



Memorandum

To: ISO Board of Governors

From: Ryan Seghesio, Chief Financial Officer & Treasurer

Date: March 19, 2015

Re: 2014 Annual Investment Report

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 2014 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 conservative investment approach focused on principal preservation and liquidity.

- As of December 31, 2014, all portfolios were in compliance with the ISO Investment Policy.
- During 2014, the ISO achieved a total return of 1.0% on the unrestricted cash and investment balance, which was \$154.3 million at the end of the year. Total return information on other portfolios will be described in the report.
- Short-term interest rates (up to three years) gradually increased during the year as the market anticipated the start of tightening by the Federal Reserve. However, the yield curve flattened as mid- to long-term interest rates (5 years and greater) gradually decreased during the year as the decline in oil prices dampened inflation pressures while general global economic uncertainty increased the demand for US Treasury Bonds.

The following table shows the level of U.S. Treasury interest rates at the end of the previous two years:

U.S. Treasury Bond	Yield as of 12/31/13	Yield as of 12/31/14
2-year	0.38%	0.67%
3-year	0.78%	1.10%
5-year	1.75%	1.65%
10-year	3.04%	2.17%

A brief summary of key portfolio characteristics follows, and a detailed list of investments is in Attachment 1.

DISCUSSION AND ANALYSIS

Unrestricted portfolio

The market value of the ISO's unrestricted portfolio as of December 31, 2014 was \$154.3 million. This portfolio contains the funds received by the ISO related to 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). \$11.5 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 2013.

The portfolio's total return for 2014 was 1.0% and, as of December 31, had a duration of 1.3 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. Despite the increase in short-term rates during the year, the portfolio actually experienced a small price return of 0.08%, due to the performance of some of the longer term bonds and the timing of purchases made during the year. The income return on the portfolio of 0.96% made up the rest of the total return.

There were no significant changes to the investment strategy during the year, although the purchase activity increased compared to prior years due to the maturity of a large portion of the portfolio. In general, these purchases were spread among US Treasuries, government agencies, and corporate bonds maturing from two – five years.

Key portfolio stats by quarter are contained in the table below:

UNRESTRICTED FUNDS	Q1-2014	Q2-2014	Q3-2014	Q4-2014
Balance (quarter end)	\$109.1 million	\$121.5 million	\$141.4 million	\$154.3 million
Total return (for the quarter)	0.36%	0.57%	-0.18%	0.28%
Yield to maturity (qtr end)	0.57%	0.56%	0.71%	0.75%
Duration (quarter end)	1.4 years	1.3 years	1.4 years	1.3 years

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, 2014, the market value of the 2013 bond proceeds was \$13.2 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.

BOND PROCEEDS	Q1-2014	Q2-2014	Q3-2014	Q4-2014
Balance (quarter end)	\$21.6 million	\$19.3 million	\$15.2 million	\$13.2 million
Total return (for the quarter)	0.01%	0.05%	0.03%	0.01%
Yield to maturity (qtr end)	0.13%	0.09%	0.08%	0.11%
Duration (quarter end)	0.5 years	0.5 years	0.4 years	0.3 years

Generation interconnection project related funds

The ISO maintains a pool of funds related to generation interconnection project deposits. As of December 31, 2014, the market value of these funds was \$111.4 million. These funds are invested in money market funds and FDIC-insured certificates

of deposit. The total return on these funds was 0.4% and the duration of the portfolio was 0.8 years.

GIP DEPOSITS	Q1-2014	Q2-2014	Q3-2014	Q4-2014
Balance (quarter end)	\$81.5 million	\$107.9 million	\$111.5 million	\$111.4 million
Total return (for the quarter)	0.11%	0.10%	0.08%	0.09%
Yield to maturity (qtr end)	0.48%	0.39%	0.39%	0.38%
Duration (quarter end)	1.5 years	1.1 years	0.9 years	0.8 years

Market funds

The ISO manages restricted funds for market participants, consisting 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, 2014, the market value of these funds was \$337.5 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 0.04% in 2014.

MARKET FUNDS	Q1-2014	Q2-2014	Q3-2014	Q4-2014
Balance (quarter end)	\$296.4 million	\$290.5 million	\$262.6 million	\$337.5 million
Total return (for the quarter)	0.01%	0.01%	0.01%	0.01%
Yield to maturity (qtr end)	0.04%	0.04%	0.04%	0.05%
Duration (quarter end)	0.0 years	0.0 years	0.0 years	0.0 years

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 Employee Pension Benefit Committee and the Board 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, 2014, the market value of the trust was \$9.1 million and the custody account was \$11.5 million. The portfolios returned 2.73% 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.

RETIREE MEDICAL PLAN FUNDS	Q1-2014	Q2-2014	Q3-2014	Q4-2014
Balance (quarter end)	\$20.3 million	\$20.9 million	\$20.5 million	\$20.6 million
Total return (for the quarter)	1.11%	3.32%	-2.05%	0.39%