

# Memorandum

**To:** ISO Board of Governors

**From:** Ryan Seghesio, Chief Financial Officer & Treasurer

**Date:** March 12, 2014

**Re:** 2013 Annual Investment Report

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***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 Board of Governors. This report provides the Board with unaudited information about the 2013 investment performance of the various unrestricted and restricted fund balances held by the ISO. In general, the funds we invest are from general business operations, bond offerings, and market 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 and liquidity.

- As of December 31, 2013, all portfolios were in compliance with the ISO Investment Policy.
- During 2013, the ISO achieved a total return of 0.5% on the unrestricted cash and investment balance, which was \$124.5 million at the end of the year. Total return information on other portfolios will be described in the report.
- Interest rates were volatile throughout the year amidst speculation over the continuation of the Federal Reserve's Quantitative Easing program. 10-yr U.S. Treasury yields increased over 100 basis points (>1%) in May and despite some correction in September, finished the year at elevated levels compared to the beginning of the year. The following table shows the level of U.S. Treasury interest rates at the end of the previous two years:

<b>U.S. Treasury Bond</b>	<b>Yield as of 12/31/12</b>	<b>Yield as of 12/31/13</b>
2-year	0.25%	<b>0.38%</b>
3-year	0.36%	<b>0.78%</b>
5-year	0.72%	<b>1.75%</b>
10-year	1.78%	<b>3.04%</b>

A brief summary of key portfolio characteristics follows, and required data is detailed in the Attachments.

## **DISCUSSION AND ANALYSIS**

### ***Unrestricted portfolio***

The market value of the ISO's unrestricted portfolio as of December 31, 2013 was \$124.5 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). \$12.9 million of these funds at year-end have been earmarked as assets related to the ISO Retiree Medical Plan. These assets are invested under a separate investment policy that the Board approved in March 2013.

The portfolio's total return for 2013 was 0.5% and, as of December 31, had a duration of 1.5 years. 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. The portfolio actually only experienced a price decline of 0.5% during the year, which partially offset nearly a 1.0% income return.

Other than the segregation of the Retiree Medical Plan assets, the only significant change during the year was the implementation of the FDIC-insured certificates of deposit (CD) strategy. An outside investment manager was engaged to execute the strategy on \$5 million of the portfolio. The strategy involves purchasing CDs from US banks up to amounts not exceeding \$250,000, the FDIC insurance limit. The strategy performed very well, as the initial portfolio was structured with maturities ranging from 6 months to 2 years at an overall yield of 0.73%. This compares to the approximate 0.10% that the \$5 million of cash was earning prior to the strategy.

### ***Bond proceeds***

The ISO manages a pool of bond proceeds related to the 2013 bond issue. These proceeds represent the remaining funds from the 2009 bonds that are being used for capital expenditures. The investment of bond proceeds is primarily restricted to U.S. Treasury and government agency securities and the yield that the ISO can earn is restricted by IRS arbitrage rules.

As of December 31, 2013, the market value of the 2013 bond proceeds was \$23.6 million. The total return on investments was 0.1% and the duration of the portfolio was 0.03 years. All investments held at the end of the year were within one year of maturity as these funds are being allocated to the various capital projects approved.

In addition to the balance above, the ISO balance sheet contains approximately \$19.7 million in restricted funds related to the 2008 bond issue. These funds represent the debt service reserve fund and are not managed by the ISO, as they are held under an investment contract tied to the bond indenture. These funds were redeemed in February 2014 to make the final bond payment on the 2008 bonds.

### ***Generation interconnection project related funds***

The ISO maintains a pool of funds related to generation interconnection project deposits. As of December 31, 2013, the market value of these funds was \$84.1 million. For nearly the whole year, these funds were invested in money market funds and, therefore, had no duration risk. The total return on these funds was 0.07% in 2013.

Due to the success of the FDIC-insured CD strategy that was implemented in the unrestricted portfolio, a similar strategy was put in place in December for these funds. Under this strategy, the funds are invested in a portfolio of CDs fully insured by the FDIC. The new strategy removes any credit risk associated with investment in money market funds, while preserving the required level of liquidity needed for the program.

By the end of January 2014, the strategy had been fully implemented on the available portfolio with an initial yield to maturity of 0.96%, substantially better than the cash rates the portfolio had been earning. While the earnings are not retained by the ISO, they are paid back to the project depositor, the ISO does have a fiduciary responsibility to maximize the yield within the portfolio guidelines.

### ***Market funds***

The ISO manages restricted funds for market participants, which consist of amounts held which are to be remitted back 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, 2013, the market value of these funds was \$332.2 million. Due to their liquid nature, these funds are invested in money market funds and, therefore, have no duration risk. The average return on these funds was 0.06% in 2013.

### ***Retiree Medical Plan funds***

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. In 2013, the Board and the Employee Pension Benefit Committee approved a new investment strategy that was implemented in the latter half of the year. The new strategy was designed to better align the investment strategy of the assets with the long-term nature of the liabilities. The designated assets are held in two accounts: 1) a trust account which was established to hold the assets associated with the liabilities of current retirees and fully eligible employees; and 2) a custody account which holds designated assets from the ISOs unrestricted funds relating to the balance of the liabilities.

As of December 31, 2013, the market value of the trust was \$8.8 million and the annual total return was 4.5%. The custody account held \$12.9 million and returned 4.1% for the year. The target asset allocation remains tied to the "Moderate Portfolio" strategy in the ISO 401(k) plan, which is 55% growth, 35% stability, and 10% real return.

Attachment 1 to this document contains the monthly total returns of each of the pools of money described above. A detailed listing of investment holdings is included in Attachment 2.