Memorandum

To: ISO Board of Governors

From: William J. Regan, Jr., Chief Financial Officer

Philip Leiber, Treasurer & Director of Financial Planning

Ben Arikawa, Sr. Consultant

cc: ISO Officers

Date: March 1, 2007

Re: **Authorization for Bond Issuance**

This memorandum required Board action.

EXECUTIVE SUMMARY

We are now presenting the proposed $60 million bond issuance for Board review and approval. Bond proceeds ($52 million) will be used to fund MRTU ($50 million) and other capital expenditures ($2 million), consistent with the briefing provided January 25, 2007. The balance of the issuance will be used to fund a debt service reserve, capitalized 2007 interest, and issuance costs. The structure of the new bonds will be the same as CAISO's existing bonds: variable rate demand bonds with a swap of at least 60% of the principal amount to a fixed rate. The bonds will be supported by a bank liquidity line provided by Bank of America/JPMorganChase and bond insurance provided by AMBAC.

We request that the Board of Governors adopt the following issuance resolution:

Borrowing Resolution (2007-03-07)

MOVED, that the Chief Executive Officer or the Chief Financial Officer of the California Independent System Operator Corporation (CAISO) be, and they hereby are, authorized and empowered, in the name and on the behalf of the CAISO, to perform the following:

- ***Issue variable rate demand bonds in an amount not to exceed $60,000,000 through the California Infrastructure and Economic Development Bank.***

- ***Borrow money, incur other obligations and guarantee the obligations of the CAISO in an amount not to exceed $60,000,000, and in furtherance thereof to execute and deliver from time to time any note or other instrument evidencing indebtedness or other obligations of the CAISO, including related***

agreements and documents and guarantees of obligations or endorsements of notes, when deemed by them to be in the best interests of the CAISO, at a rate or rates of interest, and upon such other term or terms as shall be agreed upon by such officers.

- ***Procure a standby bond purchase agreement for a term not to exceed three years at a cost not to exceed 18 basis points annually plus other associated expenses.***

- ***Procure a bond insurance policy at a cost not to exceed 50 basis points of principal and interest paid over the life of the bonds and other associated expenses.***

MOVED FURTHER, that Management be authorized and directed to take any and all actions necessary and appropriate to execute an interest rate swap to partially hedge the bonds and provide for synthetic fixed rate debt for not less than 60% and up to 100% of the outstanding bond principal amount.

MOVED FURTHER, that with respect to any single transaction covered by the foregoing motions, the Chief Executive Officer or the Chief Financial Officer of the CAISO may delegate in writing to any one or more Officers of the CAISO the power to sign such instruments, agreements or other documents on his or her behalf as may be required to effectuate such transaction.

BACKGROUND AND OVERVIEW

The proposed $60 million bond offering will fund the completion of the MRTU program scheduled for implementation on January 31, 2008[1] and provide funding for approximately $2 million of other capital expenditures. Other bond proceeds will be used to pay issuance costs, 2007 capitalized interest, and establish a debt service reserve fund of $6 million.

Bond Proceeds ($ in millions)	**Amount**	**Comments**
Construction Fund	$52,255,000	$50.1 million for MRTU and $2.15 million for other capital expenditures.
Debt Service Reserve Fund	6,000,000	This amount is borrowed, but is deposited with the Bond Trustee. It is available to CAISO to offset debt repayment requirements in the final year the bonds are outstanding.
Capitalized 2007 Interest Costs	570,000	The CAISO 2007 Revenue Requirement anticipated $1.5 million in interest costs. Scheduled interest cost above that level for 2007 will be funded from bond proceeds.
Costs of Issuance	1,175,000	Costs of issuance include bond insurance premium, counsel, underwriter's fees, and other miscellaneous issuance costs.
Total	$60,000,000	

The objectives of the proposed bond offering are to:

- Provide bond proceeds to meet the known funding requirement for completion of MRTU Release 1;
- Structure debt service consistent with a stable-to-declining bundled GMC rate of $0.76 or less over the next several years;
- Match the "benefits" and "burdens" of CAISO spending by recovering the costs of CAISO system infrastructure from the users of the infrastructure over a period of time that approximates the reasonably expected useful life of those assets;
- Obtain a low-cost, low risk funding source; and
- Have funding available near the date when the existing 2004 bond proceeds are fully spent.

We filed for authorization for the proposed financing in a Section 204 application with FERC on February 9, 2007, and with the conduit issuer on February 13, 2007. We have established a financing team consisting of the following parties:

[1] As presented at the January Board meeting, CAISO requires additional funding to complete the MRTU program. The funding requirement of $50.1 million represents the difference between the December 2006 approved $189.2 million project budget and the $139.1 million estimate that was the basis for the December 2004 bond offering.

Underwriter:	Bank of America (lead), JPMorgan (co-underwriter)
Conduit Issuer:	California Infrastructure and Economic Development Bank
Bond Counsel:	Orrick, Herrington & Sutcliff
Corporate Counsel:	Stradling, Yocca, Carlson & Rauth
Bond Insurer:	AMBAC
Liquidity Banks:	Bank of America and JPMorganChase (each with a 50% share)
Pricing Agent:	Sperry Capital/Bond Logistix
Bond Rating Agencies:	Standard & Poor's and Moody's

SUMMARY OF BOND STRUCTURE AND IMPACT ON CAISO RATES & REVENUE REQUIREMENT

The type of bonds to be issued are the same as CAISO's existing Series 2000 and 2004 debt, and will have a term of six years. The bonds will be variable rate demand obligations that bear interest weekly. The weekly interest rates are set by remarketing agents who act as dealers for the bonds. Investors (typically tax-exempt money market funds) can "put" the bond back to the remarketing agents if they decide to dispose of the bond. Banks provide a standby bond purchase agreement (SBPA) to assure investors that funds will be available to repay their investment if the remarketing agent is unable to sell the bonds to alternate investors. The bonds will be supported by a debt service reserve, in the same manner as for CAISO's 2004 bonds. To protect CAISO from interest rate volatility, we will enter into an interest rate swap agreement covering 60-100% of the outstanding par value of the bonds.

The following summary table lists the annual debt service, operating reserve requirements, and net impact on CAISO's Revenue Requirement of the bond issuance. Management has structured the bond repayments from 2007-2012 to facilitate achieving the goal of a stable to declining bundled GMC. Higher amortizations of the proposed 2007 bonds in 2010-2012 are offset by reductions in debt service on the ISO's existing (Series 2000/Series 2004) bonds, which are fully retired by February 2010.

BOND FINANCIAL SUMMARY

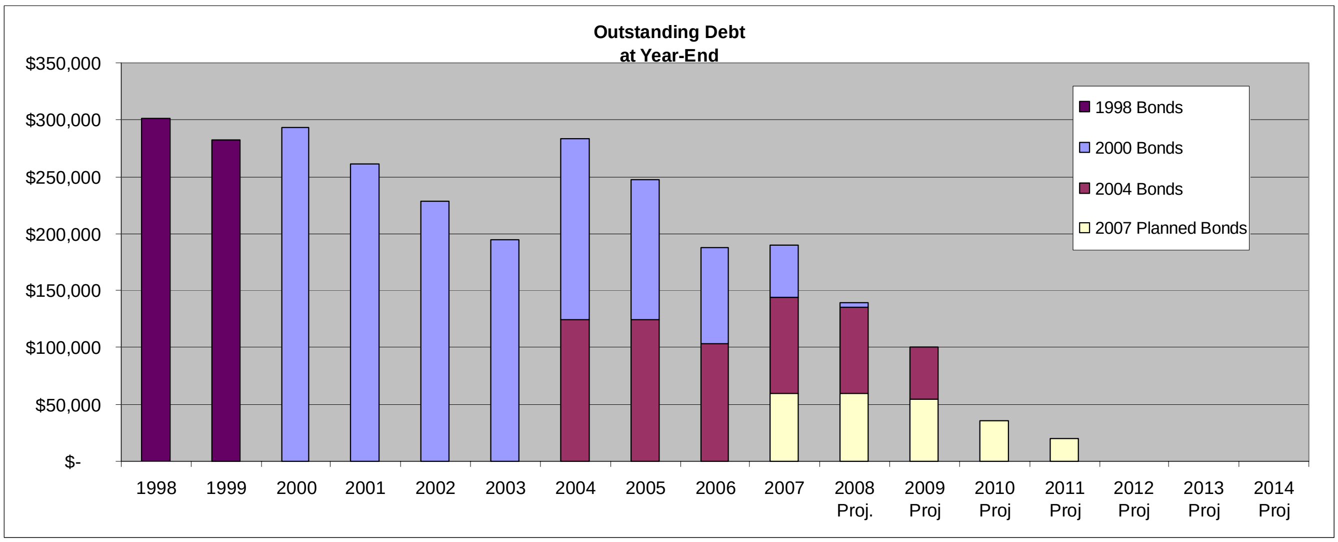
$ in thousands	(a)	(b)	(c)	(d)	(e)	(f)	(g)
Year	New Bond Debt Service-Principal	New Bond Debt Service-Net Interest	Release of DSRF	New Bond Debt Service-Total	Operating Reserve Collection (25% of debt service)	Operating Reserve Credit from Previous Year	Net Impact of Debt Service on Revenue Requirement
Rate Collection Year 2007, Debt Repayment Date 4/2008	-	$1,114		$1,114	$ 279	-	$1,393
Rate Collection Year 2008, Debt Repayment Date 4/2009	-	2,331		2,331	583	(279)	2,635
Rate Collection Year 2009, Debt Repayment Date 4/2010	5,500	2,331		7,831	1,958	(583)	9,206
Rate Collection Year 2010, Debt Repayment Date 4/2011	19,000	2,094		21,094	5,274	(1,958)	24,410

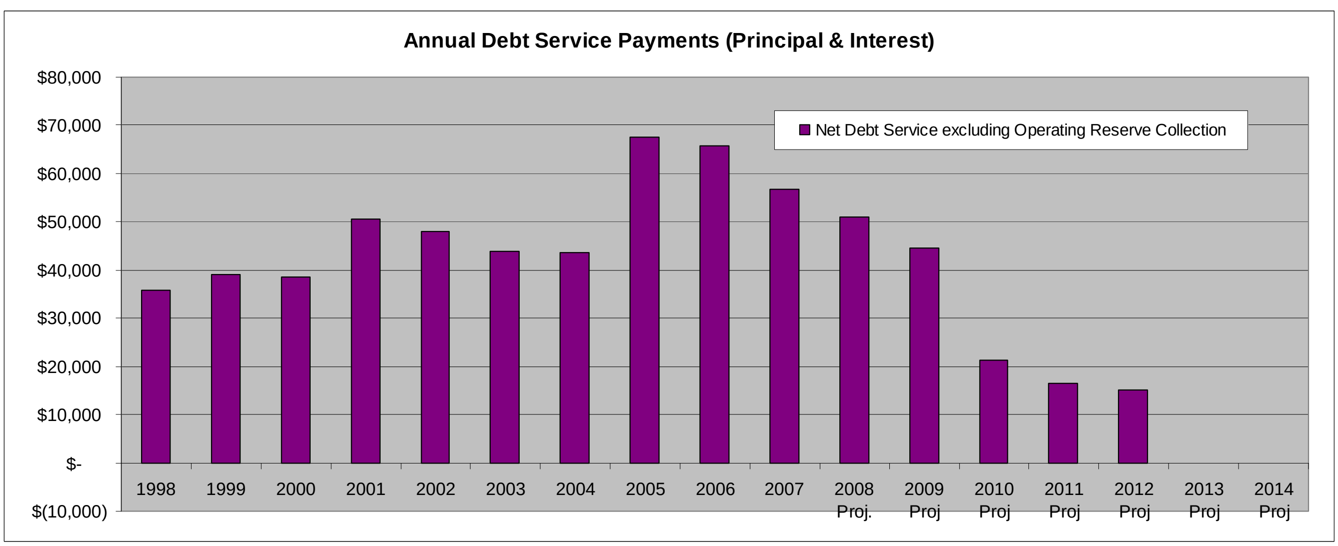
Rate Collection Year 2011, Debt Repayment Date 4/2012	15,300	1,274		16,574	4,144	(5,274)	15,444
Rate Collection Year 2012, Debt Repayment Date 4/2013	20,200	872	(6,000)	15,072	3,768	(4,144)	14,697
Total	$60,000	$10,016	$ (6,000)	$ 64,016	$ 16,004	$ (12,236)	$67,784

Notes:

- Figures above are subject to minor change based on the final bond pricing and amortization schedule.

The following charts illustrate outstanding debt at year-end and annual debt service (principal and interest) payments for the outstanding and planned 2007 bond issuance. Even with the new bonds, outstanding debt at the end of 2008 will be lower than in past years, and annual debt service payments will be lower than in 2005-2006.





DISCUSSION ON BOND STRUCTURE

Assurance of Repayment- Pledge of CAISO GMC Revenues and the Debt Service Reserve

The bonds are backed by a pledge of ISO GMC revenues, on parity with the pledge of GMC revenues that supports the existing bonds. The bonds will also be supported by a debt service reserve ("DSRF") fund of $6 million, which is 10% of the par value of the bonds. The DSRF funds will be used to pay debt service in the last year the bonds are outstanding (2013). The DSRF provides additional assurance to creditors (including the bond insurer, discussed later) that CAISO will be able to meet required principal and interest obligations. There is no net cost to CAISO for maintaining this DSRF, as the DSRF funds will be invested and will likely earn interest at or above CAISO's borrowing rate. Bondholders also have assurance of interest and principal payments through a bank standby bond purchase agreement and bond insurance. The cost of this credit support is funded by CAISO, and is described below.

Credit Enhancement: Bond insurance and Bank Standby Bond Purchase Agreement

Credit enhancement means a third party provides some assurance of payment of CAISO's obligations in exchange for a payment from CAISO. CAISO benefits from credit enhancement to the extent that the interest savings exceed the cost of the credit enhancement. CAISO investigated different bond structures and determined that variable rate demand bonds, which require credit enhancement, were the most economic. Variable rate demand bonds require two forms of credit enhancement: assurance of ultimate payment and a liquidity arrangement. These two forms of credit enhancement may be procured separately in the form of bond insurance and a standby bond purchase agreement, or together in the form of a bank direct pay letter of credit. CAISO explored both alternatives and found the option of bond insurance and a standby bond purchase agreement more cost effective.

Bond insurance provides prospective bond investors with the highest degree of assurance against losses on their investment. The bond insurer guarantees ultimate payment of principal and interest to investors, and as a result, investors can rely on the insurer's AAA/Aaa credit rating rather than the bond issuer's rating.

The ISO solicited bids from five bond insurers, including MBIA and AMBAC, which each insure a portion of CAISO's existing debt. Four insurers responded and submitted offers of bond insurance. The pricing of three of the four offers was lower than price CAISO paid for the 2004 bond insurance. We selected AMBAC on the basis of the lowest submitted bid.

In addition to bond insurance, variable rate demand obligations require a bank liquidity line of credit (standby bond purchase agreement or "SBPA"). As short-term investors, the bond purchasers are entitled to "put" the investment they purchased back to the dealer (remarketing agent) on weekly basis. The remarketing agent then attempts to find another investor for the bond. If this is not possible, the banks providing the liquidity line would be required to purchase the bonds. The SBPA ensures that there will be a liquid market for the bonds at all times, and that CAISO would not need to repurchase the bonds prior to their scheduled retirement dates.

CAISO approached the existing two providers of the SBPA for the 2000 and 2004 bonds, Bank of America and JPMorganChase. This bank group made an attractive offer for 364-day and

3 year facilities, with the pricing substantially lower than the cost for CAISO's existing 2000 and 2004 SBPA facilities.

CAISO Credit Ratings and Bond Ratings

CAISO Management met with representatives of Moody's and Standard & Poor's during January and February to discuss the proposed financing and to provide an update regarding CAISO. These agencies assign two ratings of importance to CAISO. The first is an underlying rating that applies to CAISO's corporate obligations. S&P has reaffirmed its rating of BBB+ rating with a positive outlook, indicating it anticipates an upgrade of the rating upon the successful implementation of MRTU. Moody's has increased CAISO's rating from A3 to A2. Those ratings are important in this transaction as it affects the pricing of the bond insurance and bank liquidity.

The second rating assigned by Moody's and Standard and Poor's applies to the bonds. The rating of CAISO's 2000/2004 bonds is AAA/VMIG-1 and AAA/A-1+ , respectively, and we expect the 2007 bonds will receive the same high ratings. These high debt ratings are based on the credit support provided by the bank liquidity and the bond insurance, and represent the credit strength of the banks and insurer.

Interest Rate Swap

The ISO is issuing "variable rate demand bonds" with interest rates that fluctuate weekly. Because we do not want to retain 100% exposure to floating short-term interest rates (which can be volatile and could increase if the Federal Reserve decides to continue to increase rates to control inflation), Management recommends the procurement of an interest rate swap to eliminate some of this exposure. CAISO's existing debt is approximately 60% hedged in this manner. With the interest rate swap, CAISO agrees to pay fixed interest rate on a notional principal amount in exchange for a variable payment stream calculated as a variable interest rate index times the notational principal amount. The variable payment stream CAISO will receive will closely match the interest payable on the ISO bonds. The notional principal amount specified in the swap decreases as the bonds are retired over the next six years. The net result of this is that the ISO achieves a "synthetic fixed rate" for a portion of its variable rate bond program.

Management recommends obtaining an interest rate swap to cover between 60%-100% of the 2007 bonds. CAISO's past retention of some variable interest rate exposure has resulted in substantial interest cost savings, as since 2000, short-term interest rates have been below the price at which we could have obtained fixed rate bonds in the year 2000 and 2004 issuances. However, there is the need to balance those potential prospective savings against the possibility that short-term interest rates could increase significantly[2]. Additionally, the current pricing on a five year interest rate swap is attractive--as of February, the rate for a 5 year swap was 3.6%, while the short-term BMA index rate was 3.65% (and average BMA index interest rates have been 3.46% since January 2006). If this relationship holds, Management may elect to obtain a swap for closer to 100% of the bonds. This determination

[2] Short-term interest rates have historically been below longer-term rates. However, currently, the yield curve is much flatter than usual, with short-term rates comparable to longer term rates.

will be made closer to the closing date of the transaction, currently planned for on April 5. To ensure that the fixed interest rate that CAISO will pay to the swap counterparty is reasonable, we will use the services of a "pricing agent" with swap expertise to assist CAISO in reaching a negotiated rate or holding a competitive process with at least two swap counterparties.

NEXT STEPS

Management is preparing for issuance of the bonds on April 5, 2007. Drafting of bond related documents is ongoing as of the date of this memorandum. The final version of these documents will be in substantially the same form as those from CAISO's existing Series 2004 bonds and will be consistent with this memorandum. Final documents including the Official Statement, Loan Agreement, Indenture of Trust, Standby Bond Purchase Agreement and Insurance Agreement will be made available for Board review prior to the close of the transaction. A copy of the draft of the official statement relating to the proposed bonds is attached for your information.[3]

The proposed issuance will also be submitted for approval to the Board of the conduit issuer of the bonds, the California Infrastructure and Economic Development Bank, on March 21. Additionally, we recognize that FERC approval of our Section 204 application (authorization for bond issuance) is pending CAISO Board approval of the transaction.

BOARD ACTION REQUESTED

Management requests that CAISO Governing Board approve the transaction as outlined above by adopting the proposed resolution. In sum, the transaction includes:

- A $60,000,000 bond issuance.
- Procurement of a three-year standby bond purchase agreement at a cost of 18 basis points and other associated costs.
- Procurement of a bond insurance policy at a cost not to exceed 50 basis points of principal and interest paid over the life of the bonds and other associated expenses.
- Authorization to enter into an interest rate swap agreement to cover not less than 60% and up to 100% of the outstanding principal of the proposed bonds.

[3] With the exception of: (i) information that will not be available until the bonds (or the swap, as the case may be) are close to being finalized, (ii) information that relates exclusively to other parties (Ambac and the counterparty to the swap), and (iii) the insertion of documents being prepared by bond counsel (a summary of the legal documents and the form of the legal opinion of bond counsel), we do not expect that there will be any material changes between this draft version and the final version of the Official Statement. Should that occur, we will so advise and will seek your further approval as may be necessary and appropriate.