California ISO
Your Link to Power

California Independent
System Operator Corporation

Memorandum

To: ISO Board of Governors

From: Yakout Mansour, President and Chief Executive Officer

Date: July 3, 2008

Re: CEO Report

This item does not require Board action.

Below are highlights of events affecting the California Independent System Operator (CAISO) since the date of the last meeting with the Board of Governors ("Board").

1. Operations

a) We've experienced the driest months on record in March, April and May with below average rainfall and very low snowmelt runoff, which affects grid operations. California water levels are presently at around 50% capacity and 60% of normal. Hydro conditions will continue to be strained for the remainder of the summer. As a result, we are witnessing the obvious impact of lower hydro availability in the shoulder hours for energy and ancillary services which increases reliance on thermal generation for these services.

It is early in the summer and already we have experienced wildfires impacting our grid operations. As many as 1,400 fires have been burning in California over the past couple of weeks. Among the fires starting in mid-June, the Humboldt fire near the town of Paradise affected grid operations the most. It started on June 11 and quickly burned under two of the three 500kV lines comprising the California-Oregon Intertie ("COI"). For the next several days, the COI was threatened several times resulting in several emergency curtailments. In those cases, the COI schedules had been curtailed by 2000 MW. This fire also damaged the 115kV transmission system feeding power into Paradise – twice causing relatively short power outages for about 17,000 PG&E customers. Throughout this incident, CAISO staff coordinated closely with Cal-Fire and PG&E representatives to reduce the danger to the firefighters and to minimize the impact to customers. Having fires like this so early in the year is a troubling result of the second dry year in a row, with the hottest summer periods still ahead of us.

b) We have managed a large amount of unscheduled flows and COI congestion. We are not experiencing reduced system loads as a result of what some may anticipate in an economic downturn. Peak load for June was approximately 5% (2300 MW) above the California Energy Commission's 1-in-2 projected load and the Resource Adequacy procurement requirement. Wind generation was 231 MW at the time of the June peak on a base capacity of 2800 MW. The good news is imports remained high at net 8900 MW.

c) The CAISO, in conjunction with the California Electric Training Advisory Committee ("CETAC") concluded its 10th annual Summer Workshop 2008 training in May for Real Time Operations Dispatch personnel. The five-week training had record-breaking attendance reaching 475 participants and bringing together 25 organizations to work collaboratively to strengthen their knowledge, increase communications and ensure grid reliability. The Workshop included a very well received MRTU overview by the California ISO; 32 hours of NERC certified training; 20 hours of lectures and instructor led courses covering subjects on black start concepts and voltage control, emergency operations procedures, restoration contingency planning, and remedial action schemes; and 12 hours of break-out sessions with hands on simulation exercises and restoration drills. Overall, Summer Workshop 2008 was a tremendous success receiving very positive feedback from the participants and interest from many companies to send more of their personnel, and/or to participate on the CETAC committee.

2. Market Development

a) MRTU has reached a state where a comprehensive dialogue with market participants can begin around a Go Live date. Internally, we have turned the corner on readiness based on our assessment of system performance, quality of solution and operational walkthroughs.

The bidding infrastructure and day ahead market has been performing consistently for some time now and has produced daily results nearly uninterrupted since the beginning of June. The real time market turned a corner in mid-June and now produces consistent solutions well in excess of 90% of the time. Performance issues with the Market Quality System and Settlements have been resolved and our robustness efforts have borne fruit with far less system interruption due to data errors. With those performance improvements, we are in position to release a multitude of additional charge codes that represent the bulk of the revenue in the market.

Related to quality of solution, we now have published a preliminary and final report by a third party, LECG, who was tasked with assessing the quality of the pricing solutions results. That report indicated there were only two issues – one of which is already resolved and the other is expected to be resolved in short order.

We know two critical areas need to be demonstrated to market participants to build confidence – traceability of data and delivery of settlements charge codes. Traceability of data issues are the result of data transfer issues between systems and show themselves as missing data or mismatches between the bids entered and the data available in reporting systems. For settlements, as of this report, all charge codes are coded and calculated but validation is behind. At this point, we have 44 charge codes available for validation and expect the balance of them to be delivered in short order by our internal teams. Others will be produced as the result of scenario execution. It should be noted that 95% of the market activities fall into 47 charge codes out of the 123 coded in the system.

We believe remaining issues can be readily solved and should not stand in the way of rigorous testing by the entire market. During July and early August we will complete the scenario testing. We will work closely with market participants to resolve remaining issues, resolve charge code validation issues and successfully execute the scenarios. The Program Management believes a Fall Go Live date is feasible and will continue our executive outreach program to gauge overall readiness, and we will collaborate closely with participants to determine a final Go Live date.

b) The CAISO has worked with stakeholders to complete a ranking of the inventory of market initiatives collected from market participants over the past two years. This ranking process marks the completion of an important milestone that enables the CAISO to move to the next step of incorporating these into the context of creating a vision for a Five Year Strategic Plan for Markets. Developing a strategic vision for the future market design and formulating an implementation plan to move the CAISO towards that vision is an exciting next step. In the coming years, the CAISO will face a vastly different operating environment than what has been experienced in the past with the addition of large quantities of intermittent renewable resources, active demand participation in the CAISO markets, and the impact on tighter water use and greenhouse gas regulations.. We anticipate incorporating the ranked inventory of market initiatives into a plan for future design enhancements to effectively meet the needs of the future industry structure by this fall.

I would note, two initiatives clearly stood out in the ranking process and can be addressed more immediately. One will streamline the process of resource adequacy capacity contracting by defining a Standard Resource Adequacy Capacity Product in the CAISO Tariff. The other will better align the CAISO's reserve products with NERC minimum operating requirements and facilitate the use of demand response resources through the development of a 30 minute operating reserve product. I would like to thank the stakeholders for their participation in the ranking process and their support for incorporating these initiatives into a longer term vision of the future markets.

3. Legal/Compliance Update

a) Since the last Board meeting, FERC has issued 19 rulings related to the CAISO, including important orders relating to MRTU. I would like to mention four specifically. First, FERC issued a significant MRTU order, accepting two separate CAISO compliance filings and addressing multiple issues in a 100-page ruling issued on June 20. FERC accepted CAISO's proposal to procure ancillary services on a more granular basis and addressed issues related to the residual unit commitment process, full network model and bid cost recovery, among other things. In another MRTU order, FERC accepted the CAISO's proposal to cap start up and minimum load costs under MRTU. This is an important market power mitigation tool that we will have in place for day one of MRTU.

Turning from MRTU to other issues addressed by FERC, the Commission issued an order in response to a complaint by MMC Energy related to whether MMC's units could bid into the CAISO's spinning reserve market. The units in question are aggregated facilities with a small generator of less than 1 megawatt and a larger gas-fired combustion turbine, where the smaller unit remains spinning and synchronized to the CAISO-controlled transmission system while the larger unit is brought on-line if the facility is dispatched by the CAISO to provide supplemental energy. FERC determined that MMC facilities should not be permitted to participate in the spinning reserve market, and found that the MMC facilities do not provide spinning reserves as defined by the CAISO tariff. This is an important ruling in that it reinforces how essential it is that market participants provide the products needed for reliability and that comply with the CAISO tariff. It is also important for ensuring equity to other market participants who are providing the products defined by the tariff and for those counting on and paying for the resources.

The final order I would like to bring to the Board's attention is the order accepting most elements of the backstop capacity mechanism approved by the Board in March. This backstop mechanism, titled the "Transitional Capacity Procurement Mechanism ("TCPM"), is in effect as of June 1 and will remain the backstop payment mechanism until

MRTU. FERC agreed with the CAISO's recommended pricing, which was based on the pricing from the former tariff provision but increased to adjust for inflation. FERC also accepted the additional flexibility that the CAISO suggested related to the definition of a significant event that would trigger a TCPM designation, and added a new requirement that the CAISO grant a TCPM designation for 30 days if the CAISO issues a must-offer waiver denial to a generation resource.

b) With respect to the CAISO's compliance efforts, I am pleased to report that our mandatory standards compliance group, in close coordination with a team from information security, physical security, human resources and information technology, achieved auditable compliance on 168 standards by July 1. The effort included ensuring that over 400 employees with access to critical infrastructure and cyber assets received training by July 1, and conducting background checks on over 100 employees, as required by the standard. The CAISO has received independent confirmation that it has developed the documentation needed to demonstrate compliance for these requirements and sub-requirements, and will be self-certifying compliance with the WECC by mid-July.

4. Transmission Planning and Infrastructure Development

a) On June 18, 2008, the CAISO presented its preliminary transmission plans for meeting the Renewable Portfolio Standard ('RPS") goals to the Renewable Energy Transmission Initiative ("RETI") Stakeholder Steering Committee meeting. RETI is a statewide initiative providing an open, transparent and collaborative process for identifying areas with significant renewable energy potential, providing relevant data to decision-makers, and fostering the transmission infrastructure development needed to meet the RPS goals. In support of RETI, and as a steering committee member, the CAISO assessed the ability of the three large investor-owned utilities within the CAISO footprint, to meet the 20% RPS mandate during the 2010 to 2020 timeframe and offered conceptual transmission plans to access renewable resource areas to achieve the 33% RPS mandates. The CAISO also identified 5 potential transmission plans to expeditiously access an additional 500 to 1,000 MW of solar generation.

The CAISO's findings were that the addition of the Tehachapi Renewables Resource Transmission Project and the Sunrise Powerlink, if approved by the California Public Utilities Commission ("CPUC") and constructed, will provide enough transmission capacity to allow the state to meet its 20% RPS goal through 2018. To further assist in reaching this goal, significant solar generation can be interconnected to the Tehachapi Project based on the diversity of energy production between wind and solar resources.

b) The CAISO continues to be engaged in the Sunrise proceeding before the CPUC, and recently filed briefs in Phase 2 of the proceeding. This phase considered the costs of the various alternatives to Sunrise, as well as the costs to mitigate the environmental issues identified by the draft Environmental Impact Report. Recently, the CPUC issued an order indicating that it intended to re-circulate the draft Environmental Impact Report for further comment, which will delay the issuance of a proposed decision to October. The order indicates that the CPUC intends to issue a final decision on Sunrise by the end of the year.

5. Financial Highlights

a) On June 19, the CAISO issued fixed rate bonds in the amount of $196.9M providing funding to retire all previously outstanding debt effective July 1 and new money for capital expenditures budgeted for 2008 to 2009. The bonds were issued at attractive fixed interest rates with yields varying from 2.2% to 3.58%. The Board decision to refinance in March has been validated by subsequent events. High interest rates that began in late January on CAISO's previously outstanding debt continued in June due to downgrades of CAISO's Bond insurers (Ambac and MBIA) from AAA to as low as A2 with negative outlook. By refinancing, the CAISO avoids incremental interest costs over the life of the bonds of about $10 million or more, assuming the conditions in late June persist. The new debt will provide for a stable, low cost capital source of funding to meet the CAISO's capital needs and will help assure the CAISO meets its goal of maintaining a bundled GMC at about the current level of $0.76 over the next several years. The success of this financing has laid the groundwork for financing of the new CAISO headquarters which will take place in early 2009.

b) The CAISO 2009 budget preparation process was launched in June. We held an initial stakeholder budget meeting on June 6 where we reviewed our Strategic Plan, provided a forecast of rates and the revenue requirement for the next six years, capital project expenditures for 2009-2010, year-to-date 2008 financials, and financing plans. Management issued budget guidelines to the organization for meeting a bundled GMC objective of $0.76 for 2009.

c) Preliminary year-to-date revenues through May 2008 are $76.6M, $0.8 million lower than budget. The variance is primarily due to lower Grid Management Charge ("GMC") revenues resulting from lower than expected load and exports. Our preliminary analysis indicates that this is a result of the mild weather through the late winter and spring, continued poor hydro conditions and challenging economic conditions in California. Preliminary year-to-date operating expenses through the same period are $65.2M, $0.4M lower than budget. The variance is primarily due to the timing of payments of invoices in the various expense categories, offset by higher labor and benefits expenses.

6. People

a) The CAISO has 6 new hires that joined us in June. We have 2 budgeted vacancies. We are pleased to announce the following new hires:

Ernest Thompson - Transmission Dispatcher, Operations
Bryan Swann - Senior Market Monitoring Analyst, Market Monitoring
Mariam Zarrabi - Market Monitoring Analyst Market Monitoring
Stephen Brazill - Senior Systems Engineer, Corporate Services
Dagmar Haller - Business Solutions Manager, Corporate Services
Adrienne Vaughan - Senior Project Manager, Corporate Services

b) I am also pleased to report that the CAISO launched its 2nd Annual Summer Internship Program welcoming the 2008 class of 24 interns – an increase of 9 interns over last year's program. This year we have a diverse population of interns in each division representing 14 universities that include: Arizona State University, Cal Poly San Luis Obispo, Brigham Young, Cornell, Sacramento, Chico, Indiana University, Iowa State, Portland State, McGeorge School of Law, Wichita State, UC Davis, UC Berkeley, and Yale. The majority of the interns are pursuing majors in either electrical engineering or economics, with many pursuing advanced degrees in these fields.

7. Strategic Plan

"Attachment A" to my CEO Report is Management's mid-year progress toward achieving the objectives in the Five-Year Strategic Plan for 2008 to 2012.