

Memorandum

To: CAISO Board of Governors
From: Yakout Mansour, President and Chief Executive Officer
Date: August 29, 2008
Re: CEO Report

This memorandum does not require Board action.

Not surprisingly, the top item in my report concerns the status of the market redesign and technology upgrade (MRTU) program and our continued efforts to achieve internal readiness. In addition, there are several other matters worthy of discussion. Below are highlights of these events and a discussion of how they affect the California Independent System Operator Corporation (CAISO).

1. MRTU READINESS

a) Program update. Since my last report, we have continued to address a number of critical challenges, as we reported to the Board at the last meeting. The November 1 date to Go Live was contingent on reaching a specific level of stability and performance beyond doubt, as we always committed. Although significant progress was made overall, Management decided that we have not achieved what we felt necessary to firm up the date. Moreover, we have not entertained whether the shortcoming could be made up in order to maintain the November date because of the uncertainties involved and our intent not to keep the market participants subject to a high level of uncertainty on the Go Live date. Therefore, the decision was made to defer the November 1, 2008 date. At the same time, it was obvious to us that vendor engagement and continued focus on the little, yet troubling, outstanding issues must move a quantum leap to overcome the difficulties we faced. I am pleased to report that the response to those needed changes has been excellent and resulted in remarkable improvement in addressing the outstanding issues and resolving variances. I am also pleased to report that the degree of readiness today is better than what we were hoping to achieve by the end of July, but the time lost could not be recovered.

As you heard from the market participants, December and January are problematic as dates to Go Live, which means a new, February 1 Go Live date. Based on what we will report today, which will continue to be substantiated at every one of the upcoming Board meetings, we see February 1 as the latest Go Live date, subject to our readiness demonstration to you all on the way to the date.

b) Program organization and budget. The additional delay carries with it the associated challenge of keeping exceptionally dedicated employees motivated and focused, as well as the increased costs of having outside vendors continue their support. In response to these demands I have asked that Steve Berberich, Vice President of Corporate Services, be even more directly and completely engaged in management at the program and project levels to assure everyone we will get the job done. Steve's increased efforts have already shown results in keeping the team unified and focused on the objective, particularly with respect to the recent success demonstrated by having all functionality installed in preparation for the restart of the market simulation. Debi Le Vine continues her indispensable and tireless work on the project and together Steve and Debi, as well as all the individuals supporting the program, should be credited with getting us to where we stand today.

As expected, we necessarily engaged in discussions with the various vendors associated with the program and can assure the Board they clearly understand our need for extended efforts and, more importantly, our heightened sensitivity of any critical path issue that could impede progress towards our objective. At this time we have entered into commitments that have exhausted the \$189.223 million budgeted for the program and anticipate requiring an increase in the budget of approximately \$8.277 million in order to Go Live in early 2009. Again this represents a remarkable achievement when we consider the program over the past two years has required about \$1.5 million to \$3 million per month to sustain this level of effort and now we are able to account for approximately twelve months of expenses for only a fraction of what one would have expected (i.e., the Go Live date associated with the last budget approval was February 1, 2008). We have been able to accomplish this with a number of efficiencies, including rolling contractors off of the project as tasks progress, working closely with our vendors to manage their deliverables, and devoting internal CAISO resources to the program.

2. MARKET & INFRASTRUCTURE DEVELOPMENT

a) Joint transmission paper. In a recently published paper entitled *Experiences with Joint Transmission-Project Development in the West* (Paper), a group of public power entities¹ contend that the CAISO tariff represents an obstacle to efficient transmission planning, public/investor-owned utility partnerships, and achievement of California's important renewable resource goals. It is not our usual practice to comment on papers of this sort, but given the particular mischaracterizations of the CAISO tariff, our role in the cancellation of certain transmission projects, and the important steps we have taken to remove barriers to renewable resource development, we opted to deviate from our norm and respond. In our response we highlight the mission of CAISO and use this as the foundation for a discussion of the issues raised in the paper. We take this matter seriously, as we should any challenge to the principles on which CAISO is premised, and we will continue to vigorously support our mission with respect to these important issues at the local, state and national level.

b) Generator interconnection procedure reform. On July 28 we filed the tariff language necessary to implement the generator interconnection procedure reform (GIPR) policy approved by the Board at our last meeting. The GIPR represents one of the cornerstones of our efforts to support the renewable portfolio standards established by the state and will in all likelihood be watched closely by others who are considering reforms of their own to address similar issues. Although this matter is pending before

¹ The sponsors are the Imperial Irrigation District (IID), the Turlock Irrigation District (TID), the Los Angeles Department of Water and Power (LADWP), the Sacramento Municipal Utility District (SMUD), and the Western Area Power Authority (WAPA).

the Federal Energy Regulatory Commission (FERC) and we plan to file a response to comments that were recently received on the proposal, we are pleased to report that a majority of parties generally support the proposal. This initial success in large part is attributable to the dedication by all interested parties and, on behalf of CAISO, I would like to thank everyone for their participation and support.

c) *Western Renewable Energy Generation Information System (WREGIS).* WREGIS is a western interconnect-wide renewable energy registry and tracking system established to promote verified tracking of renewable energy production and procurement and facilitate the growth of renewable energy. Newly established, WREGIS went on line on June 25, 2007 and is administered by the Western Electricity Coordinating Council. The California Energy Commission (CEC) and the Western Governors Association are the sponsoring co-founders of WREGIS, with the CEC's efforts intended to carry out its statutory mandate to establish a tracking and verification system for renewable portfolio standards compliance. CAISO participated in the implementation process and is on schedule to complete certification as a qualified reporting entity (QRE) in August. QREs report generation output data into the WREGIS tracking system on behalf of renewable generators. CAISO played a prominent role in the formulation of the terms under which balancing authorities may participate in WREGIS and has received significant interest from load serving entities and renewable generators desiring to have CAISO act as their QRE. CAISO has developed a streamlined process for parties to apply to receive WREGIS QRE services, which should be fully implemented by September, with CAISO providing QRE services to the parties who have made initial requests.

d) *Congestion revenue rights annual allocation auction.* The delay in MRTU has resulted in the need to unwind the rights issued for 2008 and the continued reliance on the firm transmission rights currently auctioned through March 31, 2009. The congestion revenue rights effort to allocate and auction rights for 2009 recently commenced and will conclude in November. Adjustments to this process will continue to be evaluated as the timing of MRTU is determined.

3. OPERATIONS

a) *Conditions and forecasts.* Continued generally mild weather has definitely spelled relief this summer, particularly in light of the low hydro year, although peak loads and total energy consumption in August are just shy of last year. In any event, we are already looking towards next summer and our number one concern will be whether we experience a 3rd dry year in 2009. Observed precipitation is well off normal with monsoonal moisture that typically affects southern California below average. Recent 120 day and 160 day weather forecasts predict dry conditions will prevail into winter and, as of August 1, three of Northern California's major water reservoirs, Shasta, Oroville, and Folsom all were at their 7th lowest levels in the last 48 years, with typically 4 months of drawdown to go. Even assuming normal precipitation for water year 2009, these reservoirs likely will remain well below full for summer 2009 and another year of significantly reduced energy production from hydro-electric facilities should be expected.

b) *Renewable resource integration.* CAISO and the industry face an important transformation regarding electricity production and delivery with the onset of new and diverse environmental goals to increase the grid's renewable power mix and lower greenhouse gases. These environmental mandates have triggered a proliferation of proposed wind, solar and geothermal generation projects as well as increased interest in other innovative technologies, such as storage and advanced metering. CAISO is taking the lead on efforts to define system operation and infrastructure changes needed to reliably integrate this large base

of renewable resources into the grid. Such efforts necessarily involve the participation of a broad array of entities and CAISO has initiated discussions with those entities that will play a critical role in making renewable integration a success, including the CPUC, CEC, and regional entities such as the Bonneville Power Administration. CAISO will continue to focus attention on the objectives and execution of these initiatives.

4. FINANCIAL HIGHLIGHTS

a) 2009 Budget overview. At this time it appears we are tracking towards a 2009 grid management charge (GMC) of about 76.8 cents, which is slightly below the target amount per the 2008 goal. We had hoped to achieve an even lower GMC of closer to 76 cents, however have had upward pressure due to volumes that are lower than anticipated. 2008 revenues are forecast to come in about \$1 million below budget due to cooler weather this year, and our 2008 transmission volume forecast of about 248,600GWh falls short of our budget. As a result, our 2009 forecast has also been adjusted downward from 255,000GWh to 252,400GWh. This results in a \$1 million under-recovery that affects the 2009 revenue requirement, and the lower volumes also affects the denominator of the rate equation. Even with that challenge, our 2009 proposed revenue requirement of \$194 million is only 1.2% higher than 2008, and it is again below the threshold agreed to by customers that will allow us to avoid a rate case at FERC on the 2009 budget. Throughout the fall we will review our forecasts for 2008 and update the 2009 revenue requirement and rates as necessary.

b) Iron Point facility update. Preparations in pursuit of constructing a new facility for CAISO at our property on Iron Point road in Folsom continue. Most significantly we filed an application with the City of Folsom to formally initiate the permitting process, which generated some local media interest that highlighted in particular the need for the facility and noted that it would not result in an increase on customers' electric bill. The Architectural Review Board approved the submittal with a couple of points that we will clarify at the Planning Commission hearing scheduled September, 17. Also, we received the required traffic study and will review this information with the City of Folsom on August 28th. Our community outreach efforts continue and upcoming milestones with approval of the Board include completion of 60 % the design phase in September and the initial site work currently scheduled for October.

5. EXTERNAL ACTIVITIES

a) San Francisco Action Plan. For several years CAISO has been engaged in activities focused on resolving the reliability needs in the San Francisco area. One aspect of the plan included the construction of new generating facilities to replace the aging Potrero facility. On July 22 the San Francisco Public Utilities Commission (SFPUC) voted to rescind the contract to build the new "peaker" plants in favor of a phased closure of the Potrero facility with a retrofit of some of the units. The Board of Supervisors has requested that the SFPUC study whether the remaining retrofitted units may be replaced by transmission system upgrades to allow the entire plant to be shut down. In the immediate time horizon we do not anticipate any implications with respect to reliability as Potrero remains under a reliability must-run agreement; however, we will continue to closely monitor the situation.

b) Once-through cooling. CAISO continues its participation in the informal working group organized by the State Water Resources Control Board (SWRCB), which also includes the CEC, the CPUC, the State Coastal Commission, the California State Lands Commission, and the California Air Resources Board. In addition, we expect to deliver a report in early September in response to the SWRCB commissioned study completed in

April 2008 titled *Electric Grid Reliability Impacts from Regulation of Once-Through Cooling in California*. We believe continued cooperation among the state agencies is essential to assuring that our collective responsibilities can be achieved.

c) *Board nomination process.* Recently we kicked off the nomination process for the vacancy that will occur when Governor Gage's term expires at the end of this year. The first step in the process is the formation of a stakeholder Board nominee review committee, comprised of a 36-member committee that includes six stakeholders from each of the six member-class sectors. Next steps include the identification of at least four qualified candidates by an independent search firm. The list of candidates will then be forwarded to the committee for evaluation, including personal interviews. The member-class sectors will then rank the candidates, which in turn will be aggregated by the independent search firm for a final ranking to be forwarded to CAISO, to confirm qualifications, and then ultimately sent to the Governor's office. The Governor's office has the discretion to appoint from the list provided. The appointee will be subject to confirmation by the State Senate.

6. PEOPLE

a) *Laura Manz, Vice President of Market and Infrastructure Development.* It is my pleasure and privilege to welcome Laura Manz to the CAISO family in the newly created position of Vice President of Market and Infrastructure Development. Some of you already know Laura, previously Director of FERC and CAISO Regulatory Affairs for SDG&E. Laura has been at the forefront of California's progress toward maximizing the benefits of open wholesale markets, planning for a stronger grid through transmission investment, leveling the playing field for renewable and demand response resources, and initiating collaborative deployment of new reliability standards. Her familiarity with advanced concepts, theory and application in the field of electricity transmission and electricity markets made her an ideal choice and we are fortunate Laura has accepted the challenge this position presents. We are confident Laura's expertise and leadership in the market and transmission regulatory arenas that made her not just an asset to SDG&E, but an asset to the entire California electricity industry will continue to serve here at CAISO. In fact, Laura has already made her presence felt by initiating the task of integrating our infrastructure planning and market development groups into the combined group she leads consistent with our goal to achieve more effective infrastructure planning through the use of market signals, and we expect many good things to come from this effort. Again, my thanks to Laura.

b) *John Anders, Director of Organizational Effectiveness.* I would also like to welcome John Anders in his new role as a member of the executive team. John is a man of tested ability, sound judgment and keen perception. These are attributes that have served him well in the eight years he has provided legal counsel to our organization and they are the same characteristics that will make him successful as Director, Organizational Effectiveness. In this key position that has been expanded, John will report directly to me with corporate wide accountability for strategic planning, organizational effectiveness, enterprise risk management, corporate governance, and executive operations support.

c) *CAISO Academy.* We are proud to have graduated twenty students from the CAISO Academy, now certified with advanced skills in our Transmission Economic Assessment Methodology, including participants from other organizations.