



Memorandum

To: ISO Board of Governors
From: Yakout Mansour, President and Chief Executive Officer
Date: December 10, 2007
Re: **CEO Report**

This item does not require Board action.

Below are highlights of events affecting the California ISO since the date of the last meeting with the Board of Governors.

Operations

1. Firestorm Update - The October and November firestorms in southern California were considered one of the worst disasters in history. The October firestorm triggering three days of Transmission Emergencies where we experienced some of the most challenging grid conditions ever encountered—with more than twenty transmission lines out of service, including the 500 kilovolt Southwest Powerlink and the Pacific DC Intertie, and the threat of islanding the San Diego Baja, Mexico sub-region.

I would like to acknowledge the dedication of utility management and line crews from SDG&E, SCE, and PG&E who worked under extreme conditions to restore transmission facilities in coordination with the ISO staff to re-energize the system. I would also like to recognize the contributions made by power plant owners who quickly responded to the need for additional generation to offset the transmission lines that were out of service. Emergency power was also supplied by Mexico's Comisión Federal de Electricidad, which was critical to maintaining reliability when San Diego nearly disconnected from the larger western grid. Fires continued to affect the southland as evidenced over the Thanksgiving weekend. During all of these incidents, we activated contingency plans that worked and were able to maintain reliability of the grid with minimal interruption to end use customers. We are keeping the people who have lost homes or loved ones in our hearts and minds during this holiday season.

2. Service Adequacy Review - In view of the drought recorded over 2007 and the possibility of another lower than normal precipitation this winter, the ISO is assessing the service adequacy of the next peak period under various scenarios for early preparation and adjustment if necessary.

Infrastructure Planning

The ISO continues to devote considerable amounts of time and effort on transmission infrastructure initiatives driven by transmission planning process requirements, State environmental policies and regulations, and regulatory proceedings associated with key project approvals as summarized below.

1. Transmission Planning Process Requirements - The ISO has concluded extensive stakeholder outreach activities and is preparing to submit our FERC Order 890 compliance filing on December 21. FERC Order 890 requires all transmission providers to amend existing open access transmission tariffs to implement a coordinated, open, and transparent transmission planning process. This filing represents a comprehensive effort for California ISO and stakeholders to develop a more proactive transmission planning process over the short- and long-term horizons ensuring a reliable, economically efficient transmission system that also facilitates the achievement of State policy objectives. Our filing will include amendments to the MRTU Tariff and a newly created Business Practice Manual covering the transmission planning process. The MRTU Tariff amendments do not have any impacts on the MRTU implementation schedule and system specifications.

2. FERC Technical Conference on Interconnection Queue - The ISO is serving on one of four panels at a FERC Technical Conference on Interconnection Queuing Practices on December 11. The conference focused on alternatives for addressing current challenges with managing the queue, at a national level, while adhering to the FERC Order to standardize the agreements and procedures for interconnecting large generation facilities. The California ISO generation interconnection queue includes a significant growth in new renewable projects over the last two years driven by the Renewable Portfolio Standard ("RPS") target, representing approximately 40,000 megawatts, on a cumulative basis, through November 2007. This renewable generation is typically located in remote areas with inadequate transmission infrastructure. Entry into the queue today is relatively easy from a financial and application perspective. Our recommendation was that FERC authorize the California ISO to establish multiple clusters for the queue by key geographic interconnection points effective January 1, 2008 and grant the ISO greater flexibility and authority for insuring that projects in the queue are financially viable by imposing greater dollar thresholds and stricter entry criteria.

3. Initiatives Supporting the State Climate Change Policies - The ISO released its final Integration of Renewables Report, providing key findings from engineering studies and comprehensive recommendations for achieving the successful implementation of the State's 20 percent RPS target. The Report examines the transmission system and operational impacts of integrating large amounts of renewable power coming on line in the next few years and shows the feasibility of interconnecting 4,200 megawatts of new wind and solar power into the resource mix, bringing the total renewable resources in California to more than 13,000 megawatts.

The Report concludes that the impact of the 20 percent RPS target is manageable. The largest increase in renewable energy resources will come from wind generation and the majority of this new wind generation will be installed in the Tehachapi Wind Resource area. The Report concludes that the planned \$1.8B transmission upgrades for the Tehachapi area are sufficient to support the 4,200 megawatts of new renewable resources and makes specific recommendations on the types of wind generation resources that should be installed and the standards that should be met. Changes to operating practices however, will be required to integrate the large amounts of renewables. The 20 percent renewables is expected to increase the 3-hour morning ramp and 3-hour

evening ramp rates depending on the season, by up to 1,500 megawatts and 984 megawatts, respectively. ISO regulation capacity requirements, regulation ramping requirements, and maximum load following ramping requirements are also expected to increase. To address these requirements, the Report recommends the implementation of state-of-the-art forecasting tools and practices. Implementing MRTU will also help to mitigate ramping issues associated with large amounts of wind generation provided that Day-Ahead and Hour-Ahead wind forecasts are integrated into MRTU. Additional storage technology associated with wind generation would also be beneficial, particularly for intermittent resources. The Report recommends working with stakeholders to explore market mechanisms for incenting and financially compensating storage technology.

The Report also concludes that aligning demand-related resources with renewable power helps to offset the variability in output produced by intermittent resources. To that end, the California ISO opened its Demand Response Laboratory ("DR365") related to our vision for viable year-round demand response - not just during peak periods. DR365 showcases technologies that will allow aggregated blocks of demand response to bid into electricity markets just like conventional plants. We encourage you to visit!

4. Sunrise Powerlink Transmission Project ("Sunrise") Update - Phase I of the CPUC proceeding addressing the need for the Sunrise project concluded in November representing the achievement of another major milestone since the Board of Governors approved this project almost fourteen months ago. ISO staff was actively engaged in this phase of the proceeding. We expect the Commission to issue its draft Environmental Impact Report in early January which initiates Phase 2, the California Environmental Quality Act ("CEQA") analysis phase. The CPUC decision approving the certificate of public convenience and necessity is expected by early fall 2008.

Market Redesign & Technology Upgrade (“MRTU”) Program

1. Integrated Market Simulation (“IMS”) Schedule - With a little more than three months remaining until program launch on March 31, the California ISO is committed to working closely with all of our stakeholders to orchestrate a successful transition to the new and improved market structure. Market simulation is the test drive of the new market, providing market participants a chance to get used to the functionality and features before it goes live. These simulations to date have not been challenge-free. As is often the case, when testing large and complex systems, both the ISO and market participants have been challenged to meet testing timelines, criteria, and test results. I want to extend my appreciation to market participants for their dedication, due diligence and patience in ensuring proper test results.

The California ISO remains committed to having the proper system and environment ready for both the ISO and market participants. To that end, we have re-assessed the ability to enter IMS Update 2 by December 17 due to achieving less than desired system and environment readiness. Therefore, in consultation with the market participants, we have proposed and received concurrence to extend IMS Update 1 until December 21, providing the ability for market participants to test additional fixes, retest and run new scenarios, and validate additional settlement charge codes. IMS Update 2 will start with the first Day-Ahead Market on January 2 followed by the Real-Time Market on January 3, 2008. This will allow the California ISO additional time to test the IMS Update 2 systems and environment. We will continue to closely monitor and assess progress on testing and ask for continued support from the market participants.

2. ISO Outreach - The California ISO has stepped up its executive level outreach meetings and market participant triage support to help ensure that all program challenges—internal to the ISO and at market participant sites—are identified and successfully addressed. Additionally, we have taken a number of steps in recent months to improve the readiness status of both the ISO and market participants. Again, we appreciate the spirit of teamwork and collaboration demonstrated in support of the program.

3. Congestion Revenue Rights (“CRRs”) – I am very pleased to report that the CRR auction and allocation processes continue to work successfully. In mid-November, the California ISO was the first grid operator to allocate a ten-year financial hedge for transmission users in accordance with the Energy Policy Act. We posted the results of the allocation process for long-term CRRs on-time, in accordance with the CRR schedule, providing Load Serving Entities (“LSE”) and other holders a more stable cost structure by offsetting the congestion costs for using the power grid. Long-term CRRs are an extension of annual allocation and auction process. On December 3, the CRR team posted the results of all six Tier 3 markets (Seasons 2, 3 and 4 on-and-off peak) for the 2008 Annual Allocation, in accordance with the MRTU schedule. The first annual CRR auction is scheduled to open on December 11 and close on December 13. I want to acknowledge the team for their hard work in ensuring the success of this critical and initial functionality of the new market.

Financial Highlights

Year-to-date revenues through November are \$193.2, \$11.7M higher than budget. The increase is due to a one-time refund of the SDG&E Grid Management Charge (“GMC”) of \$6.9M and higher interest and other income of \$8.9M, offset by lower GMC revenues of \$4.1M. Lower GMC revenues are primarily due to milder weather than predicted during the first half of the year (and the resultant less than projected market volumes). Additionally, there was less reliance on the ISO market as more participants were self-providing for ancillary services. Year-to-date operating expenses through November are \$131.5M, at budget.

People

To date, the California ISO has 6 budgeted vacancies. We are pleased to welcome the following new hires:

Sushant Barave, Regional Transmission Engineer, Planning and Infrastructure Development
Kim Launer, Senior Software Quality Assurance Analyst, Information Technology
Wendy Zhang, Associate Regional Transmission Engineer, Planning and Infrastructure Development
John Huetter, Systems Support Analyst, Information Technology
Ron Olsen, Rig Engineering Representative, Operations
Gopinathan Gopakumar, Associate Market Design Engineering Specialist, Operations
Stephanie O'Guinn, Technical Assistant, Corporate Services
Wayne Nickolisen, Grid Resource Coordinator, Operations
Claudia Romero, Network Model Administrator, Operations
Tricia Johnstone, Business Architect, Market Development and Program Management

As we conclude 2007, I would like to acknowledge the dedication and hard work of all California ISO employees. Throughout the year, our employees also served as "ISO Ambassadors" giving back to the community and those in need. This holiday season, the ISO representatives and employees once again participated in the "Gifts from the Heart" Program delivering gifts to over 200 children and senior citizens in need.

Business Plan

We are progressing towards updating our Five-Year Business Plan, having concluded broad outreach efforts with over fifty California and regional industry leaders representing all of the sectors in our market. We are now conducting internal deliberations reviewing assumptions and framing our strategic objectives and corporate initiatives. We look forward to working with you to articulate the direction and business strategy of the California ISO over the next five years.