

Memorandum

To: ISO Board of Governors
From: Ryan Seghesio, Chief Financial Officer and Treasurer
Date: May 11, 2011
Re: **2010 Annual Investment Report**

This memorandum does not require Board action.

EXECUTIVE SUMMARY

The investment policy of the California Independent System Operator Corporation requires the Chief Financial Officer to submit an annual investment report to the ISO Board of Governors. This report provides the Board with unaudited information about the 2010 investment performance and year-end unrestricted and restricted fund balances related to operations and debt issuance. In general, the funds we invest are ISO corporate funds from bond offerings or general business operations and market related funds associated with generation interconnection deposits, collateral and other funds held for market accounts. Because of the nature of the funds, we pursue a very conservative investment approach focused on principal preservation.

- As of December 31, 2010, all portfolios were in compliance with the ISO's Investment Policy.
- During the first half of the year, we conducted a thorough review of the unrestricted cash and investment balances and their related cash flows. As a result of this review, an additional \$100 million was identified as being eligible for placement in the actively managed investment portfolio versus the separate cash pools in which the funds had been placed.
- The portfolio stats will now be presented on the separate portfolios managed due to the unique and distinct characteristics of each source of funds.
- The ISO achieved a total return of 2.14% on the unrestricted cash and investment balances during 2010, which were \$144.3 million at the end of the year. Total return information on other portfolios will be described in the report.

- The ISO took advantage of an improving bond market to liquidate its holdings in the AIG subsidiary, International Lease Finance Corp. Following this liquidation, all remaining holdings at the end of the year were within the minimum credit ratings standards set forth in the investment policy.
- We continue to experience a low interest rate environment. While the general level of interest rates began to increase in the first quarter of the year, they declined rapidly in the second and third quarters, falling to levels last seen in early 2009. Interest rates rose from these levels during the last two months of the year, but ended the year at lower levels compared to December 2009. If interest rates begin to rise, it could decrease the market values of the bonds that the ISO holds.

DISCUSSION AND ANALYSIS

Unrestricted portfolio

The market value of the ISO unrestricted portfolio as of December 31, 2010 was \$144.3 million. This portfolio contains the funds received by the ISO related to the grid management charge collections for the annual revenue requirement (operations and maintenance budget, debt service and debt service reserve, capital expenditure reserve, and operating reserve). Approximately half of these funds need to be managed in highly liquid investments with maturities of less than one year as they provide for the costs of ongoing operations.

The portfolio's total return for 2010 was 2.14% and, as of December 31, had a duration of 1 year. Duration is one measure of risk to a fixed income portfolio and is highly correlated to weighted average days to maturity. Essentially, duration indicates the approximate percentage price movement of the portfolio given a 100 basis point (1%) move in interest rates.

Due to improving bond market conditions and the need to further diversify the portfolio, we sold a handful of bonds during the year and reinvested them into other fixed income positions. The sales resulted in \$1.2 million in realized gains, offset by a \$170,000 loss on the sale of the International Lease Finance Corp (AIG) position. The credit quality of this position had declined during the financial crisis well beneath the standards set forth in the investment policy.

For 2011, the ISO has constructed a benchmark portfolio in a style similar to the ISO's unrestricted portfolio. Going forward, this will provide a useful benchmark for Management to assess the performance of the ISO's investment strategies. The benchmark portfolio was constructed using sub-indices of the Citigroup US Broad Investment Grade (BIG) Bond Index. For comparison, the benchmark index returned 2.19% during 2010. However, the benchmark index allocates 50% to the money market sector (investments maturing within one year), while the ISO unrestricted cash portfolio averaged approximately 75% in the money market sector during 2010 due to the large

cash balance carried related to the settlement of the generator fines refund case. Adjusting the benchmark index to a similar allocation to cash lowered the comparative return to 1.23%.

Bond proceeds

The ISO manages two pools of bond proceeds: the 2008 bonds (primarily for the implementation of the new market and refunding of earlier bond issues) and the 2009 bonds (primarily for the construction of the Iron Point site). The investment of bond proceeds is primarily restricted to US treasury and government agency securities and the yield that the ISO can earn is restricted by IRS arbitrage rules.

As of December 31, 2010, the market value of the 2008 bond proceeds was \$27 million (\$20 million related to the reserve fund). The total return on investments was 1.93% and the duration of the portfolio was 2.1 years.

The 2009 bond proceeds had a market value of \$76.9 million (\$15 million related to the reserve fund). The total return on investments was 0.72% and the duration of the portfolio was 1.6 years.

Large and small generation interconnection project related funds

The ISO maintains a pool of funds related to generation interconnection projects. As of December 31, 2010, the market value of these funds was \$72 million. The funds are currently invested in money market funds and therefore, have no duration risk. The total return on these funds was 0.17% in 2010.

In 2010, a substantial improvement was made to the investment process of the large generation interconnection project related funds. In prior years, the funds were invested in one market fund, although the ISO implemented the use of a money market portal to diversify the funds across several money market fund offerings. The enhancement will allow for greater returns to be achieved while diversifying the risk of being overexposed to one fund offering.

Market participant funds

The ISO manages restricted funds for market participants, which consist of amounts held to be remitted to market participants or others on their behalf. The majority of these funds are the required collateral deposits that the ISO collects as part of its credit policy to reduce the impact of defaults. As of December 31, 2010, the market value of these funds was \$220.5 million. Due to their liquid nature, these funds are invested in money market funds and therefore, have no duration risk. The total return on these funds was 0.17% in 2010.

In 2010, a substantial improvement was also made to the investment process of the market collateral funds. As with large generation interconnection project funds, in prior years, the funds were invested in one market fund, although, the implementation of the money market portal has allowed the ISO to diversify the funds across several money market fund offerings. The enhancement will allow for greater returns to be achieved while diversifying the risk of being overexposed to one fund offering.

Retiree Medical Plan VEBA Trust

The ISO sponsors the California ISO Retiree Medical Plan, a defined benefit plan, to provide post-employment health care benefits to eligible employees who retire from the ISO. A trust was established for the purposes of funding the plan and all assets of the trust are to be used for the exclusive benefit of the participants and beneficiaries of the plan. As of December 31, 2010, the market value of the trust was \$4.6 million. The total return on investments was 2.94% and the duration of the portfolio was 2.9 years.

An investment summary containing key portfolio characteristics can be found in Attachment 1. A detailed listing of investment holdings can be found in Attachment 2.