

Memorandum

To: ISO Board of Governors
From: Yakout Mansour, President and Chief Executive Officer
CC: ISO Officers
Date: March 1, 2007
Re: *CEO Report*

This item does not require Board action

The following highlights some of the events affecting the ISO and/or the electricity industry since the date of the last meeting of the Board of Governors.

Market Redesign Technology Upgrade (MRTU) Program

- Market Simulation Phase 2 began on January 22nd allowing Market Participants to submit bids and download reports. Phase 2 also introduced the Inter-Scheduling Coordinator ("Inter-SC") Trade functionality. Also, at the end of January, the Congestion Revenue Right ("CRR") team completed the Dry Run market simulation and is working on the report to be filed at FERC the end of March.
- The ISO continues to make progress on software development and certain program-wide activities. Last week the ISO reached an important milestone with the initial integration test (using real Master File data) between the Scheduling Infrastructure and Business Rules ("SIBR") system and the Integrated Forward Market ("IFM") system. As I understand it, the test went quite well. That said, we continue to face vendor delivery challenges, requiring us to continually reassess, and make appropriate modifications to, our development and testing schedules. So far, the February 1, 2008, implementation date of the new market is intact.
- Both internal and external MRTU readiness efforts are continuing. The key business units are well on their way toward implementing the readiness plans developed last year and the balance of the business units are developing their readiness plans and are beginning implementation. Externally, the Readiness Team has completed an initial assessment of 60 of the 75 market participants to ensure that they are also on track for the February 1, 2008, "Go Live."
- I am pleased to report that our new State Estimator is ready to support MRTU operations. As you recall, last year the ISO developed and implemented its first-ever State Estimator application. During February, the ISO reached a

significant milestone in its march toward MRTU implementation when the State Estimator was “accepted” as ready to support MRTU. This is great news and my thanks and congratulations to all involved!

2006 Achievements

- I am pleased to attach to this report the 2006 scorecard. As detailed in the scorecard, the ISO had its best year from an operational perspective, achieving perfect scores on all of the established North American Electric Reliability Corporation (“NERC”) and Western Electricity Coordinating Council (“WECC”) standards. Moreover, consistent with our commitment to “reliability at a reasonable cost”, the ISO achieved such scores while continuing to decrease (\$192 Million) ISO-operator controllable costs. This is remarkable in light of the fact we experienced a “1-in-57” year heat wave and already had thin reserves going into the summer.

The ISO also continued to move forward on the market side and California experienced another year in the trend of low and reasonable electric energy costs. While the mammoth MRTU project has its challenges, we are committed to implementing the new design by February 1, 2008. The new market design is the platform on which we will take the ISO toward market excellence.

The ISO also made good progress in furthering needed infrastructure development. Over 1100 MW of new transmission capacity was realized (energized) in 2006. Moreover, in support of State public policy initiatives regarding the development of new renewable resources, the ISO approved critical new transmission projects (Sunrise Powerlink) and pushed the envelope with proposed innovative ratemaking methods designed to support the development of renewable resources (FERC Declaratory Order regarding a new “Third Category” of transmission).

The ISO could not have accomplished its goals without the help of others. The State’s new Resource Adequacy rules and the load-serving entities’ related procurement efforts helped ensure that the resources the ISO needed to serve load were ready and available. Moreover, suppliers delivered on their obligations to make their resources available and had one of the lowest generation outage rates on record.

Operational Issues

- The ISO is in the process of finalizing its Summer 2007 Supply and Demand Operational Outlook and will provide a briefing at the Board meeting. Over the years we have coordinated our assessments with the California Energy Commission (“CEC”) and other State entities and that coordination continues this year. One significant development is that our assessment reflects a new “probability-based” analysis. For purposes of our analysis, we have used the CEC-developed probability methodology and ISO data. Highlights of our results indicate that, consistent with Summer 2006, while we will have sufficient supplies to meet demand under a range of operating conditions, we will continue to be challenged to meet California’s load growth. In addition, we will once again see tight supply conditions in Southern California and the risk of having to shed firm load, particularly in Southern California (South of Path 26, or “SP26”) continues to be of concern under high load and adverse supply conditions. As usual, the ISO will continue to count on the continued success of the State’s Resource Adequacy programs, new generation additions, continuing increases in demand response and interruptible programs, and, as discussed below, our own efforts to ensure we can reliably operate the system under adverse conditions. Finally, it goes without saying but *conservation* will continue to be an important factor to help meet demand.
- As noted above, the ISO continues to prepare for Summer 2007 operations. Similar to last year, over the next six to eight weeks, the ISO will be meeting with various market participant sectors to brief them on expected summer

operating conditions and continue to establish the cooperative working relationships that will enable us to reliably operate the grid throughout the summer. The ISO will also work through the established North American Electric Reliability Corporation ("NERC") and Western Electricity Coordinating Council ("WECC") forums and processes to further ensure coordinated control area summer operations.

Regulatory/Government Highlights

- On February 15, 2007, FERC issued Order No. 890, its Final Rule in the Order No. 888 Reform Proceeding. The Final Rule applies to all public utilities including ISOs and RTOs, and all utilities will be required to make a series of compliance filings over approximately the next six months. FERC clarified that the purpose of the Final Rule is not to redesign approved ISO/RTO markets and stated that it does not expect that significant changes to those markets will be required as a result of the Final Rule. The Final Rule is likely to have the greatest impact on the ISO's transmission planning process. The rule states that all transmission providers must participate in a coordinated, open and transparent planning process on both a local and regional level and that each transmission provider's planning process must meet the nine principles set forth in FERC's Notice of Proposed Rulemaking. FERC stated that each transmission provider must describe its transmission planning process in its tariff and that it will allow regional differences in planning processes. We provide more detail in the Regulatory Update. Management will continue to keep the Board apprised of specific developments regarding the ISO's compliance requirements resulting from the Final Rule.
- On February 13, 2007, FERC issued an order approving the Reliability Capacity Services Tariff ("RCST") Settlement and the 2007 RCST Cost Allocation Tariff Amendment. FERC expressly stated that "RCST meets the reliability needs of the ISO and ensures that generators providing reliability services will be appropriately compensated, thereby reducing the likelihood that units will be mothballed or shut-down." FERC approved the proposed settlement effective as of June 1, 2006, and the 2007 RCST ISO Tariff amendment, effective as of January 1, 2007. The order is discussed further in the Regulatory Update. The FERC order brings important clarity to a compensation issue that has remained unresolved since the 2000-2001 electricity crisis.

Financial Highlights (estimated)

- January 2007 estimated revenues are \$16.8M, \$0.8M higher than budget. The variance is due to higher interest income (which is applied against bond and other interest expenses of \$0.7M), partially offset by lower estimated GMC revenues. The revenue variance is primarily attributable to the generally mild January weather. January 2007 estimated operating expenses are \$11.7M, \$0.2M lower than budget.

People

- The ISO now stands at 512 full-time employees, including seventeen new hires that joined us in the month of February. We have 28 vacancies. Included in the vacancies and headcount are the 8 MRTU positions, 8 positions paid for by the Western Electricity Coordinating Council and 3 positions to be reimbursed through the new Generator Interconnection study process. The new hires are: Grace Arupo, Legal Counsel, General Counsel; Rizwaan Sahib, Associate RIG Engineering Representative, Operations; Saurabh Monga, Associate

Market Design Engineering Specialist, IT; Daniel Britton, Senior Systems Engineer, IT; Brian Cummins, Manager, EMS Information Technology, IT; Michelle, Moroni, Corporate Training Analyst, Human Resources; Brian, Ohearn, Senior Systems Engineer, IT; Katie Hobson, Metering Analyst, IT; Lyubov Karvchuk, Associate Regional Transmission Engineer, PAID; Rahul Kalaskar, Market Performance Analyst, Operations; Dyane Smith, Payroll Administrator, Human Resources; Denise Antoniadis, Director, Strategic Planning & Executive Operations; Jerald (Jay) Jones, Systems Support Analyst, IT; Lourdes Estrada-Salinerro, Business Process & Quality Analyst – Lead, Market Development and Program Management; Liu, Shucheng, Principal, Market Development, Market Development and Program Management; Loretta Barnard, Senior Software Quality Assurance Analyst, IT; and Sean Whaley, Senior Systems Support Engineer, IT.

- As you know, I have asked Steve Greenleaf to assume a new exciting role in Market Development as Director of Regional Market Initiatives. I am committed to furthering our efforts on regional collaboration and I have asked Steve to spearhead those efforts. In his new capacity Steve will be reporting directly to Chuck King. Let me first of all express my sincere appreciation to Steve for his outstanding service in his role as the Director of Executive Operations for the last 18 months. As a new CEO, I needed someone who is trustworthy, knowledgeable, and respected to help me in my role as I feel my way through the organization and help the executive team in coordinating our overlapping efforts. Steve was the obvious choice and we would not be where we are without him. As he takes on a new and very important challenge, he proves again his commitment and loyalty to our organization. I am sure he will continue his outstanding performance and help us bridge the gaps with our neighboring systems.
- In conjunction with Steve's move and to further highlight the strategic planning function in the organization, it is my pleasure to introduce Denise Antoniadis as Director of Strategic Planning and Executive Operations. Denise comes to the ISO with a wealth of experience and a reputation that will further strengthen the ISO. She brings 18 years of experience at PG&E in various management roles in field operations, customer services, controller, rates, and general corporate initiatives including business process improvement and market readiness. Her last nine years included industry-focused roles with major consulting firms, including Capgemini and Ernst & Young. Most recently, Denise served at KPMG as its Director, Western Region energy practice, where she focused on compliance, performance management, risk management, market strategy, business process improvement, system implementation, and market readiness, just to mention a few. Welcome Denise!