California Independent
System Operator Corporation

Memorandum

To: ISO Board of Governors

From: Philip Leiber, Chief Financial Officer & Treasurer

Date: March 18, 2009

Re: **2008 Investment Performance Report**

This memorandum does not require Board action.

EXECUTIVE SUMMARY

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

- A list of investments identifying the investment type, issuer, agency rating(s), 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 reporting statement that the portfolio is in compliance with the policy or manner in which the portfolio is not in compliance; and
- Portfolio performance information and any relevant benchmarks.

Attachment 2a contains a summary of the investment portfolio as of December 31, 2008, and a statement that the portfolio holdings are in compliance with the *Investment Policy* (**Attachment 1**) adopted by the Board in December 2008. The investment policy adopted by the Board in December requires that individual securities purchased by the ISO shall be held in a custodial account by a third party custodian. On March 18, 2009, the ISO finalized an agreement with such a custodian and individual securities are expected to be transferred to that custodian by month-end.

The 2008 investment return was 1.33%, inclusive of 3.15% interest earnings offset by a 1.81% decline in value of investments. This compares favorably to overall performance of the U.S. fixed income market, as measured by the Barclays Capital US Credit Index[1], which provided a return of -3.08% for 2008.

[1] A subindex of the Lehman U.S. Government/Credit Index. The index includes both corporate and non-corporate sectors. The corporate sectors are Industrial, Utility, and Finance, which include both U.S. and non-U.S. corporations. The non-corporate sectors

DISCUSSION AND ANALYSIS

The ISO's corporate investment portfolio contains both unrestricted and restricted funds.

1. ***Operations related funds (Unrestricted).*** **Attachment 3a** shows the value of the Operations Related/Unrestricted funds at $200.6 million[2], or 69% of the total portfolio. These funds are available for general corporate use (though not all are available for current use), and include the following (figure references are unaudited):
    - Operating & Capital Reserve Funds: the Operating & Capital Reserve account is defined in the ISO Tariff, with a targeted funding level of not less than 15% of the O&M budget, or about $23.5 million for year 2009. When the 2009 grid management charge (GMC) rates were set during early December 2008, the Operating and Capital Reserve was projected to have $40.5 million on hand at December 31, 2008, resulting in a credit towards 2009 GMC rates of $17 million.
    - Funds received from GMC and other revenues that will be disbursed for routine ISO expenditures (accounts payable as of December 31, 2008 is approximately $12.2 million). Accrued compensation related amounts as December 31, 2008 totals $21.5 million.
    - Cash related to other obligations: Significant items include Amendment 33 fines and interest to ultimately be refunded to market participants ($56.7 million), Transmission Studies Deposits ($55.5 million), GMC Refund Liability ($2.7 million) and other longer-term ISO obligations including employee benefit plan obligations (approximately $12.5 million).

2. ***Restricted Bond Related Funds***. **Attachment 3b** shows the value of the Bond Related/Restricted funds at $90.2 million, or 31% of the total portfolio. The bond related funds include bond repayment accounts for semi-annual interest payments and annual principal amortization ($1.6 million), a debt-service reserve fund ($19.8 million, a capitalized interest fund ($0.9 million), and unspent project funds from the 2007 and 2008 bond issuances ($67.9 million).

The funds are invested in a variety of short-term (less than one year) and medium-term (1-5 year) financial instruments as authorized by the *Investment Policy*. The ISO's conservative *Investment Policy* has investment objectives of (1) safety of principal, (2) liquidity and (3) earnings. The *Investment Policy* was updated during 2008 and approved by the Board in December. Investments of the bond-related funds are further limited to permissible investments authorized by the bond indenture. **Attachment 2b** provides a listing of investments by asset class for the entire ISO investment portfolio (unrestricted and restricted funds).

The ISO's recorded interest earnings in recent years are listed in the following table. **Attachment 4** compares the realized yield on the portfolio to a baseline rate that would have been earned if all funds had been invested in a treasury money market fund. The ISO earned approximately 1.33% on the portfolio during 2008, inclusive of declines in investment market value. This was 0.78% (equating to $1.96 million) higher than the treasury money fund approach. This incremental yield is a measure of the value of the more active approach to the management of

are Sovereign, Supranational, Foreign Agency, and Foreign Local Government. The index is calculated monthly on price-only and total-return basis. All returns are market value-weighted inclusive of accrued interest.

[2] Differences between the sum of these figures and the $200.6 million include differences between the actual the year-end operating reserve balance and the forecast used in December to set 2009 GMC rates.

the investment portfolio exercised by the ISO as compared to a passive money market only strategy. This included holding longer-term instruments with maturities of up to five years. The 1.33% return consisted of two components: interest earnings of 3.15% offset by unrealized losses (changes in market value of investments) of 1.81%. Overall, the performance is viewed positively, given the difficult investment climate in 2008, where the majority of fixed income funds other than money market funds declined in value.

	Year Ended 12/31/2006	Year Ended 12/31/2007	Year Ended 12/31/2008
Total Earnings	$8.9 million	$10.9 million, 4.92%	$7.56 million in interest, or a 3.15% return Less: $4.3 million in changes in market value of investments, (1.81% return) Equals: Net earnings of $3.25 million, 1.33%
Commentary	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.	Interest rates fell beginning in July 2007, as the Federal Reserve cut interest rates in response to the recessionary threat and tightened credit market conditions. The ISO's earnings exceeded money market rates due to the purchase and holding of longer-term investments prior to and after such declines that stabilized the rate earned on the portfolio.	Interest rates continued to decline rapidly throughout 2008 as the Federal Reserve cut interest rates in response to weakening economic conditions (See Attachment 4). In late 2007, the ISO moved funds from prime money market accounts to treasury/ government money market funds given the perceived increased risk of loss related to prime funds (certain prime money funds did experience losses during 2008—however no money market fund in which the ISO was invested suffered a decline in value). Declines in value in certain corporate bond holdings resulted in a $4.1 million unrealized loss as of 12/31/2008.

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Notable Treasury Related Events During 2008

- During fall 2007, the ISO transitioned from general money market funds to treasury money market funds given concern about questionable investment holdings of the money market funds. Numerous money market funds were shown to have significant expose to debt from structured investment vehicles (SIVs) that held mortgage and other asset backed securities. In some instances, such exposure resulted in losses to money fund investors. During early 2008, the ISO transitioned from treasury money market funds to government security funds, which offered improved yields without significant increase in risk. Yields on treasury money market funds dropped rapidly throughout

2008, and by September at the height of the financial crisis dropped to near 0%, as investors fled to the safest assets possible. By late 2008, we began to redeploy funds back to prime money market accounts.

- During December 2008, the Board approved updates to the ISO's *Investment Policy*.
- During 2008, the ISO's investment portfolio had individual bonds that experienced declines in value totaling $4.3 million. Of these unrealized losses, a portion was related to declines in bond values which are likely to be temporary in nature. As the ISO typically holds bonds to maturity, no ultimate losses are anticipated for those positions. Two bonds have losses which may be other than temporary in nature: International Lease Finance (ILF) and American General Finance (AGF). The ISO will likely continue to hold the ILF position as we believe the likelihood of recovery in value is significant. Due to continued concerns about the viability of AGC given parent company AIG's uncertain future, the ISO disposed of the AGF position in February 2009 at 44 percent of the par value, compared to the purchase price of 98.82% of par value.

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