Memorandum

To: ISO Board of Governors

From: Ryan Seghesio, Chief Financial Officer & Treasurer

Date: July 3, 2013

Re: **Decision on Refinancing of 2009 Series A Bonds**

This memorandum requires Board action.

EXECUTIVE SUMMARY

Currently, $193 million of principal remains outstanding on the ISO's 2009 bond issue. These bonds can be called, (i.e., redeemed early) at the ISO's discretion on February 1, 2015. Given the dramatic decrease in the level of interest rates since these bonds were issued in July 2009, it is probable that the ISO would exercise this call feature and refinance the debt outstanding in 2015. However, that assumption is contingent on the level of interest rates 18 months from now.

Given the recent rise in interest rates over the past 60 days, Management proposes to execute an advance refunding bond issue as soon as possible to lock in the current level of interest rates and guarantee a level of savings over 2009 rates. The total present value of savings to be achieved over the remaining 26 years of the bonds would be $21.5 million.

Accordingly, Management requests that the Board authorize it to take any and all actions necessary to effectuate the bond offering as detailed in the resolutions below:

> ***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 $210 million, through the California Infrastructure and Economic Development Bank ("Bond Offering") with a term not to exceed 26 years secured by a mortgage on the Iron Point Facility to refinance the design, construction, commissioning, furnishing, equipping and occupancy 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 2009 (the "2009A Bonds") 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 remaining in the debt service reserve fund relating to the 2009A Bonds to the construction fund and/or the escrow fund relating to the Bond Offering;

Provide for defeasance of a portion of the ISO's obligations with respect to the 2009A Bonds through the use of ISO internal funds;

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

Procure bond insurance to secure such bonds to the extent determined advantageous by the ISO Management, and to enter into agreements related thereto; and

To 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 is 5.88% per annum.

Call Feature

The bonds were sold with a five-year call feature, giving the ISO the discretion to redeem some or all of the outstanding bonds on February 1, 2015 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 over the past four years. The call cannot be exercised until the call date; therefore, there is risk that if interest rates continue to rise over the next 18 months, the call could become less appealing.

Current refunding in 2015 at today's interest rates

Over the past two years, Management has been discussing current markets and options with investment banking contacts. With the stable low interest rates, Management elected to watch and assess rates during this time and opted to remain exposed to potential interest rate movements. This has been a good strategy as the ISO has captured value as historically low interest rates continued to move lower.

At the same time, the ISO has been evaluating the risk and benefit tradeoff of remaining exposed to interest rates – only if rates continue at very low levels will the savings be available for refunding in 2015.

Current market conditions

Over the past 60 days, the overall level of interest rates has risen rapidly as the market has responded to the possibility that the Federal Reserve will begin to end their various quantitative easing measures. The interest rate level on 10-year U.S. Treasury bonds has increased approximately 90 basis points (0.90%), while the municipal market has performed at times even poorer, rising approximately 115 basis points (1.15%) in the 10-year area. Many market experts believe the back-up in interest rates has been slightly exaggerated and that there will be a settling of rates over the next several months at lower levels, although few expect them to return to the low levels of 60 days ago. At the time of this memo, the municipal market has already seen some improvement and stabilization.

Advance refunding today

In the tax-exempt 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, 2015 (the call date). The escrow account would also pay the debt service obligations due prior to the call date.

An advance refunding today is subject to inefficiencies due to the negative arbitrage caused by the current low U.S. Government security interest rates compared to our higher interest costs on the existing bonds. For example, as stated earlier, the proceeds of the new bond issue would be invested in U.S. Treasury bonds with maturities of approximately 18 months (escrow would have to be liquid by the call date) which currently yield 25 basis points, or ¼ of 1 percent. This is significantly lower than the 5.88% interest expense accruing on the old bonds.

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 resulting in approximately $1.4 million in savings on our average annual debt service. The total present value of savings to be achieved over the remaining 26 years of the bonds would be $21.5 million. An advance refunding today removes interest rate risk over the next 18 months that the ISO would be exposed to if chose to wait until the call date. By comparison, the amount the ISO would save should the interest rates remain where they are through 2015 is $2.5 million per year. Management believes the value of locking in savings now outweighs the potential upside to waiting until 2015, given the significant risk that interest rates will move higher between now and then.

Debt service reserve fund closure

As part of this refunding transaction, most of the remaining funds associated with the 2009 Bonds, which consists of the $15 million debt service reserve fund, will be deposited into the 2009 Bond Construction Fund. This fund currently has approximately $13 million of unspent bond proceeds which is being used for capital projects identified in the 2009 bond documents. Any excess amounts in the 2009 debt service reserve fund due to market value movements will be deposited into the refunding escrow.

The new refunding bonds are currently being structured without a debt service reserve fund. Based on current trends in the market for highly-rated issuers with ample cash reserves, investors are no longer demanding a debt service reserve fund for added protection. Our initial discussions with the rating agencies about our desire to issue without a debt service reserve fund have gone well.

FERC – Section 204 filing

The ISO made the required Federal Power Act Section 204 filing with FERC on June 13, 2013. 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 August 2, 2013. This date will correlate with other bond issuance processes setting the ISO up to potentially issue the bonds the week of August 5th.

CONCLUSION

Management recommends that the Board approve the execution of the advance refunding bond issue. With interest rates beginning to increase, the risk of waiting until the call date on the 2009 Bonds could cause savings to erode quickly. At current interest rates, the ISO will achieve total present value savings of $21.5 million over the remaining 26 years of the bonds, a reduction of nearly $1.4 million in annual debt service expense.

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