California Independent
System Operator

Memorandum

To: ISO Board of Governors

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

Philip Leiber, Treasurer & Director of Financial Planning

Date: January 18, 2008

Re: Decision on Reimbursement Resolution and Briefing on 2008 Proposed Bond Issuance

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This memorandum requires Board action.

Executive Summary

This memorandum provides an overview of a proposed bond issuance for May 2008 that would provide $60 million in funding for 2008-2009 capital projects. The bonds would be amortized over six years and would permit a bundled Grid Management Charge ("GMC") rate consistent with the target of $0.76 per MWh. The total face value of the bonds would be approximately $70 million, including $60 million for 2008-2009 capital projects, $3 million for issuance costs and capitalized interest, and $7 million for a debt service reserve fund (which would be used to offset final year debt service costs). Management intends to submit a Section 204 application with Federal Energy Regulatory Commission ("FERC") in February requesting authorization for the bond issuance. Management will provide an update of the proposed structure (type of bond, composition of financing team, etc.) and will request Board approval for the bond issuance at the March Board meeting.

Filing a Section 204 application with the Federal Regulatory Energy Commission ("FERC") notifying it of the proposed bond offering conditioned upon Board approval is prudent from a timing prospective, and has proven a successful approach in previous CAISO bond offerings. Proceeding in this manner allows concurrent consideration by the CAISO and FERC, with ample time for FERC to review the proposed issuance and to raise any concerns it may have before a final Board approval, thus avoiding the need to potentially return to the Board for a second approval. Further, this approach allows the Board to raise its concerns related to the offering and provide Management with the time necessary to address any such concerns from the Board. By presenting the proposed bond issuance to the Board at this time, Management is seeking Board recommendation and input. Thus, if and when the Board approves the bond offering during the March session, it will be approving a bond issuance with specific information consistent with the level of detail required to be presented to the Board.

Management also requests that the Board approve a "reimbursement resolution" enabling CAISO to use the proposed bond proceeds to pay back CAISO corporate funds in the event the latter are spent on capital needs prior to the availability of the bond funds.

Background and Proposed Financing

Funding Need

The proposed bond issuance will provide funding for 2008/2009 capital needs while facilitating the maintenance of the GMC at approximately 76 cents over the next several years. Capital needs for 2008 and 2009 are consistent with the spending forecasts identified in the 2007-2011 business plan, which were further validated in the 2008 capital budgeting process. The 2008 capital budget of $30 million (presented and approved by the Board in December 2007) reflects several important categories of projects including Compliance/Regulatory Requirement (Market Design Enhancements including convergence bidding and scarcity pricing), essential projects (including an Energy Management System operating system upgrade), strategic initiatives (including Payment Acceleration) and Future Market System Enhancements (placeholders for work on several applications). Approximately $22 million of the $30 million capital budget for 2008 will be funded from the proceeds of the bond issuance. The remainder of the $60 million in bond funds will be used to fund capital projects in 2009.

Objectives

The objectives of the proposed 2008 bond offering are to:

- Provide bond proceeds to fund capital funding needs over the next two years;
- Structure debt service to meet our goal of maintaining a stable 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 (CAISO’s capital spending needs in 2008/2009 are anticipated to be higher than we expect they will be in subsequent years, and according, are most appropriately funded over several years consistent with this principal; and
- Obtain a low-cost, low risk funding source.

Recommended Bond Structure

Management has discussed financing alternatives with several firms including JPMorgan and Bank of America (which have assisted CAISO in past transactions) as well as Wells Fargo and Royal Bank of Canada. These firms have provided a range of useful ideas to help CAISO meet the objectives noted above, and Management will pursue a structure that best meets those objectives. There is currently a significant amount of volatility in the financial markets due to the continued fall-out from the sub-prime mortgage situation. Such events have particularly affected the pricing, availability and the attractiveness of credit enhancement provided by bond insurers, and this also has an impact on the relative merits of the different bond structure alternatives. We will continue to evaluate alternatives over the next several weeks. We will work with the financing team to structure and issue bonds with the following characteristics:

- *Bond type*: At present, the optimal structure appears to be tax-exempt, variable rate demand bonds (“VRDBs”). This is the same type of debt as CAISO’s existing Series 2000, 2004 and 2007 bonds A particular advantage of VRDBs relates to the minimal disclosures required in the bond official statement. Fixed rate bonds, which were also considered, require a full-disclosure official statement which is more costly to prepare. Another structure, auction rate securities, was a potential option in earlier transactions, but is not viable currently given certain concerns and fallout from the sub-prime mortgage situation.

- *Term*: Final maturity: 2014, a six year term.

- *Amortization Schedule*: Management will finalize an amortization schedule for the new bonds that will, in conjunction with other projected CAISO spending, support a stable overall bundled GMC rate of about 76 cents. This is further discussed in the subsequent section of this memorandum entitled “Impact on Projected GMC Rates”.

- *Credit Enhancement:* CAISO's existing three series of bonds (2000, 2004, and 2007) are variable rate demand bonds backed by bond insurance and a standby bond purchase agreement. An alternative structure, a bank letter of credit, was the form of credit enhancement used for CAISO's initial 1998 financing. This latter approach will likely be the preferred form of credit enhancement for variable rate demand bonds issued this year unless concerns about the bond insurers are resolved in the next several weeks.
- *Interest Cost*: We anticipate an all-in interest cost of approximately 4%. This includes ongoing interest and other bond support costs, and amortization of issuance costs over six years.
- *Fixed vs. Variable Interest Rate Exposure*: CAISO retained exposure to variable interest rates for about 35% of its 2000 and 2004 bonds, taking advantage of short-term interest rates that are lower than longer term rates in the tax-exempt market. For the 2007 bonds, CAISO obtained an interest rate swap to fix the interest rate for the full value of those bonds, taking advantage of a favorable pricing opportunity. We will consider interest rate and swap market conditions for this transaction nearer to the time of issuance, and retain not more than 40% variable interest rate exposure for these bonds.
- *Establishment of a debt service reserve fund ("DSRF")*: CAISO's 2004 and 2007 bonds have a DSRF, and this is also considered necessary to interest bond investors in this offering. This structure is typical in municipal "revenue bond" (as opposed to general obligation bond) transactions. A DSRF would be available to pay debt service in the event of CAISO financial difficulties, or would be used to pay debt service in later years. The DSRF will result in the issuance of bonds in an amount that exceeds the amount CAISO as bond fund proceeds. The excess amount, approximately 10% of the issuance amount, is maintained as a separate investment by the bond trustee, and would be used to meet interest or principal payments if CAISO is unable to do so.
- *Face Value of Bonds*: CAISO will issue bonds with a face value of approximately $70 million (providing for $60 million for 2008/2009 capital expenditures funding needs, $3 million for costs of issuance and capitalized interest in 2008, and $7 million as a DSRF).
- *Financing Team:*
    - *Underwriter Responsibilities*: CAISO requested proposals from four firms (and received three responses) to serve as senior underwriter for the issuance, and will select the firm that offers the best combination of anticipated service and cost. As with previous issuances other firms may serve as co-underwriters. CAISO may request that two firms serve as co-underwriters for the issuance, with each firm responsible the initial placement of a portion of the total amount issued, and subsequently serving as "remarketing agents" for the bonds (setting the periodic variable interest rates and serving as a dealers for the bonds). JPMorgan and Bank of America each co-managed a portion of the 2004 and 2007 bonds.
    - *Credit Enhancement Alternatives:*
        - *Letter of Credit*: Credit enhancement and a liquidity facility are necessary for a variable demand bond offering. A bank letter of credit serves both purposes, and at this time we anticipate we will procure such a letter of credit versus the option of bond insurance and a standby bond purchase agreement. A bank letter of credit is anticipated to be less costly than the option of using bond insurance and a standby bond purchase agreement.

- *Bond Insurance with a Standby Bond Purchase Agreement*
  - *Bond insurance*: Bond insurance could also serve as the credit enhancement for the VRDB bond structure anticipated. Management will solicit several bond insurers to provide such credit support for the new issuance. The market for bond insurance is currently very uncertain given the continuing story of the bond insurer's exposure to sub-prime mortgage debt, and this will affect the cost, availability and attractiveness of bond insurance. A disadvantage of bond insurance versus a letter of credit is that bond insurance must be paid in full up-front, and if the bond insurer were downgraded or becomes insolvent, it would be necessary for CAISO to pay for replacement credit enhancement. The costs of a letter of credit option are payable quarterly while the bonds are outstanding, avoiding this risk. Given the problems the bond insurers have had due to sub-prime mortgage exposure, this is a real possibility that must be considered in this decision.
  - *Standby Bond Purchase Agreement*. With bond insurance, a bank standby bond purchase agreement (a form of a limited letter of credit) could serve as the liquidity facility for the bonds. In the event that bond remarketing agents can not find willing investors to purchase the bonds, the bank would be required to purchase the bonds. CAISO's existing bonds (2000, 2004, 2007) have SBPAs provided by a syndicate of two banks, Bank of America and JPMorganChase.

- *Conduit Issuer*: Tax exempt bonds proceeds are available to a 501(c)(3) not-for-profit entity such as CAISO, but such bonds must be issued by a qualified issuer, a government entity. Management anticipates using the same conduit issuer CAISO used for 2000, 2004, and 2007 bond offerings, the California Infrastructure and Economic Development Bank, though Management will consider alternatives[1] if the need arises.
- *Legal Representation including Bond Counsel and Issuer Counsel*: We requested proposals from several legal firms to potentially serve as bond counsel (which will represent the interests of the Conduit Issuer) and issuer counsel (which will represent the interests of CAISO). We have tentatively selected Stradling, Yocca, Carlson & Rauth as bond counsel (subject to conduit issuer approval), and Hawkins, Delafield & Wood to serve as issuer counsel.
- *Swap Counterparty*: Management believes it prudent to limit company exposure to variable interest rates, as noted above. If CAISO issues variable rate demand bonds, we would enter into an interest rate swap to retain not more than 40% exposure to variable interest rates. We will conduct a swap bidding process to select the swap provider.

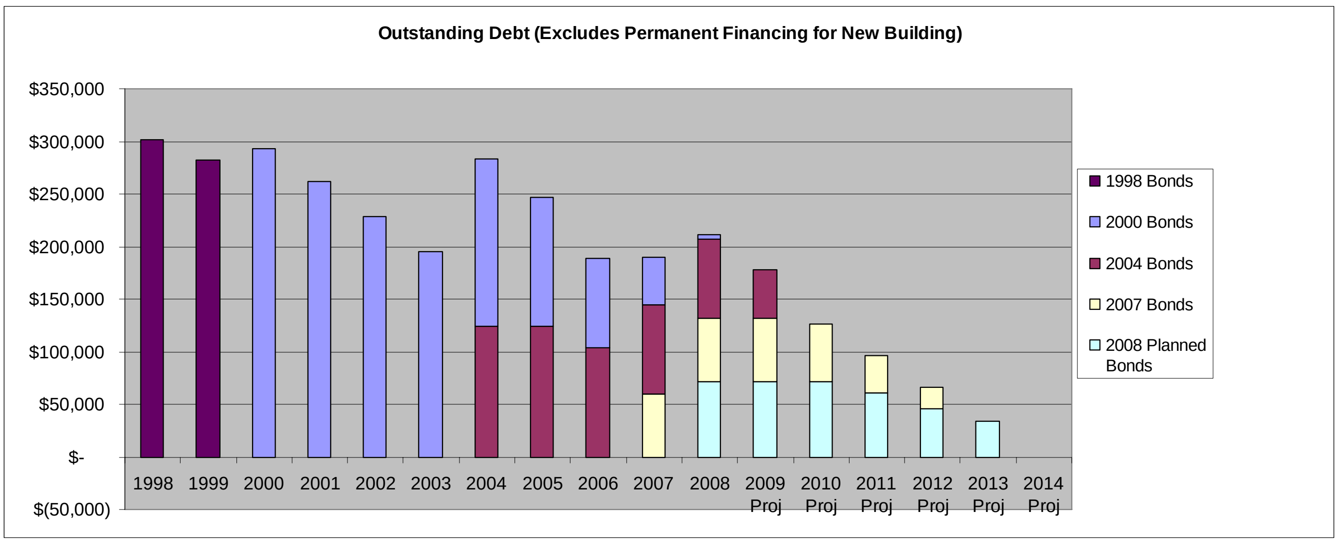
Assurance of fair pricing and other transactional advice: CAISO utilized the services of a "pricing agent" in previous bond transactions to assist CAISO in various aspects of the transaction. In 2007, we retained Sperry Capital to assist CAISO in conducting a bidding process to select an interest rate swap provider and to obtain investments for the bond construction fund (where bond proceeds are invested until drawn by CAISO for spending needs), and the debt-service reserve fund. The CAISO anticipates using a pricing agent for services of a similar scope for this transaction.

[1] Other potential issuers include the California Statewide Community Development Authority, the Association of Bay Area Governments, of the California Municipal Financing Authority. Considerations include cost, ability to accommodate our financing schedule and other factors.

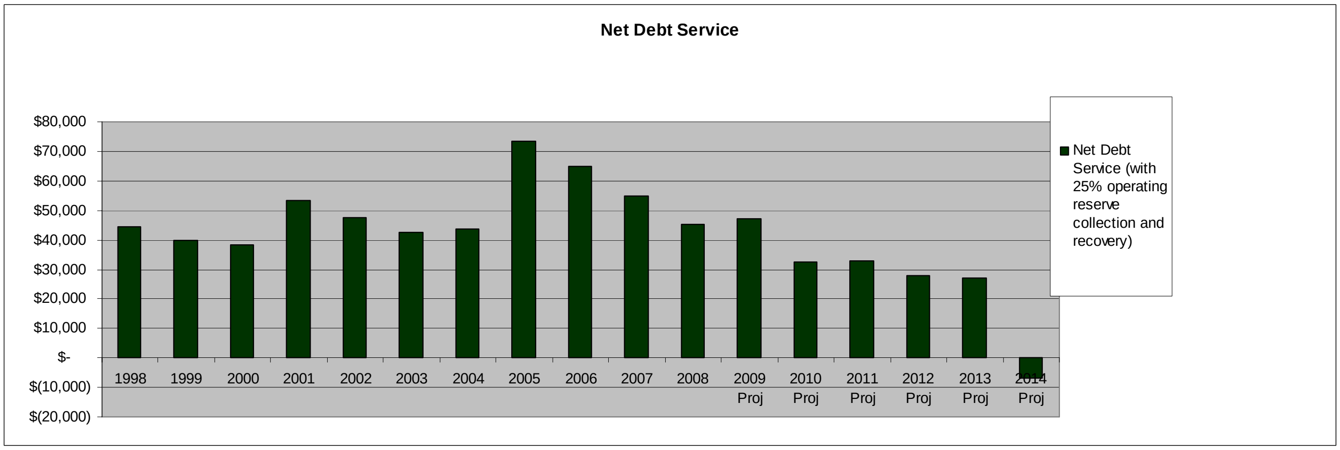
Impact on Projected GMC Rates

CAISO has prepared a financial projection[2] of the components of the Revenue Requirement to provide information useful in structuring the amortization schedule of the new bonds. Based on this projection, we have prepared a preliminary amortization schedule for the new proposed bonds that amortizes the debt over six years. There are no debt service costs for the 2008 bonds in included in the 2008 Revenue Requirement, based on the assumption that interest carrying costs will be funded from bond proceeds. Principal repayment takes place in 2011-2014, when there is no longer any debt service on CAISO's existing Series 2000 and 2004 bonds, which are retired by April 2009, and February 2010 respectively. This financial projection results in a bundled GMC rate consistent with the target of about $0.76 per MWh throughout the projection period.

We note that this rate and revenue requirement projection may be impacted by the effect of funding the new facility, if approved by the Board. There may be some incremental impact of the new building on the revenue requirement, and this will depend on the final building cost estimate and debt service terms for the mortgage (principal repayment schedule and interest rates) compared with the baseline costs "continue leasing" approach (with appropriate upgrades to provide for an appropriate comparison).



[2] Assumptions include:
- Debt Service and outstanding debt as shown in subsequent charts.
- O&M costs grow at 4% for salary/benefit related costs and 1.5% for other costs.
- Baseline/ongoing capital expenditures are funded on a pay-as-you-go basis through the Revenue Requirement after 2009.



Filing with FERC

Consistent with prior CAISO bond offerings and the method accepted by FERC, Management will file a Section 204 application with FERC seeking authorization to issue bonds. Within the application, CAISO explicitly notifies FERC that the bond issuance is conditioned upon Board approval. Further, CAISO informs FERC that assuming approval of the issuance is obtained from the Board, CAISO will then file a supplement to the application. Because of the level of detail necessary to be provided to the Board prior to Board approval of the bond, a filing with FERC is made prior to seeking Board approval. This provides FERC substantial time to consider the proposal and to raise any concerns it may have with the CAISO. Management can then address such concerns and modify the structure of the proposed bond offering. This helps to expedite the process and allows CAISO to use the Board's time efficiently. Thus, by the time Management seeks Board approval in March, details of the bond will have been finalized. Given that FERC is not required to respond within a certain period (although it normally provides a response within sixty days after the filing) Management will make such a filing in February to allow for a May 2008 bond issuance. (*See* Schedule discussion below.)

Schedule

Management anticipates completing the bond transaction in May 2008. The proposed high-level schedule has been developed with consideration of the following factors:

- Need for funding: The $30 million capital/project budget for 2008 will be funded from the $8.5 million capital/project element of the 2008 GMC revenue requirement until bond funds are available.
- Need for an achievable schedule for CAISO personnel and involved third parties, including underwriters, attorneys, the conduit issuer, and others.
- Sequence and length of required steps in the process including assembling a financing team, obtaining regulatory (FERC) approval, and other coordination with the conduit issuer and the CAISO Governing Board.

A high-level schedule for the proposed transaction follows, and a more detailed calendar is under development at this time.

Step	Date
Initial Discussion of Funding Needs During 2008 Budget Presentation	December 13, 2007
Further define funding needs and consider alternative bond structures	December/January
Begin assembly of financing team (Bond Counsel, Issuer Counsel, Underwriter, Rating Agencies, Bond Insurer, Liquidity Banks) and calendar	December/January
Initial Presentation of Financing Plan and request authorization of reimbursement resolution	January 28/29, 2008 Board Meeting
File Section 204 Filing with FERC requesting authorization to issue bonds conditioned upon subsequent Board Approval (FERC typically requires 60 days to act on such a filing)	February
Bond preparation work including structuring, coordination with bond insurers, conduit issuer, pricing agent, etc	February - March
Request for Board approval of bond issuance resolution	March 26-27, 2008
FERC Approval for Issuance (60 days from filing) following supplemental update from CAISO Regarding Board approval	Subsequent to CAISO Board Approval
Approval of Conduit Issuer (requires CAISO Board Approval)	April 22
Bond Issuance	Early to mid May
Report to Board on 2008 Bond Issuance	May 21-22, 2008

Conclusion and Proposed Board Resolution

Management will finalize the financing team over the next several weeks, refine the terms of the bond transaction and move forward towards the anticipated issuance date, including the filing of a Section 204 application with FERC in February. Management will request authorization for the bond transaction at the March Board meeting, when the overall terms of the transaction are have been agreed to. CAISO Board approval of the transaction is necessary to receive FERC and conduit issuer approval, and the schedule reflects this.

As noted, Management is aiming to obtain necessary bond funding by May 2008, and should be in a position to fund capital spending through that date with the $8.5 million in funding for capital/project expenditures collected in the 2008 GMC revenue requirement. However, in the event that CAISO is required to spend funds from its GMC operating reserve during 2008 prior to the availability of the bond funds, the following resolution will enable the CAISO to reimburse the GMC operating reserve from the 2008 bond proceeds when they become available. Without such a resolution, CAISO's ability to use bond proceeds to pay for expenditures sixty days prior to the bond issuance date is limited. Accordingly, Management requests approval of the following reimbursement resolution as specified below:

RESOLUTION DECLARING OFFICIAL INTENT OF
CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION
TO REIMBURSE CERTAIN EXPENDITURES FROM PROCEEDS OF INDEBTEDNESS
ADOPTED JANUARY 29, 2008

WHEREAS, the California Independent System Operator Corporation (the "Corporation") expects to pay certain expenditures (the "Expenditures") in connection with its 2008-2009 capital and project budgets (collectively, the "Project") prior to and in anticipation of the issuance of indebtedness for the purpose of financing the capital expenditures on a long-term basis;

WHEREAS, the Corporation reasonably expects that debt obligations will be issued in one or more series and that certain proceeds of such debt obligations will be issued to pay or reimburse the Expenditures for the Project in an amount not to exceed $60,000,000; and

WHEREAS, Section 1.150-2 of the Treasury Regulations requires the Corporation to declare its official intent to reimburse itself for prior expenditures for the Project with proceeds of debt obligations;

NOW, THEREFORE, THE CORPORATION hereby resolves:

1. ***The Corporation finds and determines that the foregoing recitals are true and correct.***
2. ***The Corporation hereby declares its official intent to use proceeds of indebtedness to pay or reimburse itself for Expenditures in an amount not expected to exceed $60,000,000.***
3. ***This Resolution shall take effect from and after its adoption.***