

- **Board of Directors**  
**Audit, Budget and Finance Committee**

August 20, 2001 Board Meeting

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9-4

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**Subject**

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Adopt Interest Rate Swap Resolution providing for the execution and delivery of two interest rate swap agreements in aggregate not to exceed \$200 million

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**Description**

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**Background**

In May 2000, the Board approved an increase in the use of variable-rate debt to 32 percent of total revenue bond debt. This recommendation came after a significant amount of analysis and discussion by the Subcommittee on Financial Policies and Reporting regarding Metropolitan's overall debt and asset mix. The advantage of variable-rate debt is that interest rates on variable-rate debt have been lower than traditional fixed-rate debt. By increasing the proportion of variable-rate debt, Metropolitan will lower debt service payments on outstanding bonds, if variable rates follow historical patterns. In addition, the analyses demonstrated that Metropolitan's overall (bottom-line) sensitivity to interest rate changes could actually be reduced by increasing the proportion of Metropolitan's revenue bond debt that was in a variable mode (weekly or daily interest rates). As short-term interest rates rise or fall, the interest earned on Metropolitan's short-term investments rise or fall commensurately, offsetting the change in the debt service payment. Thus, interest costs would be reduced relative to having long-term fixed-rate debt and overall interest rate risk could be reduced by taking a more global look at the balance sheet. This is consistent with the overall approach to managing Metropolitan's finances – focusing on both sides of the balance sheet to enhance value to the member agencies and ratepayers.

Currently, Metropolitan's variable-rate debt exposure is 20 percent of total revenue bond indebtedness. Upon issuance of the Board-approved \$200 million variable-rate water revenue bond issue scheduled to close the second week of August 2001, Metropolitan's variable-rate debt exposure will increase to 25 percent of total revenue bond indebtedness. Staff determined that a \$200 million notional amount fixed to floating interest rate swap transaction will be an effective way to increase Metropolitan's variable-rate debt exposure to meet the Board's variable-rate debt guideline, and save an estimated \$2 million per year in debt service costs through lower interest rate payments. The Subcommittee on Investments and Bond Financing reviewed and recommended this action at its meeting on June 28, 2001.

**Interest Rate Swaps**

Section 5922 of the California Government Code permits government agencies to utilize interest rate swaps to reduce debt service costs and reduce the amount or duration of interest rate risk. Interest rate swaps are agreements between two parties in which each party agrees to pay interest payments to the other. For example, Metropolitan would agree to receive from a counterparty a fixed interest rate of 4.50 percent on a notional amount of \$100 million in exchange for paying a variable rate equal to the weekly Bond Market Association Municipal Swap Index (see Figure 1.) The fixed-rate payment would be used to offset payments on Metropolitan's outstanding fixed-rate debt. In this way, Metropolitan increases its variable-rate exposure, without issuing any new debt. The notional amount is used as the basis for calculating the interest rate payments to be made by each party. Interest rate swaps can have terms anywhere from a few days to 30 years.

Interest rate swaps are effective tools for managing interest rate risk and helping to lower costs. The market for interest rate swaps is large and growing. Many public agencies use these tools as part of new money transactions and in bond refundings to lower interest costs, and to mitigate interest rate fluctuations and risk. Agencies that

have utilized swaps include Central Basin Municipal Water District, Jacksonville (Fla.) Electric Authority, the Southern California Public Power Authority, Intermountain Power Agency, City of Anaheim, City of Oakland, Los Angeles County and the New York Power Authority. Metropolitan has executed one swap with AIG Financial Products Corporation for \$108 million in conjunction with a debt refunding in 1996.

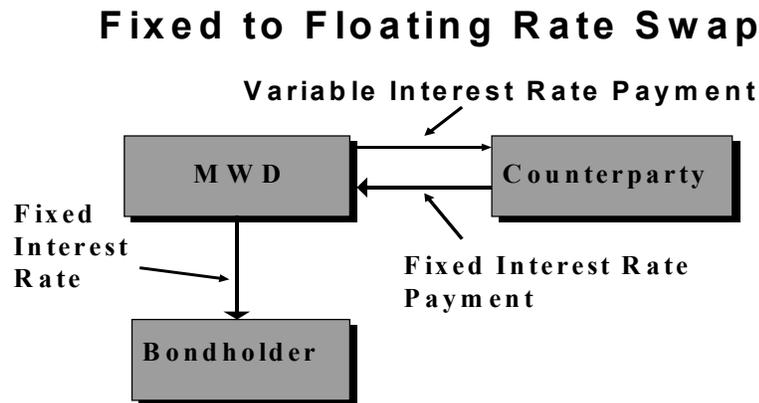


Figure 1

### Proposed Transaction

As reported at the last Audit, Budget and Finance Committee meeting, Metropolitan is currently preparing to take advantage of current swap market conditions to enter into a \$200 million notional amount fixed to floating interest rate swap transaction with two separate swap counterparties (\$100 million with Bear Stearns Financial Products, Inc. and \$100 million with UBS PaineWebber). Both counterparties are highly rated credits; Bear Stearns Financial Products, a subsidiary of Bear Stearns and Co., is rated AAA/Aaa (its parent company is rated A/A2), and UBS PaineWebber is rated AA+/Aa1.

Metropolitan will receive a fixed interest rate payment from each swap counterparty and in return make a variable interest rate payment to each swap counterparty. The fixed interest rate payment to be received by Metropolitan is reflective of a market rate determined by many factors, including the term of the swap agreement. For example, as of June 28, 2001, the 10-year fixed receiver payment was approximately 4.43 percent. Metropolitan's variable interest rate payment will be based on a national swap index, the Bond Market Association Municipal Swap Index (BMA). The BMA index has averaged approximately 3.40 percent over the past 10-year period. Current projections indicate that Metropolitan would be able to reduce its debt service costs by approximately \$2 million per year by entering into this interest rate swap. This swap transaction does not require Metropolitan to issue any debt. Approval of the Interest Rate Swap Resolution ([Attachment 1](#)) will enable Metropolitan to effect this swap transaction.

### Financial Systems and Controls

The Subcommittee on Investments and Bond Financing has been working with staff to develop an interest rate swap program. The program would provide greater flexibility and more use of interest rate swaps to manage interest rate exposure. While the Subcommittee and staff develop the financial policies and controls, the Subcommittee recommended that Metropolitan execute the proposed transaction in order to take advantage of savings opportunities.

In conjunction with the review and analysis of the interest rate swap program, staff will be upgrading financial software and systems to ensure that appropriate controls and reporting are in place. Since the use of swaps introduces another level of complexity to the management of Metropolitan's financial assets and liabilities, it is critical that the institutional infrastructure be upgraded to take advantage of opportunities without exposing Metropolitan to greater risk. Staff will assess existing staffing responsibilities, skills and training required, as well as necessary software and hardware.

Staff is currently implementing an updated treasury management system to help manage the investment function, ensuring more timely, accurate and efficient tracking and reporting. This system will be implemented before the end of the calendar year. In addition to the treasury management system, an integrated financial management system (capable of incorporating debt) will be acquired. The system would help staff, senior management and the Board to monitor credit and interest rate exposures and transaction activity. This integrated system is scheduled to be implemented by the end of the fiscal year.

### Transaction Costs

The costs of legal counsel and financial advisory services associated with this transaction are expected to be less than \$100,000.

### Policy

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An Interest Rate Swap Resolution of Metropolitan's Board of Directors is required to authorize the execution and delivery of interest rate swaps and other related agreements.

### CEQA

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The proposed action, i.e., the adoption of the resolution, is not defined as a project under the California Environmental Quality Act (CEQA), because it involves continuing administrative activities (Section 15378(b)(2) of the State CEQA Guidelines). In addition, the proposed action is not subject to CEQA because it involves government fiscal activities, which do not involve any commitment to any specific project which may result in a potentially significant physical impact on the environment (Section 15378(b)(4) of the State CEQA Guidelines).

The CEQA determination is: Determine that the proposed action is not subject to CEQA per Sections 15378(b)(2) and 15378(b)(4) of the State CEQA Guidelines.

### Board Options/Fiscal Impacts

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#### Option #1

Adopt the CEQA determination and adopt the form of Interest Rate Swap Resolution ([Attachment 1](#)) to approve the execution of a \$200 million notional amount fixed to floating interest rate swap transaction.

**Fiscal Impact:** Initial reduction in debt service costs of approximately \$2 million.

#### Option #2

Do not adopt the form of Interest Rate Swap Resolution ([Attachment 1](#)) related to the execution of a \$200 million notional amount fixed to floating interest rate swap transaction.

**Fiscal Impact:** Potential lost opportunity to reduce debt service costs.

### Staff Recommendation

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Option #1

  
 Brian G. Thomas  
 Chief Financial Officer

8/1/2001  
 Date

  
 Ronald R. Gastelum  
 Chief Executive Officer

8/1/2001  
 Date

### Attachment 1 – Interest Rate Swap Resolution

THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

RESOLUTION \_\_\_\_\_

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RESOLUTION OF THE BOARD OF DIRECTORS  
OF THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA  
APPROVING CERTAIN INTEREST RATE SWAP AGREEMENTS  
IN CONNECTION WITH THE CARRYING OF  
WATER REVENUE BONDS

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## THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

## RESOLUTION \_\_\_\_\_

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RESOLUTION OF THE BOARD OF DIRECTORS  
OF THE METROPOLITAN WATER DISTRICT OF  
SOUTHERN CALIFORNIA  
APPROVING CERTAIN INTEREST RATE SWAP AGREEMENTS  
IN CONNECTION WITH THE CARRYING OF  
WATER REVENUE BONDS

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WHEREAS, pursuant to Section 5922 of the Government Code of the State of California (the "Government Code"), in connection with the issuance or carrying of its bonds or the acquisition or carrying of any investment or program of investment, The Metropolitan Water District of Southern California ("Metropolitan") may enter into various arrangements, including interest rate swap agreements, forward payment conversion agreements, futures or contracts providing for payments based on levels of, or changes in, interest rates or other indices, or contracts to exchange cash flows or a series of payments or contracts, including, without limitation, interest rate floors or caps, options, puts or calls to hedge payment, rate, spread or similar exposure;

WHEREAS, pursuant to Resolution 8329 adopted by Metropolitan on July 9, 1991 (the "Master Resolution"), Metropolitan has heretofore authorized the issuance of Water Revenue Bonds (the "Bonds") on behalf of Metropolitan by adoption of supplemental resolutions from time to time, with the payment of the principal of, interest on, and any redemption premiums thereon being secured by and payable solely from the Net Operating Revenues (as defined in the Master Resolution) of Metropolitan;

WHEREAS, in connection with the carrying of the Bonds, Metropolitan desires to enter into certain interest rate swap agreements as described herein authorized under the Government Code pursuant to the terms and subject to the conditions set forth in this Resolution;

WHEREAS, pursuant to the Government Code, the Board of Directors (the "Board") of Metropolitan hereby finds and determines that it is prudent and advisable for Metropolitan to enter into such interest rate swap agreements authorized under the Government Code in accordance with the terms and conditions set forth in this Resolution (the "2001 Swaps" and each, a "2001 Swap"); and

WHEREAS, the Board has determined that the 2001 Swaps are designed to reduce the amount or duration of the interest rate risk or result in a lower cost of borrowing when used in combination with the carrying of the Bonds;

NOW, THEREFORE, the Board of Directors of The Metropolitan Water District of Southern California, DOES HEREBY RESOLVE, DETERMINE AND ORDER as follows:

## ARTICLE I

### DEFINITIONS

**SECTION 1.01. Government Code Section 5922 Determinations.** In accordance with Section 5922 of the Government Code of the State of California, the Board hereby determines that the 2001 Swaps contemplated herein are designed to reduce the amount or duration of the interest rate risk or result in a lower cost of borrowing when used in combination with the carrying of the Bonds.

**SECTION 1.02. Definitions.** Unless otherwise defined herein, all terms shall have the meanings set forth in Section 1.02 of the Master Resolution. Unless the context otherwise requires, the terms defined in this Section shall, for all purposes of this Resolution and of any certificate, opinion or other document herein mentioned, have the meanings herein specified, to be equally applicable to both the singular and the plural forms of any of the terms herein defined.

“Ad Hoc Committee” means the Chairman or Acting Chairman of the Board of Metropolitan, the President and Chief Executive Officer or Acting President and Chief Executive Officer of Metropolitan and the Chairman or Acting Chairman of the Audit, Budget and Finance Committee of Metropolitan or such other members or committee designated by the Board from time to time.

## ARTICLE II

### APPROVAL OF 2001 SWAPS; SECURITY AND PAYMENT OF 2001 SWAPS

#### **SECTION 2.01. Approval of 2001 Swaps.**

(a) Metropolitan is hereby authorized to enter into the 2001 Swaps on the terms and subject to the conditions contained herein and in Section 5922 of the Government Code. The 2001 Swaps shall consist of an interest rate swap agreement with Bear Stearns Financial Products Inc. and an interest rate swap agreement with UBS AG. Each 2001 Swap shall: (i) be based on a notional amount not to exceed \$100,000,000; (ii) contain the terms and conditions set forth in the ISDA Master Agreement prepared by the International Swaps and Derivatives Association, Inc., as amended or supplemented by any schedules, confirmations or other documents relating thereto, as agreed to by the Ad Hoc Committee pursuant to Section 2.01(b) below; and (iii) when combined with the carrying of the Bonds, result in an expected overall net present value savings to Metropolitan.

(b) The Ad Hoc Committee is hereby authorized and directed to negotiate, execute and deliver, on behalf of Metropolitan (in consultation with the Chief Financial Officer and the

General Counsel of Metropolitan), the terms and conditions of each 2001 Swap. The Ad Hoc Committee is hereby empowered to establish on behalf of Metropolitan (in consultation with the Chief Financial Officer and the General Counsel of Metropolitan) such terms and conditions of each 2001 Swap as the members of the Ad Hoc Committee shall agree upon in their sole discretion as being in the best interests of Metropolitan, subject only to the provisions of Section 5922 of the Government Code, the Act (as defined in the Master Resolution) and this Resolution, and shall be so empowered solely to implement the fundamental policies established by this Resolution in a manner that is most advantageous to Metropolitan. The terms and conditions of each 2001 Swap shall be set forth in the 2001 Swap. Such terms and conditions as so set forth, together with the other terms and conditions set forth in this Resolution, shall, upon execution and delivery of the 2001 Swap by the Ad Hoc Committee, or its designee, on behalf of Metropolitan, be all the terms and conditions of such 2001 Swap.

**SECTION 2.02. Security and Payment of 2001 Swaps.** The obligation of Metropolitan to make scheduled payments under a 2001 Swap, and the obligation of Metropolitan in respect of amounts due pursuant to a termination of a 2001 Swap and any other amounts due thereunder shall be payable solely from and secured by a lien upon Net Operating Revenues on a parity with Metropolitan's obligations under the Bonds and shall constitute Parity Obligations as defined in the Master Resolution.

**SECTION 2.03. Establishment and Application of 2001 Swap Fund.** Metropolitan shall establish, and the Treasurer of Metropolitan shall maintain, a separate fund designated as the "2001 Swap Fund." Net Operating Revenues shall be deposited into the 2001 Swap Fund at such times and in such amounts as may be required under the terms of such applicable 2001 Swap or other documents relating thereto, in order to make payments due by Metropolitan thereunder. The 2001 Swap Fund is hereby designated a "debt service fund" or "sinking fund" for purposes of Section 5.06 of the Master Resolution. Metropolitan shall establish, and the Treasurer of Metropolitan shall maintain, such additional funds and accounts with respect to each 2001 Swap, including funds and accounts for the deposit of payments to be made or received by Metropolitan thereunder, as shall be required pursuant to the 2001 Swaps.

**SECTION 2.04. Execution of Related Documents; Further Action.** The Chairman of the Board of Metropolitan, the President and Chief Executive Officer of Metropolitan and the Chief Financial Officer of Metropolitan, be and each of them, is hereby authorized, empowered and directed to execute such other documents in connection with the execution of the 2001 Swaps, including any credit support documents, and take such other actions as they deem necessary or advisable in order to carry out and perform the purposes of this Resolution.

### ARTICLE III

#### MISCELLANEOUS

**SECTION 3.01. Severability of Invalid Provisions.** If any one or more of the provisions contained in this Resolution shall for any reason be held to be invalid, illegal or unenforceable in any respect, then such provision or provisions shall be deemed severable from the remaining provisions contained in this Resolution and such invalidity, illegality or unenforceability shall not affect any other provision of this Resolution, and this Resolution shall

be construed as if such invalid or illegal or unenforceable provision had never been contained herein. Metropolitan hereby declares that it would have adopted this Resolution and each and every other Section, paragraph, sentence, clause or phrase pursuant thereto irrespective of the fact that any one or more Sections, paragraphs, sentences, clauses or phrases of this Resolution may be held illegal, invalid or unenforceable.

**SECTION 3.02. Article and Section Headings and References; Interpretations.** The headings or titles of the several Articles and Sections hereof shall be solely for convenience of reference and shall not affect the meaning, construction or effect of this Resolution.

All references herein to "Article," "Section" and other subdivisions are to the corresponding Articles, Sections or subdivisions of this Resolution; the words "herein," "hereof," "hereby," "hereunder" and other words of similar import refer to this Resolution as a whole and not to any particular Article, Section or subdivision hereof.

**SECTION 3.03. Governing Law.** This Resolution shall be construed and governed in accordance with the laws of the State of California.

**I HEREBY CERTIFY** that the foregoing is a full, true and correct copy of a Resolution adopted by a two-thirds (2/3) vote of the total vote of the Board of Directors of The Metropolitan Water District of Southern California at its meeting held on August 20, 2001.

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Executive Secretary  
The Metropolitan Water District of Southern  
California