent years past, we are very mindful of what a 3rd dry year would mean for operations next summer. Long term forecasts to January 2009 continue to indicate dry conditions over California and, with major in-state storage reservoirs nearing historic lows, normal precipitation levels will not come close to filling reservoirs for next summer. As always we will continue to monitor all of these factors and bring matters to your attention as appropriate.

b) Renewable Resource Integration. Our efforts to prepare for the reliable integration of renewable resources continue with an emphasis on outreach meetings with other agencies and entities. At this time we are near completion of the remaining impact assessments for the 20% renewable portfolio standard requirements, including the evaluation of existing fleet capability and the magnitude of over generation conditions. Specifically we are evaluating new renewable forecasting services for day-ahead and hour-ahead wind and solar forecasts and developing new data requirements from wind and solar resources to support these forecasting efforts. Along these same lines we have initiated a joint effort with the Bonneville Power Administration to assess the viability of intra-hour scheduling at the inter-ties and/or the increased use of dynamic scheduling to facilitate renewable energy transactions across balancing authority areas. Finally, it is worth noting that Proposition 7, the renewable energy generation initiative on the ballot for the upcoming November general election, would require a reassessment of our current efforts if approved by voters.

5. PEOPLE

a) Dan Ozene, PhD, Director of Regulatory and Policy Development. I am excited to announce that Dan Ozenne, PhD, will join the California ISO on November 3 as Director of Regulatory and Policy Development. Dan will represent the California ISO on policy-related issues at external forums that focus on market and transmission collaboration. In particular, he will provide leadership and policy direction for strategic initiatives such as demand response and smart grid technologies. Dan has more than 25 years of energy industry experience in strategic and business planning, both in corporate management and as a consultant. Currently, he is Regulatory Policy Group Manager for Sempra Energy Utilities. Please join me in welcoming Dan to the ISO.

b) Dr. Anjali Sheffrin, Chief Economist and Director of Western Regional Initiatives. As you know the Five-Year Strategic Business Plan calls for improved inter-regional coordination and trade, with an emphasis on supporting the sale and transfer of renewable resources within the western grid. We also want to help develop standards for demand response products and explore private/public partnerships that spark infrastructure investment. Fortunately for us, we have just the person to lead such a major endeavor, whom you know well. Dr. Anjali Sheffrin has accepted the position of Chief Economist and Director of Western Regional Initiatives. Anjali will create innovative solutions that will promote a seamless western grid structure, using inter-departmental teams to take a fresh approach to the west wide challenges the industry faces. Anjali will establish a common framework for aligning internal initiatives to develop solutions for improving regional reliability, through efficiency and transparency. Please welcome Anjali to her new position at the ISO.