

Memorandum

To: ISO Board of Governors
From: Yakout Mansour, President and Chief Executive Officer
Date: March 26, 2008
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.

Market Redesign & Technology Upgrade (“MRTU”) Program

1. Integrated Market Simulation (“IMS”) Update 2

Our extensive internal testing and remediation efforts enabled the ISO to begin its final round of market simulation – Integrated Market Simulation Update 2 on February 19, 2008. This round of testing proved to be very collaborative, with the ISO hosting a live phone bridge, twice daily progress calls and several market participants on-site at the ISO offices. This produced very positive results, resulting in a greater level of cooperation and expediting issue identification and resolution. The ISO benefited by receiving immediate feedback on system performance and participants appreciated the opportunity to work directly with MRTU subject matter experts.

Overall, although the market simulation has run every day over the last two weeks of simulation and produced results that were validated, the ISO was unable to build the desired confidence level in the new systems due to inconsistent time points in publishing the Day Ahead Market results. The performance variance was due in limited part to underlying system issues, but more predominantly related to human error in executing required processes. We are dealing with these process issues and in many cases are redoubling the staff commitments to help improve execution. Testing activities concluded on March 21 as planned to integrate remaining functionality, and are targeted to resume again in April with the additional functionality, bringing the testing environment to 100 percent of planned program operations. Given the beneficial and highly-cooperative experience of working with participants on-site, the ISO plans to invite them back when testing resumes. I thank them again very much for their dedication, patience, and cooperation.

At this time, I would like to advise the Board and the market participants that the go-live date will not be before this summer. While it is our plan to have our systems and processes ready by May 1, overall preparedness requires at

least three months of training and unstructured testing by the market following the final release of functionality. We will continue to work closely with market participants to ensure all system results are satisfactory and acceptable level of readiness is achieved. Therefore, the go-live date will be in the fall, with the exact date to be announced with your approval sometime in July.

2. Congestion Revenue Rights ("CRR") and Firm Transmission Rights ("FTR")

With the delay of MRTU go-live beyond April 1, the ISO proposed and received Board approval on the CRR Contingency Plan. The plan, which was supported by all market participants, provides for the return of monies received for rights that are no longer going to be in effect for 2008 and an FTR auction for the period from April 1, 2008 through March 31, 2009. I am pleased to report that the FTR Auction was successfully completed on March 13. The total revenue was \$101,697,492, and the total cleared MW amount was 145,205. Congratulations to the team for accomplishing the entire process on an expedited basis in a little over 2 months.

3. Integrated Balancing Authority Area (IBAA)

A key issue for the ISO is how to schedule and settle transactions to and from the California ISO controlled grid with neighboring Balancing Authority Areas (BAAs). In particular, interconnected systems having multiple scheduling and pricing points pose significant risk to ISO markets and reliability because of the potential for parties to inappropriately arbitrage between the multiple pricing points for reasons completely unrelated to the true use of resources in either system. This also poses significant challenges for the ISO in conducting its congestion management reliably, the cost of which is unfairly borne by the rest of the market. An integral component of the MRTU design from the start has been to adopt a modeling approach that more closely models these external resources so that adverse impacts on ISO markets and reliability are minimized. To this end, the ISO developed the Integrated Balancing Authority Area (IBAA) modeling approach that, based on available data, allows the ISO to model and price transactions to and from these areas in a manner that significantly reduces the potential adverse impacts.

In order to obtain FERC approval of the adoption of ISO IBAA proposal for the areas identified as the most integrated and for which the identified risks require testing systems during market simulation, we had planned to seek Board of Governors approval of the proposal this month and file with FERC shortly thereafter. Although this issue has been in discussion with various stakeholders for almost two years, concerns from some affected parties continue to be raised, but renewed interest in negotiating further has been brought to our attention over the last two weeks. Therefore, in light of these concerns and the expression of will to resolve, we have determined it is appropriate at this time to make another attempt to resolve those issues for additional consideration by all parties. Therefore, given the time constraints, it will be crucial to proceed with seeking approval of the current IBAA proposal during the May 21-22 Board of Governors meeting. Otherwise, the ISO will be prevented from providing a sound solution to this very important issue at the start of MRTU.

Operations

I am pleased to report the California ISO received recognition at the NERC Operating Committee meeting in early March during a session covering NERC Awareness audits and best practices. The ISO was referenced as "setting the bar high" (an example of how it should be done) on communications during Emergency Conditions. The example cited was our national (FERC, NERC, DOE) regional (WECC) and local (regulators and utilities) communications during the firestorm in 2007. The ISO was also recognized for its accomplishments in improving situational awareness tools in the control room.

Summer Workshops are starting again April 21 and will run for 5 consecutive weeks, concluding May 23. This year's planning process with the California Electricity Training Advisory Committee (CETAC) has been the most effective yet, with great participation from the 10 involved entities and focus on meeting NERC Standards as well as student needs. Great interest has been generated in the Summer Workshops and record breaking attendance is expected again with registrations coming in from the IOUs, SMUD, WAPA, LADWP, PNSC, CFE and BPA, just to name a few. This year's focus will be on the reliable operation of the grid during emergency situations and will be reinforced with the use of each entity's emergency procedures. All training courses will be developed and delivered by instructors with extensive industry experience from different company perspectives, and will meet NERC Standard criteria for a total of 32 continuing education hours for certified System Operators.

Market Development and Infrastructure Planning

Sunrise Powerlink Transmission Project ("Sunrise") Update

On March 12, the ISO filed direct testimony in Phase 2 of the Sunrise California Public Utilities Commission ("CPUC") proceeding. The testimony addressed our concerns with the Sunrise alternatives that were identified by the Draft Environmental Impact Report/Environmental Impact Statement as being "environmentally superior" to the Sunrise transmission project as proposed by SDG&E. We also updated the net benefits comparison of the alternatives that had been studied in Phase 1 of the proceeding to reflect the revised costs, including environmental impact mitigation costs, provided by SDG&E. The updated net benefits show that the Sunrise proposed project continues to provide the most benefits to California ratepayers and is the preferred alternative. Our next steps are to provide rebuttal testimony on March 28. Phase 2 hearings begin in April.

Other

On March 10, at the invitation of Chairman Lloyd Levine, I spoke before the Assembly Utilities and Commerce Committee, about the delicate balance that must be struck in achieving California's environmental objectives (greenhouse gas reduction, renewable integration and elimination of once through cooled units) and the reliable operation of the grid. I encouraged the Legislators to consider the linkage between each state mandate as they vote on legislation. On March 11, I also joined CPUC Commissioner Dian Grueneich and CEC Commissioner Jeff Byron at the Senate Energy, Utilities and Communication Committee Informational Hearing on the transmission and delivery of renewable resources. My presentation focused on three areas that included: 1) ISO's role in transmission planning; 2) renewable integration; and 3) generator interconnection queue reform. I reminded the Committee that it is critical for California to move forward with the development of transmission infrastructure to meet the needs of California.

Executive Leadership Changes

I have announcements of several key ISO executive leadership changes. Unfortunately, but true, two key ISO executives will be retiring. Bill Regan, Chief Financial Officer and Vice President of Corporate Services will retire in April. Bill has the longest tenure at the ISO as an Officer that began in June 1999. I wish Bill and his wife Mary much success and happiness in the future. Armie Perez, Vice President of Planning and Infrastructure Development will retire in May. Armie joined the ISO in August 1997 before start-up, joined the Executive Team in July 2005, and has survived to witness the ISO's 10 year anniversary. I wish Armie and his wife Sue much success and happiness in the future. While it is hard to believe that Bill and Armie can really retire, we have to accept it. Again, I offer my sincere gratitude for their service and leadership and congratulate them on their great careers and respected statesmanship.

In a further announcement regarding our executive leadership, Chuck King, Vice President of Market Development and Program Management has decided to step down from his executive role to assume a senior advisory role to me on matters concerning market development and implementation. He will assume this new role following a leave of absence. I would like to express my sincere gratitude for Chuck's service as a member of the ISO executive team and look forward to working with him in his new advisory role.

The retirement announcements prompted an examination of our corporate structure to see if there were any opportunities to further our efforts to achieve organizational effectiveness and bring us a step closer towards achieving the world class position to which we aspire. As a result of looking at ways to maximize internal resources, gain cross-functional efficiencies and leverage technology, we have formed a new division—one that brings together information technology, corporate services and financial functions. The Board of Governors approved the appointment of Steve Berberich to the new position of Vice President of Corporate Services, effective on April 4, 2008. Steve has demonstrated strong leadership skills at the helm of the Information Technology Division for the past two years, instilling new fiscal discipline without compromising service quality. With a Master in Business Administration and a Bachelor of Science in Finance, he has also held management positions in the technology sectors, supervising large teams of employees and managing budgets exceeding \$100 million. I congratulate Steve on his new role and look forward to his continued leadership.

I am also pleased to announce that the Board of Governors has approved the appointment of Phil Leiber to serve as the new California ISO Chief Financial Officer, also effective on April 4. In addition, Phil will continue to serve as Treasurer. Phil is a Certified Public Accountant and holds a Master's degree in Accounting and Bachelor's degree in Business Administration as well as a Master of Science in Computer Information Systems. He has served as the ISO Director of Financial Planning since 1997 and Treasurer since 2000. Organizationally, the CFO will report to the Vice President of Corporate Services and will have direct access to me as well as the ISO Board of Governors and ADR/Audit Committee. This structure will ensure that the CFO has the appropriate access to top decision makers to carry out the important fiduciary responsibilities of this corporate office. Please join me in welcoming both Steve and Phil to their new positions.

Furthermore, the Board of Governors has approved a new organizational structure by which the Market Development and Infrastructure Planning functions will be combined into one. The consolidation is prompted by our strategic objective in our Five Year Strategic Plan to achieve more effective infrastructure planning through the influence of market forces and signals. The new market design and the introduction of locational market prices force the physics and economics to come together in the operating timeframe. By consolidating functions, we apply these market forces and signals to the longer-term planning horizon as well. The search will begin immediately for the leadership of the new group and will require strong qualifications and experience in the technical and economic aspects of the electricity market. In the meantime, Dr. Anjali Sheffrin will report directly to me.

People

The California ISO has 7 budgeted vacancies in March 2008. We are pleased to announce the following new hires in 2008:

- Paul Dobson, Senior Counsel, General Counsel
- Charlie Mogannam, Senior EMS Engineering Specialist, Information Technology
- Keith Ross, Manager, Critical Systems, Information Technology
- David Johansen, Senior Systems Support Analyst, Information Technology
- Dilip Chaubey, Senior Market Automation Programmer Analyst, Operations
- Wahida Tania, Associate Network Model Analyst, Operations

Lorri Helder, Associate Operations Procedures & Processes Analyst, Operations
John Cellucci, Information Products & Services Design Specialist, External Affairs
Duke Luu, Grid Asset Engineer, Planning & Infrastructure Development
Michelle Gamble, Accounting Technician, Finance

Financial Highlights

Preliminary year-to-date revenues through February 2008 are \$30.4M, which approximately tracks the budget. Preliminary year-to-date operating expenses through the same period are \$23.7M, \$0.4M lower than budget. The variance is primarily due to the timing of payments of invoices in the various expense categories.

2007 Performance Highlights

The California ISO achieved another year of top performance in grid and market operations particularly through two heat waves with challenging resource portfolios due to water shortages and limited imports and conditions due to the devastating fires in Southern California. We achieved this exceptional level of reliability performance while substantially reducing Reliability Management Costs by approximately \$162.1 million. These significant reductions were the result of operating decisions and actions taken by our personnel to mitigate transmission congestion and ensure local area and system reliability. From a financial standpoint, we were successful in holding down our Grid Management Charge (GMC) under the target level and accommodating approximately \$14M of unbudgeted activities. In 2007 we also implementing actions to enhance our stakeholder and customer service processes. We implemented a corporate-wide tool to track customer inquiries and attained an exceptional level of responsiveness by markedly reducing response time for issue resolution. Fourth quarter 2007 customer survey results documented that 79% of the respondents agreed that MRTU Readiness/Communication outreach efforts met their needs. Employee Opinion Survey results significantly improved over the 2006 survey results in the areas of Communication, Respect and Job Satisfaction exceeding industry norms in all areas. While we are proud of these achievements, we were also disappointed with the delay in the MRTU schedule.

Five-Year Strategic Plan for 2008 - 2012

I am pleased to present to you our Five Year Strategic Plan that represents a comprehensive strategy to guide our operations and functions over the next five years. Our strategic planning process began with extensive consultation with policy makers, electric industry leaders and consumer representatives in California and the West. The process also involved extensive internal deliberations and analyses to develop plans around our key objectives. This Plan responds to the important environmental, regulatory, workforce and energy supply / delivery challenges facing the industry and proposes strategies to address them. It defines the ISO's plans with regard to strategic objectives and corporate initiatives and describes the ISO's focus on organizational effectiveness for improving process and gaining new efficiencies in achieving the goals.