Memorandum

To: ISO Board of Governors

From: Ryan Seghesio, Vice President, Chief Financial Officer & Treasurer

Date: December 9, 2020

Re: **Decision on Refinancing of 2013 Bonds**

This memorandum requires Board action.

EXECUTIVE SUMMARY

Currently, $163.4 million of principal remains outstanding on the ISO's 2013 bond issue. These bonds can be called, (i.e., redeemed early) at the ISO's discretion on February 1, 2023. Given the dramatic decrease in the level of interest rates since these bonds were issued in November 2013, it appears likely that it would be advantageous to the ISO to exercise this call feature and refinance the debt outstanding in 2023. That, however, depends on the level of interest rates two years from now, which of course is unknown and can depend on many factors.

Interest rates are currently at historic lows. Management thus proposes to execute a taxable advance refunding bond issue as soon as possible to lock in the current level of interest rates and guarantee significant savings over 2013 rates. Contingent on interest rates at the time of issuance, the refinancing is currently projected to achieve approximately $1.6 million in annual savings, and over $19 million in net present value savings over the remaining 18 years that the bonds will be outstanding.

Accordingly, Management requests that the Board authorize to move forward to the bond offering as set forth in the following resolutions:

> ***Moved, that the ISO Board of Governors approves, authorizes and directs Management in the name and on the behalf of the ISO, to perform the following actions:***
>
> ***Issue a fixed-rate bond in the amount not to exceed $177 million through the California Statewide Communities Development Authority with a term not to exceed 18 years to refinance the acquisition or development of the Iron Point Facility, other related building infrastructure costs, capitalized interest, debt service reserve funds, and bond issuance costs, through the***

refunding of bonds issued in 2013 (the "2013 Bonds") in order to achieve debt service savings;

Incur other obligations and guarantee the obligations of the ISO in connection with the Bond Offering and in furtherance thereof to execute and deliver from time to time any note or other instrument evidencing indebtedness or other obligations of the ISO, including related agreements and documents and guarantees of obligations and endorsements of notes, when deemed to be in the best interest of the ISO;

Transfer amounts collected for the February 1, 2021 debt payment relating to the 2013 Bonds to the escrow fund relating to the Bond Offering;

Distribute a preliminary official statement and an official statement relating to the marketing and sale with respect to the Bond Offering; and

Take any and all other actions necessary to effectuate the Bond Offering.

DISCUSSION AND ANALYSIS

Original issuance

In July 2009, the ISO issued $200 million of tax-exempt bonds through the California Infrastructure and Economic Development Bank to finance the (i) design and construction of the new headquarters building, (ii) acquisition or development of computer hardware and software systems and other capital expenditures, and (iii) other related costs of issuing debt. The bonds were structured to mature over 30 years with average annual debt service payments of approximately $14.8 million. The all-in true interest cost of the debt was 5.88% per annum.

Tax-exempt advance refunding

In November 2013, the ISO issued $191.8 million of tax-exempt bonds through the California Infrastructure and Economic Development Bank to advance refund the 2009 bonds. Advance refundings are used to refinance bonds prior to a call date. The bonds were structured to mature over 26 years, matching the maturity schedule of the 2009 bonds, with average annual debt service payments of approximately $13.5 million. The all-in true interest cost of the debt is 4.48% per annum.

The 2013 bonds were sold with a 10-year call feature, giving the ISO the discretion to redeem some or all of the outstanding bonds on February 1, 2023, at their face value (100%). The ISO chose to include this call feature in the bond financing structure to give us the flexibility should interest rates make the decision beneficial. This now represents a significant value to the ISO given the drop in interest rates since 2013.

The call cannot be exercised until the call date; therefore, there is risk that if interest rates rise over the next two years, the call could become less appealing.

Current market conditions

Interest rates have fallen to historically low levels in 2020, largely due to the economic disruptions stemming from the coronavirus pandemic. Furthermore, over the last several years, the yield curve has flattened substantially due to Federal Open Market Committee actions and contained long-term inflation expectations. Both situations present very attractive refinancing options for issuers of long-term debt.

Taxable advance refunding today

In the municipal bond market, issuers commonly utilize advance refundings to refinance debt. An advance refunding would allow the ISO to issue new debt at today's lower interest rates, and then use the proceeds to establish an escrow account of U.S. Government securities that would pay off the old debt on February 1, 2023 (the call date). The escrow account would also pay the debt service obligations due prior to the call date.

An advance refunding is subject to inefficiencies due to the negative arbitrage caused by the current low U.S. Government security interest rates compared to the higher interest costs on the new borrowing. For example, as stated earlier, the proceeds of the new bond issue would be invested in U.S. Treasury bonds with maturities of approximately two years (escrow would have to be liquid by the call date) which currently yield 16 basis points, or 0.16%. This is significantly lower than the current estimate of where we can price bonds at today, approximately 2.6%.

Despite the inefficiencies of this approach, interest rates have fallen enough, and the time to the call date is short enough for this approach to result in positive savings. An advance refunding could be executed today at approximately 2.6% all-in true interest cost, resulting in approximately $1.3 million in savings on our average annual debt service. The total net present value of savings to be achieved over the remaining 18 years of the bonds would be approximately $19.1 million. Additional savings of approximately $0.3 million per year would be realized on the lower tariff-required 25% debt service reserve. An advance refunding removes interest rate risk over the next two years that the ISO would be exposed to if we chose to wait until the call date.

Internal Revenue Service regulations around tax-exempt financings only allow issuers to advance refund a bond issue once with tax-exempt bonds; therefore, a taxable advance refunding is our only option. However, taxable rates have fallen even greater amounts in 2020 than tax-exempt rates, and for much of the second half of the year, have been at lower levels than tax-exempt levels. This presents a unique opportunity to convert the ISO's debt to a taxable structure at very efficient levels. There are also other advantages of converting to a taxable structure as described in the next section.

Benefits of taxable debt and other refinancing advantages

In addition to annual financial savings, there are several other benefits the refinancing will provide the ISO. First, the new issue will be an unsecured corporate note, a common structure in the taxable market. This structure relieves the ISO of pledging the Iron Point building and operating revenues as part of the bond deal. Pledging these assets adds costs and complexity to the financing as well as cumbersome administrative responsibilities for no material benefit.

Second, converting to a taxable structure relieves certain restrictions associated with tax-exempt financings. One of these is the efficient use of software between the Iron Point facility and the Lincoln Operations Center. The Lincoln Operations Center did not exist at the time of the 2013 refinancing; therefore, it is not named in the tax certificate as an acceptable site for which bond financed assets can be used. There is a formula that allows for certain usage, although, there is a complex manual tracking of this process that is performed by ISO personnel to ensure we do not exceed the allowance. The refinancing will remove this restriction and allow for more efficient use of software between the sites.

Another restriction that will be lifted is the private use of the Iron Point Facility. Tax-exempt financed buildings have tight restrictions on any use of the building for private use, essentially use by entities other than the ISO. While not a major factor, a taxable bond offering would offer greater flexibility to allow meetings by outside groups.

FERC – Section 204 filing

The ISO made the required Federal Power Act Section 204 filing with FERC on November 5, 2020. The request for approval to issue securities was contingent on the Board's approval at this meeting. We have asked FERC for a ruling by January 5, 2021. This date will correlate with other bond issuance processes setting the ISO up to potentially issue the bonds the week of January 11th.

CONCLUSION

Management recommends that the Board approve the execution of the advance refunding bond issue. The refinancing will provide immediate annual savings to stakeholders as well as other benefits to ISO operations.

Upon approval, Management will continue to work with the outside parties associated with the bond issuance to prepare for an early January pricing and issuance. The current market conditions at that time will be assessed by Management before final execution.