

# Memorandum

**To:** ISO Board of Governors

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

**Date:** March 13, 2013

**Re:** 2012 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 2012 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 and liquidity.

- As of December 31, 2012, all portfolios were in compliance with the ISO Investment Policy. The Board approved revisions to the Investment Policy at its September 13-14, 2012 meeting.
- During 2012, the ISO achieved a total return of 1.0% on the unrestricted cash and investment balance, which was \$153.8 million at the end of the year. Total return information on other portfolios will be described in the report.
- Interest rates remained at historically low levels in 2012 as domestic economic activity remained stagnant and concerns over European sovereign defaults continued to create demand for U.S. Treasury securities. The following table shows the level of US Treasury interest rates at the end of the previous two years:

US Treasury Bond	Yield as of 12/31/11	Yield as of 12/31/12
2-year	0.25%	<b>0.25%</b>
3-year	0.36%	<b>0.36%</b>
5-year	0.83%	<b>0.72%</b>
10-year	1.89%	<b>1.78%</b>

While the ISO is able to invest certain reserves in fixed income securities with slightly longer maturities (within five years), the majority of the assets must be maintained in highly liquid money market type securities (maturities within one year). The impact of low rates is therefore reflected in lower portfolio yields.

A brief summary of key portfolio characteristics follows and all data is summarized in the tables of Attachment 1.

## DISCUSSION AND ANALYSIS

### *Unrestricted portfolio*

The market value of the ISO's unrestricted portfolio as of December 31, 2012 was \$153.8 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). The ISO ends the year with its largest unrestricted cash and investment balance due to the collections through the grid management charge of large expenses that are disbursed in the first two months of the next year. The large expenses consist primarily of the debt service payments due on the outstanding bonds.

The portfolio's total return for 2012 was 1.0% and, as of December 31, had a duration of 1.2 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.

In 2011, the ISO constructed a benchmark portfolio in a style similar to the ISO's unrestricted portfolio. This provides a useful benchmark for Management to assess the performance of the ISO's investment strategies. For comparison, the benchmark index returned 1.46% during 2012. There are several reasons why the benchmark was able to outperform the ISO's portfolio including:

- Longer duration: The benchmark averaged a duration of 1.5 years during the year versus the ISO's average of 1.2 years.
- Less money market exposure: The benchmark contains a 50% weighting in the money market sector; however, the ISO held a larger percentage in the first

month and second half of the year as liquidity was increased to fund the Q1 expenses mentioned above.

### ***Bond proceeds***

The ISO manages a pool of bond proceeds related to the 2009 bond issue (primarily for the construction of the Iron Point site and other 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, 2012, the market value of the 2009 bond proceeds was \$17.3 million. The total return on investments was 0.16% and the duration of the portfolio was 0.1 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 \$35 million in investments related to the bond issues that represent the debt service reserve funds for the 2008 bonds and 2009 bonds. These are not managed by the ISO as they are held under investment contracts tied to the bond indentures.

### ***Large and small generation interconnection project related funds***

The ISO maintains a pool of funds related to generation interconnection project deposits. As of December 31, 2012, the market value of these funds was \$76.1 million. The funds are currently invested in money market funds and, therefore, have no duration risk. The total return on these funds was 0.20% in 2012.

### ***Market collateral 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, 2012, the market value of the collateral was \$123.0 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 0.14% in 2012.

### ***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. The ISO established a trust for the purpose 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, 2012, the market value of the trust was \$6.6 million. The total return on investments was 2.23% and the duration of the portfolio was 2.6 years.

Similar to the unrestricted portfolio, a customized benchmark was created in 2011 to compare the investment performance of these assets. The ISO's performance (2.23%) underperformed the benchmark's return of 3.96%. The difference resulted from the ISO averaging a 3.1-year duration versus the benchmark's 3.7-year duration. The investments in the trust were shortened during the year in preparation for the new investment strategy that is being proposed.

Attachment 1 to this document contains various displays of the portfolio characteristics discussed above. A detailed listing of investment holdings is included in Attachment 2.