

Memorandum

To: ISO Board of Governors
From: Yakout Mansour, President and Chief Executive Officer
Date: January 25, 2008
Re: *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.

Market Redesign & Technology Upgrade (“MRTU”) Program

1. Integrated Market Simulation (“IMS”) Update 2

Unfortunately, the California ISO was not able to start the final market simulation, IMS Update 2, as scheduled on January 2, 2008. This is a disappointment to us, but we believe it is best for the market. We worked feverishly over the holidays to close remaining testing variances and resolve open stability and performance issues, but despite our best efforts, we continued to find subsequent variances after fixing initial variances. The good news is that our testing and remediation efforts are showing positive results. We now have the SIBR system (“Scheduling Interface Business Rules”) performing and functioning well. We also have the day ahead market running consistently and continue to test and remediate the real time market functionality. At the same time, we are making good progress on integrating the remaining systems that are dependent on achieving stability in the real time market system.

The California ISO is firmly committed to providing rich functionality, predictable performance and stability before we start this final market simulation. Based on current progress, we believe we will be able to announce that simulation date shortly, but I must stress that we will not begin the final simulation until we can meet our commitments to you.

Given the delays in starting the final market simulation, we recognize that the April 1, 2008 go-live date is no longer viable. We are not prepared to announce another go-live date until we are satisfied that all functionality is working properly, quality pricing solutions are being produced and we receive feedback that the results are satisfactory. We appreciate your continued feedback that achieving the right result is the most important objective. We commit again that the market cannot open until both the ISO and the market participants are ready.

2. Congestion Revenue Rights ("CRR") and Firm Transmission Rights ("FTR")

The expected delay of MRTU implementation beyond April 1, 2008 also requires additional measures to: 1) adjusting CRRs released in the annual CRR Auction held in December 2007; and 2) making FTRs available for April 2008 and any additional months prior to the start of MRTU. Prior to the completion of the annual CRR Auction, the California ISO posted a proposed CRR and FTR Contingency Plan on December 13, 2007, informing parties of its intended course of action in the event of a delay of MRTU implementation beyond April 1, 2008. Details on the contingency will be covered in the MRTU update. We conducted a stakeholder conference call regarding the contingency plan and will be seeking approval of the plan by the Board on January 29, 2008. In addition, the ISO will be seeking Federal Energy Regulatory Commission ("FERC") authority for the aspects of the contingency plan, as approved by the Board, that require FERC approval, given that the ISO tariff does not currently contain such provisions. Again, I want to extend my appreciation to market participants for their involvement and support as we work through the transition.

3. Resource Adequacy ("RA") Requirements under MRTU Operations

As reported in our Regulatory Report to the Board, the California ISO received FERC's general approval on January 9, 2008 of the RA requirements under MRTU operations, as well as accepting early effectiveness of MRTU-specific RA requirements under today's Tariff in preparation for the RA program under MRTU. This is a very important milestone in preparing for our readiness toward MRTU go-live.

Operations

I am pleased to report that the California ISO was recently awarded the "Project of the Year" by the Utility Automation and Engineering T&D Magazine for technology innovation in the Geospatial Technology category. We were recognized for our innovative use of technology in managing the grid during last year's wildfires. The system enabled us to see the fires in real time and run the grid effectively by viewing a map of the grid with overlays of real-time weather and fire data.

Infrastructure Planning and Development

The ISO continues to devote considerable amounts of time and effort on transmission infrastructure initiatives driven by national and regional priorities:

1. FERC Technical Conference on Interconnection Queue

As I reported last month, on December 11, 2007, the California ISO participated in a FERC technical conference to address the challenges affecting the current Large Generator Interconnection Procedures nationwide and explore possible reforms. The California ISO, as well as other ISOs/RTOs across the country, identified issues hindering the efficient implementation of the Large Generator Interconnection Procedures. As you may recall, our recommendation was that FERC authorize the California ISO to establish multiple clusters for the queue by key geographic interconnection points effective January 1, 2008, and grant the California ISO greater flexibility and authority for insuring that projects in the queue are financially viable by imposing greater dollar thresholds and stricter entry criteria. As a result of the California ISO's participation at the technical conference, FERC expressed a desire for California ISO to propose any necessary reforms by the spring of 2008. In accordance with the FERC directive, we are conducting a stakeholder process to evaluate potential queue management reforms. To the extent that tariff changes are required to implement any identified reforms, we will seek Board approval prior to submitting proposed reforms to FERC.

2. Sunrise Powerlink Transmission Project ("Sunrise") Update

On January 3, 2008, the California Public Utilities Commission ("CPUC") and Bureau of Land Management ("BLM") issued a draft Environmental Impact Report/Environmental Impact Statement ("EIR/EIS") for Sunrise, initiating Phase 2 in the Sunrise Certificate of Public Convenience and Necessity proceeding at the CPUC. The draft EIR/EIS evaluated the environmental impacts of Sunrise as proposed by SDG&E and other routing, transmission and non-transmission alternatives. Seven scenarios were identified and ranked in order of environmental superiority, with Sunrise, as proposed by SDG&E, ranking sixth. There was also a "No Project" scenario that included components of the first three alternatives.

Phase 2 of the proceeding before the CPUC will examine the reliability and economic aspects of the alternatives, any deficiencies in the draft EIR/EIS, Electro Magnetic Field ("EMF") mitigation measures, impact of wildfires on the proposed Sunrise route and the alternatives, and cost. The California ISO will continue to play an active role in this regulatory process and intends to file comments. Comments on the draft EIR/EIS are due by April 11 and an evidentiary hearing on the Phase 2 issues is scheduled for April 2008. The final EIR/EIS is scheduled to be published in June, with a Final Decision on Sunrise anticipated in August 2008.

Financial Highlights

Preliminary year-to-date revenues through December 2007 are \$211.2 million, or \$13.6 million higher than budget. The increase is due to a one-time refund of the SDG&E Grid Management Charge ("GMC") of \$6.9 million and higher interest and other income of \$10.2 million, offset by lower GMC revenues of \$3.5 million. Lower GMC revenues are primarily due to milder weather than predicted during the first half of the year, which resulted in lower market volumes than had been projected. Additionally, there was less reliance on the ISO market as more participants were self-providing for ancillary services.

Preliminary year-to-date operating expenses through December 2007 are \$143.1 million, or \$0.7 million lower than budget. This represents a significant achievement, particularly considering the upward pressures and additional costs that were required to accomplish key initiatives in 2007. Through concerted efforts of our management team, we were able to successfully offset these increased expenses with savings from other areas of the corporation.

People

The California ISO had eight budgeted vacancies in December 2007. We are pleased to welcome one new hire in December, Venkata Srirama, Senior Systems Support Analyst in the Information Technology Division.