

Memorandum

To: ISO Board of Governors
From: Yakout Mansour, President and Chief Executive Officer
Date: May 16, 2008
Re: *Updated 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 ("Board").

Operations

In late April, we released the California ISO *2008 Summer Loads and Resources Operations Preparedness Assessment Report* describing a wide range of possible supply and demand conditions this summer. The scenarios are based on three main variables that can change dramatically from one hour to the next during extreme conditions and include electricity demand, plant outage rates, and import levels. Our report finds that in most scenarios, there will be adequate electricity supplies to handle a broad range of operating conditions and maintain the reliability of the power grid, however, system operations may be challenged under extreme conditions. Voluntary conservation and demand response programs will be important this summer and will continue to serve an increasingly important role in subsequent years. We are also counting on the continued success and further refinement of the state's Resource Adequacy program.

The summer assessment uses a deterministic analysis of planning and operating reserve margins and probabilistic analysis of operating reserve margins under high, medium and low import conditions. Of the twelve deterministic scenarios, the optimistic scenario assumes virtually full utilization of the import capability of 10,000 MW. Under this scenario, the ISO expects to have about 54,853 MW of total supply including 489 MW of new generation available this summer and 2,130 MW of demand response and interruptible load programs, resulting in an operating reserve of 16.5 percent. The normal operating reserves of 7 percent is expected to be achieved under a broad variation around the base case assumption. Naturally, the risk increases under extreme and less likely conditions and no system is expected to function normally under the very extremes. The ISO conducts the extreme case analysis to quantify the risk and develop the necessary mitigation measures to minimize the impact under those conditions. Conservation and demand response continue to be the most cost-effective tools to do so. Moreover, close communication with generators to ensure generation

fleet readiness, close coordination with our neighboring states to avail the transmission grid capability for the summer, and coordination with the load serving entities are very beneficial in our readiness efforts.

We are continuing our summer preparation efforts including discussing the assessment results with state agencies and working directly with generators, transmission owners, load-serving entities and other balancing authorities in the West to prepare for adverse conditions that may result in low operating reserves. The ISO is also integrating Cal Fire into the operator training workshops and continuing to partner with "Flex Your Power NOW!" that alerts consumers when energy demand is rising.

As California transitions to a vastly different electricity system responding to renewable resource, greenhouse gas emission, and water quality goals, careful management and greater public understanding of the benefits and challenges is required. To this end, our assessment provides a comprehensive review of various conditions to frame the challenges and focus management, industry and consumers efforts on the preparation and mitigation measures that will minimize possible impacts.

I am also pleased to report the ISO and Bonneville Power Administration ("BPA") have reached an operating agreement between our Balancing Authorities. Over the years, we've had excellent cooperation from BPA regarding emergency operations. I'd like to thank both the ISO and BPA staff for their work on this significant accomplishment in formalizing our relationship in the west for continued successful emergency operations under the NERC reliability standards.

Market Redesign & Technology Upgrade ("MRTU") Program

Significant progress has been made in integrating all the functionalities after a planned market simulation down time in early April. We are now reasonably comfortable with the overall functionality and the quality of solutions of the full system but the system robustness is of a concern when data entry issues are encountered. When all entries are in order, the systems perform well, but any glitch seems to cause execution problems instead of recognizing the issue at the front end. Our prime vendor continues to be challenged in resolving a number of accumulated related issues on time and is causing a lag in resolving our own system integration issues which, in turn, is causing an overall progress slowdown. We remain highly reliant on the competence and responsiveness of our prime vendor. A joint action plan has been reformed to address the issues and the progress is being closely monitored on an hour-by-hour basis. The Program Management believes that the early-Fall Go-Live date provides sufficient time to resolve all the outstanding issues and time needed for the market to prepare.

We received the initial assessment of LECG who is engaged to provide third party economic testing of the quality of pricing output. Their initial assessment indicates that the results are positive and that no "show stoppers" were identified. Further, we received certifications from a review performed by SAIC to test the continuity of the Tariff, requirements and systems to ensure alignment and that no material gaps existed between the three.

In summary, we will focus greatly on the system robustness over the next several weeks in parallel with supporting the market participants' efforts in the simulation exercise and their readiness. I would like to take this opportunity to reaffirm our appreciation for the tremendous efforts made by the public participants to get to a point of mutual comfort with the new system. It is not easy but an effort well spent.

Compliance with Mandatory Reliability Standards

One of the highest priorities for the ISO this year is confirming and validating compliance with mandatory reliability standards. In pursuit of this priority, the ISO is devoting resources and staff time in a corporate-wide effort to ensure that each individual standard is not only met but that there is appropriate evidence of the ISO's compliance. This month, the ISO retained Deloitte & Touche to conduct a gap assessment and review of documentation and evidence of compliance with NERC reliability standards. The immediate focus of Deloitte's review will be Critical Infrastructure Protection Standards and Transmission Planning Standards. We have also expanded our internal team this month by hiring a Senior Reliability Standards Compliance Specialist for Operations in the Mandatory Standards Compliance Department. The ISO's internal audit team is also independently evaluating evidence of compliance, and has already completed audits of eight standards this year. Finally, the ISO is emphasizing the importance of the mandatory standards compliance program by providing training in the week-long Summer Workshop attended by all ISO operators this month.

Integrated Balancing Authority Area

I have informed the Board in my previous report in May that we decided to postpone seeking your approval that was scheduled for the last meeting to give another chance to the parties to close the gap with the proposal. We continued the stakeholder process and sought the advice of independent experts including the Market Surveillance Committee ("MSC"). Although we have modified our initial proposal to address the issues identified by the independent advisors, the opposing parties have largely maintained their position. While these parties have come forward with an alternative proposal, that proposal does not comprehensively address our objectives. Therefore, in light of our need to obtain final resolution of this issue prior to MRTU start up, we are coming to the Board today seeking your approval to move forward and file the proposal at FERC. Notwithstanding our need to move forward, we continue to be hopeful that further discussions with the opposing parties can be productive and we believe that such discussions can take place in parallel with the FERC process.

Generator Interconnection Queue Reform

As the Board is aware, the volume of interconnection requests in total number and capacity is an order of magnitude higher than what the state needs and well beyond commercial and physical viability. Ironically, the study process is often criticized for not keeping pace with the volume. It is obvious to everyone, including the regulators, that the entry, processing, and exit process ought to change and soon. Setting the course for a change in future requests is relatively an easier task than the existing process. We intend to propose changes to the process starting with a filing with FERC to waive certain requirements so we can expedite the processing of the current requests followed by a more comprehensive filing at a later date to revise the tariff that will govern the process in the future. Our request for waiver, if granted, will ensure that the timeline for renewable interconnections, required to meet the 20 percent Renewable Portfolio Standard ("RPS"), is that of the transmission siting and the interconnection process will not be the critical path to meeting the legislated goal.

Devers-Palo Verde No. 2, 500 kV Transmission Line Update

On February 24, 2005, the Board approved the Devers-Palo Verde No. 2 ("DPV2") project and directed Southern California Edison Company ("SCE") to proceed with permitting and constructing the transmission project. The approval was based on findings that DPV2 will provide significant reliability and economic benefits to ISO ratepayers, improve system reliability, and enhance operational flexibility. The California Public Utilities Commission ("CPUC") reached a similar conclusion in granting SCE a certificate of public convenience and

necessity to construct DPV2. The Arizona Corporation Commission, however, denied the necessary approvals for SCE to build in that state. Notwithstanding the Arizona outcome, SCE remains committed to obtaining permitting approval for DPV2 facilities in Arizona and is pursuing all available options, including applying for federal transmission line siting as set forth in Section 1221 of the Energy Policy Act of 2005.

The ISO understands SCE intends to seek authority from the CPUC to phase the construction of DPV2 by moving forward with the California facilities. In addition, SCE is seeking permission from the CPUC to construct a "Midpoint Substation" near the California/Arizona border that will loop in the existing Devers-Palo Verde No. 1 transmission line as well as provide the interim terminus for the DPV2 line. The ISO's directive to SCE to proceed with permitting and constructing DPV2 does not preclude a phased approach and a phased approach is consistent with SCE's continuing efforts to obtain approval of the Arizona portions of the line. In addition, the Midpoint Substation has been identified by the ISO as needed, with or without DPV2, to access potential new generation in the Blythe area, including approximately 5,000 MW of new renewable generation currently in the ISO's interconnection queue. The California facilities of DPV2 also mitigate reliability concerns on the ISO grid otherwise created by the anticipated addition of generation in the Blythe area.

San Francisco Action Plan Update

The San Francisco Action Plan ("Plan") was developed by the City and County of San Francisco (CCSF), the California ISO, and other stakeholders and was approved by the ISO Board of Governors in 2004. The Plan established the conditions under which existing generation at Hunters Point and Potrero would be released from Reliability Must Run ("RMR") contracts.

The Jefferson – Martin 230 kV Line, the Potrero – Hunters Point 115 kV Line, and other projects essential to removing RMR status from the Hunters Point power plant have been completed, and the plant was retired from service in 2006. The California ISO continues to support the San Francisco Action Plan, which provides for releasing Potrero from its RMR contracts when CCSF's new peaking generation is placed into service. The ISO has been clear, as was the California Energy Commission in its 2006 licensing decision, that the area needs in-city generation in order to remove RMR status from the Potrero units and maintain reliable electric service to the area. This remains true even with the Trans Bay Cable in service.

CCSF continues to debate whether or not the new peaking units should be built. The CCSF Board of Supervisors could reach a decision on whether to approve financing and construction of new peaking units to replace the Potrero units between the time of this writing and the Board of Governor's meeting on May 21st. I will update this report at the Board meeting.

Executive Leadership

As I reported in my last report, Armie Perez, Vice President of Planning and Infrastructure Development elected to retire effective May 9, 2008. Armie joined the ISO in August 1997 before start-up and joined the Executive Team in July 2005. I wish Armie and his wife Sue much success and happiness in the future. Again, I offer my sincere gratitude for Armie's service and leadership and congratulate him on his great career and respected statesmanship.

Other

I am pleased to announce that the California ISO received top honors as the *2008 Best Places to Work* in Sacramento Region at the Sacramento Workplace Excellence Leader (SWEL) Awards event in April. More than 95 companies were nominated by their employees for this unique recognition as an extraordinary employer providing exceptional benefits, programs, training and workplaces that promote employee health, safety, advancement, diversity and security. Winning the region's top workplace award means the California ISO will serve as a corporate model for other companies, showing how innovative people strategies can help organizations achieve tremendous success. I'd like to extend my thanks to the Human Resources team for work in positioning the California ISO to the forefront of workplace leaders.

People

The California ISO has 13 new hires that joined us in March, April and May. We have 2 budgeted vacancies. We are pleased to announce the following new hires:

March

Anna Pascuzzo, Administrative Assistant, General Counsel & Corporate Secretary
Monica Mouanetry, Technical Assistant, Operations

April

Chetty Mamandur, Director, Grid Operation Development, Operations
Trang Vo, Critical Systems Analyst, Corporate Services
Edward Gibbs, Manager, Applications Development, Corporate Services
Jessica Jouanicot, Technical Assistant, Corporate Services

May

Chantele Napper-Miro, Organizational Development Consultant, Human Resources
Rod Crownover, Director, IT Support & Operations, Corporate Services
Qiuli Yu, Market Design Engineering Specialist, Operations
Yuan Li, Associate Market Design Engineering Specialist, Operations
Audley Grey, Market Design Engineering Specialist, Operations
Zhu Liang, Associate Market Performance Analyst, Operations
James Bonham, Senior Contract Engineering Specialist, Operations

Financial Highlights

Preliminary year-to-date revenues through April 2008 are \$61.4M, \$0.4 million higher than budget. The variance is primarily due to higher Grid Management Charge ("GMC") revenues resulting from higher scheduled inter-zonal flows and higher use of markets. Preliminary year-to-date operating expenses through the same period are \$52.9M, \$0.5M lower than budget. The variance is primarily due to the timing of payments of invoices in the various expense categories.