

Memorandum

To: ISO Board of Governors
From: William Regan, Chief Financial Officer and VP Corporate Services
Philip Leiber, Treasurer & Director of Financial Planning
Date: March 18, 2008
Re: *2007 Investment Compliance Report*

This memorandum is for information only. No Board action is required.

Executive Summary

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

- *A list identifying the type of investment, issuer, 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 statement that the portfolio is in compliance with the Investment Policy or manner in which the portfolio is not in compliance.*

Attachment 2a contains a summary of the investment portfolio as of December 31, 2007, and a statement that the portfolio is in compliance with the Investment Policy adopted by the Board in June 2005. The amounts discussed in the memorandum are presented prior to the completion of the availability of CAISO's audited financial statements, and any audit adjustments that may arise from the audit process.

Discussion of Portfolio Composition and Performance

CAISO's corporate investment portfolio is comprised of two types of funds:

1. **Operations related funds (Unrestricted).** **Attachment 3a** shows the value of the Operations Related/Unrestricted funds at \$143 million, or 60% of the total portfolio. These funds are available for general corporate use (though not all are available for current use), and include the following:
 - **Operating & Capital Reserve Funds:** the Operating & Capital Reserve account is defined in the CAISO Tariff, with a targeted funding level of not less than 15% of the O&M budget, or about \$23 million for year 2008. When the 2008 GMC rates were set on December 15, 2007, the account balance was forecast to exceed that level by \$21 million as of year-end, resulting in \$44 million on hand at December 31, 2007 related to the Operating and Capital Reserve.

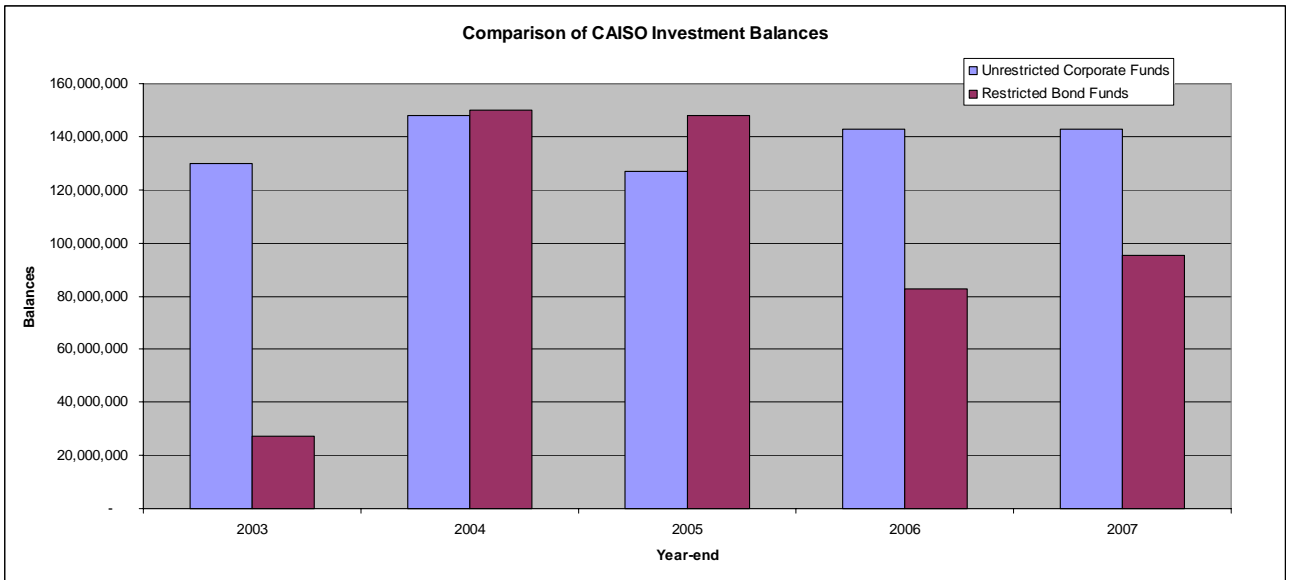
- Funds received from GMC and other revenues that will be disbursed for routine CAISO expenditures (accounts payable as of December 31, 2007 is approximately \$34.9 million [unaudited])
- Cash related to other obligations: Significant items include Amendment 33 fines and interest to ultimately be refunded to market participants (approximately \$52 million [unaudited]), Transmission Studies Deposits (\$10.6 million [unaudited]), GMC Refund Liability (\$1.8 million) and other longer-term CAISO obligations including post-retirement medical liability and other benefit related obligations (approximately \$11.7 million [unaudited]).
- Remaining funds relate to differences between actual the year-end operating reserve balance and forecast and various working capital accounts.

2. **Restricted Bond Related Funds.** Attachment 3b shows the value of the Bond Related/Restricted funds at \$95.3 million , or 40% of the total portfolio. The bond related funds include bond repayment accounts for monthly principal & interest deposits, a debt-service reserve fund, miscellaneous accounts, and unspent project funds from the 2007 bond issuance.

The funds are invested in a variety of short-term, and some medium-term financial instruments as authorized by the Investment Policy. CAISO's conservative Investment Policy has investment objectives of (1) safety of principal, (2) liquidity and (3) earnings. Investments of the bond-related funds are further limited to permissible investments authorized by the bond indentures. Attachment 2b provides a listing of investments by asset class for the entire CAISO investment portfolio (unrestricted and restricted funds).

CAISO'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 the a treasury money market fund. CAISO earned approximately 4.92%, or 0.85% (equating to \$1.86 million) better than such an approach. This is a measure of the value of the more active approach to the management of the investment portfolio exercised by CAISO as compared to a passive, money market only strategy.

	2005	2006	2007
Total Earnings	\$8.6 million	\$8.9 million	\$10.9 million
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. CAISO'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.



Notable Treasury Related Events During 2007

- CAISO implemented in late 2006 JPMorgan's Sympro investment management software with the goal of improving the efficiency of necessary portfolio accounting and compliance activities and to facilitate enhanced investment performance reporting. The reports attached to this memorandum were generated with the Sympro software. Staff are continuing to learn about the reports and functions available through the Sympro software, and will aim to provide enhanced reporting in the annual investment report over time.
- During fall 2007, CAISO 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 exposure 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, CAISO transitioned from treasury money market funds to government security funds, which offered improved yields without significant increase in risk. In connection with these and other investment market developments, Management will aim during 2008 to review the investment policy and return to the Board with any recommended changes.

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