

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

September 11, 2001 Board Meeting

9-2

**Subject**

Adopt (1) a Master Swap Resolution providing for the execution and delivery of interest rate swaps; (2) a Master Swap Policy; and (3) authorize a swap program appropriation of \$200,000 to pay the costs of issuance associated with interest rate swaps through September 30, 2002 (Appropriation No. 15372)

**Description**

**Background**

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 notional amount is used as the basis for calculating the interest rate payments to

**Fixed to Floating Rate Swap**

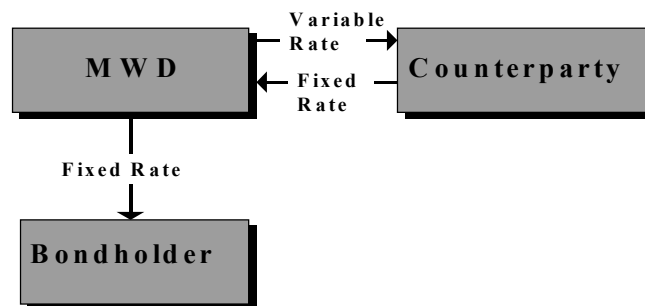


Figure 1

be made by each party. Interest rate swaps can have terms anywhere from a few days to thirty 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 bond refundings, in new money transactions to lower interest costs, and to mitigate interest rate fluctuations and risk. Agencies that have utilized swaps include Central Basin Municipal Water District, Jacksonville 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 a swap with AIG for \$108 million in conjunction with a debt refunding in 1996, and recently completed a \$224.8 million notional amount swap with UBS PaineWebber Inc. and Bear Stearns Financial Products Inc. as part of a bond refunding transaction.

The value of interest rate swaps will vary as a result of changes in market conditions. Similar to Metropolitan's investment function, efficient execution of transactions will allow Metropolitan to take advantage of market movement. As a result, the Subcommittee on Investments and Bond Financing has been working with staff to

develop procedures to allow staff to take advantage of financial tools, such as interest rate swaps, to manage Metropolitan's interest rate exposure. This is consistent with the overall approach to managing Metropolitan's finances – focusing on asset and liability management to enhance value to the member agencies and ratepayers.

### **Swap Program**

The Subcommittee on Investments and Bond Financing (“Subcommittee”) has been reviewing and analyzing the benefits to Metropolitan of establishing an interest rate swap program. This program would be established to allow Metropolitan to utilize swaps as part of the overall debt and investment management program. The program would be monitored by the Audit, Budget and Finance Committee, and executed by the Chief Financial Officer. In order to provide the necessary flexibility to execute swap transactions on a timely basis, it is recommended that the Board approve a Master Swap Resolution, similar to the Master Bond Resolution, which defines the authority for Metropolitan executing the transactions.

### **Master Swap Resolution**

The Master Swap Resolution ([Attachment 1](#)) sets forth the conditions under which Metropolitan can enter into swap transactions. The Master Swap Resolution provides for the approval of authorized swaps and related agreements as well as for the security and payment of authorized swaps, including termination payments. The Master Swap Resolution also provides the authority for the Chief Financial Officer to execute swaps up to \$50 million, sets requirements for reporting and establishes the oversight and approval authorities of the Board, Ad Hoc Committee (comprised of the President and Chief Executive Officer, the Chairman of the Board, and the Chairman of the Audit, Budget, and Finance Committee) and the Chief Financial Officer.

In accordance with Section 5922 of the Government Code of the State of California, Metropolitan's Board is required to make a finding and determine that an interest rate swap transaction will, among other things, lower costs and reduce the amount or duration of interest rate risk to Metropolitan. Each swap transaction will contain terms and conditions outlined in a standard form (the International Swap and Derivatives Association Master Swap Agreement) and various supporting forms and agreements associated with each transaction. The Board, the Ad Hoc Committee of the Board, or the Chief Financial Officer of Metropolitan will approve each swap transaction, depending on the size and average life of the transaction. The parameters for execution and approval are outlined in the Master Swap Policy ([Attachment 2](#)). All transactions greater than \$50 million must be approved by the Ad Hoc Committee, while transactions in excess of \$200 million must be approved by the Board. Every transaction will be reported to the Audit, Budget and Finance Committee and the Board at the meetings immediately following the transaction.

### **Master Swap Policy**

Similar to the annual adoption of Metropolitan's Investment Policy, staff recommends that the Board adopt a Master Swap Policy ([Attachment 2](#)) that defines the purpose of the swap program and the parameters under which the program will operate. The swap policy describes conditions under which Metropolitan may enter into an interest rate swap agreement. The swap policy includes the following terms and conditions:

- Transaction approval parameters
- Payment terms
- Term of swap agreement
- Security, including collateral requirements
- Counterparty exposure limitations
- Termination provisions
- Credit rating guidelines for counterparties
- Counterparty requirements and qualifications
- Reporting requirements – at least quarterly to Metropolitan's Board

### Transaction Costs

It is estimated that an appropriation in the amount of \$200,000 from Metropolitan's General Fund will be required to fund the costs of issuance associated with interest rate swap transaction(s) through September 30, 2002. Costs associated with swap transactions may include legal fees, rating agency fees, typesetting, printing, mailing, escrow agent fees, verification agent fees, financial advisory services, and other miscellaneous costs depending on the type of swap transaction(s).

### Subcommittee on Investments and Bond Financing

At the September 6, 2001 meeting of the Subcommittee on Investments and Bond Financing the Subcommittee unanimously recommended that the Board adopt the Master Swap Resolution and the Master Swap Policy with the following changes:

- Modify the swap approval process for swaps up to \$50 million to require approvals by both the Chief Financial Officer and the President and Chief Executive Officer in consultation with the General Counsel.
- Modify the annual swap reporting requirements to include the current authority for Metropolitan to enter into interest rate swaps, swap transactions for the upcoming fiscal year, financial objectives to be achieved utilizing interest rate swaps for such fiscal year, and swap approvals required in accordance with the swap policy.

### Policy

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A Master Swap Resolution of Metropolitan's Board of Directors is required to authorize the execution and delivery of interest rate swaps and other related agreements. Board authority is required to expend funds associated with interest rate swap transactions.

### 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

- a. adopt the form of Master Swap Resolution (**Attachment 1**) that incorporate the changes recommended by the Subcommittee on Investments and Bond Financing in order to execute interest rate swaps in an expeditious manner thereby taking advantage of swap market conditions to lower costs and reduce interest rate risk to Metropolitan;
- b. Approve the Master Swap Policy as detailed in **Attachment 2** that incorporate the changes recommended by the Subcommittee on Investments and Bond Financing which describes the conditions under which Metropolitan may enter into an interest rate swap agreement; and
- c. Approve General Fund Appropriation No. 15372 for expenses associated with the costs of issuance associated with interest rate swap transaction(s) through September 30, 2002.

**Fiscal Impact:** Potential reduction in debt service costs. Estimated costs of issuance for interest rate swap transactions of \$200,000.

#### Option #2


Do not adopt the form of Master Swap Resolution, and do not approve the Master Swap Policy.

**Fiscal Impact:** Potential lost opportunities to reduce Metropolitan's cost of debt.

**Staff Recommendation**

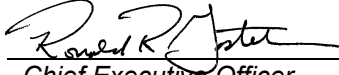
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Option #1

  
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Brian G. Thomas  
Chief Financial Officer

9/6/2001

*Date*

  
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Ronald R. Foster  
Chief Executive Officer

9/6/2001

*Date*

**Attachment 1 – Master Swap Resolution**

**Attachment 2 – Master Swap Policy**

BLA #1310

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  
PROVIDING FOR THE EXECUTION AND DELIVERY OF  
INTEREST RATE SWAPS AND RELATED AGREEMENTS  
(MASTER SWAP RESOLUTION)

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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  
PROVIDING FOR THE EXECUTION AND DELIVERY OF  
INTEREST RATE SWAPS AND RELATED AGREEMENTS  
(MASTER SWAP RESOLUTION)

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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 issuance or carrying of the Bonds or the acquisition or carrying of its investments or programs of investment, Metropolitan desires to enter into one or more interest rate swap agreements or other arrangements from time to time authorized under the Government Code pursuant to the terms and subject to the conditions set forth in this Master Swap 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 one or more interest rate swap agreements or other arrangements from time to time authorized under the Government Code in accordance with the terms and conditions set forth in this Master Swap Resolution (the "Authorized Swaps" and each, an "Authorized Swap"); and

WHEREAS, the Board has determined that the Authorized 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 issuance or carrying of the Bonds or enhance the relationship between the risk and return with respect to Metropolitan's investments or programs of investment;

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 Authorized 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 issuance or carrying of the Bonds or enhance the relationship between the risk and return with respect to Metropolitan's investments or programs of investment.

**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 Master Swap 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.

"ISDA Master Agreement" means the form of ISDA Master Agreement (Local Currency-Single Jurisdiction) prepared by the International Swaps and Derivatives Association, Inc., as amended or supplemented by any schedules, confirmations or other documents relating thereto, as such form or documents may be amended from time to time.

## ARTICLE II

### APPROVAL OF AUTHORIZED SWAPS AND RELATED AGREEMENTS

**SECTION 2.01. Approval of Authorized Swaps and Related Agreements.** (a) Metropolitan is hereby authorized to enter into one or more Authorized Swaps on the terms and subject to the conditions contained in this Article II. Prior to execution and delivery thereof, each Authorized Swap shall satisfy the following conditions:

(i) The Authorized Swap shall satisfy the criteria set forth in Metropolitan's Master Swap Policy dated ~~August 20~~ September 11, 2001, approved by the Board on ~~August 20~~ September 11, 2001, relating to interest rate swap agreements and/or other arrangements authorized by the Government Code, as such Policy may be amended from time to time (the "Swap Policy");

(ii) The Authorized Swap shall contain the terms and conditions set forth in the ISDA Master Agreement and/or such other terms and conditions as may be approved in each case by the Board, the Ad Hoc Committee or the Chief Financial Officer of Metropolitan, as applicable, each in consultation with the General Counsel of Metropolitan, in accordance with Section 2.01(a)(iii) below;

(iii) Subject to any applicable restrictions in the Swap Policy, each Authorized Swap with a notional amount of \$50,000,000 or less shall be subject to the approval of the Chief Financial Officer of Metropolitan as provided in Section 2.01(c) below; each Authorized Swap with a notional amount greater than \$50,000,000 shall be subject to the approval of the Ad Hoc Committee or the Board, as applicable, in each case determined in accordance with the transaction approval guidelines set forth in the Swap Policy;

(iv) No Authorized Swap shall be entered into hereunder unless such Authorized Swap satisfies the collateral requirements, minimum provider credit ratings, and such other criteria applicable to swaps and similar arrangements as may be set forth in the Swap Policy. Furthermore, no Authorized Swap shall be entered into if, after giving effect to such Authorized Swap, it would violate the limitations on frequency of trades or total exposure or other limitations set forth in the Swap Policy; and

(v) The Chief Financial Officer of Metropolitan shall file a certificate with the Fiscal Agent certifying that the Authorized Swap: (1) complies with the terms applicable to Parity Obligations set forth in the Master Resolution, including the issuance of Parity Obligations under Section 6.09 thereof; and (2) complies with the terms of the Swap Policy.

(b) Subject to the satisfaction of the conditions set forth in Section 2.01(a) above, 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 of Metropolitan and the General Counsel of Metropolitan), each Authorized Swap with a notional amount greater than \$50,000,000 which satisfies the transaction approval guidelines for the Ad Hoc Committee set forth in the Swap Policy. The Ad Hoc Committee is hereby empowered to establish on behalf of Metropolitan (in consultation with the Chief Financial Officer of Metropolitan and the General Counsel of Metropolitan) the terms and conditions of each such Authorized 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 the Government Code, the Act and this Master Swap Resolution, and shall be so empowered solely to implement the fundamental policies established by this Master Swap Resolution in a manner that is most advantageous to Metropolitan. The terms and conditions of each such Authorized Swap shall be set forth in the Authorized Swap. Such terms and conditions as so set forth, together with the other terms and conditions set forth in this Master Swap Resolution, shall, upon



execution and delivery of the Authorized Swap by the Ad Hoc Committee, or its designee, on behalf of Metropolitan, be all the terms and conditions of such Authorized Swap.

(c) Subject to the satisfaction of the conditions set forth in Section 2.01(a) above, the Chief Financial Officer of Metropolitan is hereby authorized and directed to negotiate, execute and deliver, on behalf of Metropolitan (in consultation with the President and Chief Executive Officer of Metropolitan and the General Counsel of Metropolitan), each Authorized Swap with a notional amount of \$50,000,000 or less. The Chief Financial Officer of Metropolitan is hereby empowered to establish on behalf of Metropolitan (in consultation with the President and Chief Executive Officer of Metropolitan and the General Counsel of Metropolitan) the terms and conditions of each such Authorized Swap as the Chief Financial Officer of Metropolitan shall determine ~~in his or her sole discretion~~ as being in the best interests of Metropolitan, subject only to the provisions of the Government Code, the Act and this Master Swap Resolution, and shall be so empowered solely to implement the fundamental policies established by this Master Swap Resolution in a manner that is most advantageous to Metropolitan; provided, however, that the President and Chief Executive Officer of Metropolitan shall also be required to execute each such Authorized Swap. The terms and conditions of each such Authorized Swap shall be set forth in the Authorized Swap. Such terms and conditions as so set forth, together with the other terms and conditions set forth in this Master Swap Resolution, shall, upon execution and delivery of the Authorized Swap by the Chief Financial Officer of Metropolitan, ~~or his or her designee~~ and the President and Chief Executive Officer of Metropolitan, or their respective designees, on behalf of Metropolitan, be all the terms and conditions of such Authorized Swap.

**SECTION 2.02. Execution of Related Documents; Further Action.**

Subject to Section 2.01 hereof, 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 any Authorized Swap, including any credit support documents, and to take such other actions as they deem necessary or advisable in order to carry out and perform the purposes of this Master Swap Resolution.

**SECTION 2.03. Reporting Requirements.**

(a) *Reporting Following Execution or Termination of Authorized Swaps.* At the first Board meeting following the execution of any Authorized Swap approved by the Ad Hoc Committee or the Chief Financial Officer of Metropolitan as provided hereunder, the President and Chief Executive Officer of Metropolitan or the Chief Financial Officer of Metropolitan or their respective designees shall present a report to the Board (in either written or oral form) advising the Board of the execution of such Authorized Swap and the terms thereof, including but not limited to, the name and credit rating of the provider and any credit enhancer, the notional amount of the Authorized Swap, the nature of any payments to be made by Metropolitan thereunder, the termination provisions, and the expected financial benefits to Metropolitan. At the first Board meeting following the termination of any Authorized Swap authorized by the Chief Financial Officer of Metropolitan pursuant to Section 2.04 hereof, the Chief Financial Officer of Metropolitan or his or her designee shall present a report to the Board (in either written or oral form) advising the Board of

the termination of such Authorized Swap and any termination payment(s) made or to be made in connection therewith.

(b) *Quarterly Reporting.* In addition, the Chief Financial Officer of Metropolitan or his or her designee shall provide a written report to the Board no less than each calendar quarter describing, among other things, all Authorized Swaps currently in effect, including the notional amount and most recent market value of each, and such additional information as may be required under the Swap Policy or as requested by the Board from time to time.

**SECTION 2.04. Termination of Authorized Swaps; Application of Termination Payments.** The Chief Financial Officer of Metropolitan is hereby authorized to terminate any Authorized Swap in accordance with its terms; provided, however, in the event any such elective termination results in a termination payment payable by Metropolitan in excess of \$5,000,000 (taking into account any offsetting transaction(s) in connection with such termination), such elective termination shall be subject to the prior approval of the Ad Hoc Committee. Unless otherwise directed by the Board, upon termination of any Authorized Swap, any termination payment received by Metropolitan shall be applied as the Chief Financial Officer of Metropolitan shall determine, in consultation with the Ad Hoc Committee, as being in the best interests of Metropolitan, subject only to the provisions of the Government Code, the Act and this Master Swap Resolution.

**SECTION 2.05. Authorization Period.** The authorization granted pursuant to this Master Swap Resolution shall remain in full force and effect until such time as such authorization is revoked or otherwise terminated by the Board; provided, however, that any such revocation or termination shall not affect the validity of any Authorized Swap entered into pursuant to this Master Swap Resolution prior to such revocation or termination.

**SECTION 2.06. Conflict With Swap Policy.** In the event of any conflict between this Master Swap Resolution and the Swap Policy, the terms of this Master Swap Resolution shall control.

### ARTICLE III

#### SECURITY AND PAYMENT OF AUTHORIZED SWAPS

**SECTION 3.01. Security and Payment of Authorized Swaps.** Except as otherwise provided herein, the obligation of Metropolitan to make scheduled payments pursuant to an Authorized Swap 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 ("Swap Payments"). Swap Payments shall be set aside and payable by Metropolitan in accordance with Section 5.06 of the Master Resolution. The obligation of Metropolitan in respect of amounts due pursuant to a termination of an Authorized Swap and any other amounts related thereto ("Termination Payments") shall be payable solely from and secured by a lien upon Net Operating Revenues with such priority of payment as shall be determined by the Board, the Ad Hoc Committee or the Chief Financial

Officer of Metropolitan, as applicable; provided, however, in no event shall any Termination Payment be payable senior to Metropolitan's obligations under the Bonds.

**SECTION 3.02. Establishment and Application of Master Swap Fund.**

Metropolitan shall establish, and the Treasurer of Metropolitan shall maintain, a separate fund designated as the "Master Swap Fund." In connection with each Authorized Swap, the Treasurer of Metropolitan may create a separate subaccount within the Master Swap Fund relating to such Authorized Swap. Net Operating Revenues shall be deposited into the Master Swap Fund at such times and in such amounts as may be required under the terms of such applicable Authorized Swap or other documents relating thereto, in order to make Swap Payments or other payments due by Metropolitan thereunder. The Master Swap Fund is hereby designated a "debt service fund" or "sinking fund" for purposes of Section 5.06 of the Master Resolution.

**SECTION 3.03. Establishment and Application of Funds and Accounts.**

Metropolitan shall establish, and the Treasurer of Metropolitan shall maintain, such additional funds and/or accounts with respect to each Authorized Swap, including funds and accounts for the deposit of Termination Payments to be made or payments to be received by Metropolitan thereunder, as may be required pursuant to the terms of such Authorized Swap or other documents relating thereto, including the Master Resolution or any Supplemental Resolution or paying agent agreement relating to the Bonds.

## ARTICLE IV

### MISCELLANEOUS

**SECTION 4.01. Severability of Invalid Provisions.**

If any one or more of the provisions contained in this Master Swap 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 Master Swap Resolution and such invalidity, illegality or unenforceability shall not affect any other provision of this Master Swap Resolution, and this Master Swap 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 Master Swap 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 Master Swap Resolution may be held illegal, invalid or unenforceable.

**SECTION 4.02. 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 Master Swap Resolution.

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

**SECTION 4.03. Governing Law.** This Master Swap 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~~ September 11, 2001.

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Executive Secretary  
The Metropolitan Water District of Southern  
California

# THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

## MASTER SWAP POLICY

September 11, 2001

### 1. Authority

A Master Swap Resolution (“Master Resolution”) of the Board of Directors of the Metropolitan Water District of Southern California (“Metropolitan”) authorizing the execution and delivery of interest rate swap transactions and related agreements was approved on September 11, 2001. The Master Resolution authorizes Metropolitan to enter into swap transactions from time to time to better manage assets and liabilities and take advantage of market conditions to lower overall costs and reduce interest rate risk.

The Master Resolution authorizes the execution of swaps and related agreements, provides for security and payment provisions, and sets forth certain other provisions related to swap agreements between Metropolitan and qualified swap counterparties. In the event of a conflict between the terms of the Master Resolution and the terms of the Master Swap Policy, the terms and conditions of the Master Resolution shall control.

### 2. Purpose

The incurring or carrying of obligations and management of investments by Metropolitan involves a variety of interest rate payments and other risks that a variety of financial instruments are available to offset, hedge, or reduce. It is the policy of Metropolitan to utilize such financial instruments to better manage its assets and liabilities. Metropolitan may execute interest rate swaps if the transaction can be expected to result in the following:

- Reduce exposure to changes in interest rates on a particular financial transaction or in the context of the management of interest rate risk derived from Metropolitan’s overall asset / liability balance.
- Result in a lower net cost of borrowing with respect to Metropolitan’s debt or achieve a higher net rate of return on investments made in connection with, or incidental to the issuance, incurring, or carrying of Metropolitan’s obligations or other Metropolitan investments.
- Manage variable interest rate exposure consistent with prudent debt practices and guidelines approved by the Board.

Metropolitan shall not enter into interest rate swaps for speculative purposes.

**3. Form of Swap Agreements**

Each interest rate swap executed by Metropolitan shall contain terms and conditions as set forth in the International Swap and Derivatives Association, Inc. (“ISDA”) Master Agreement, including any schedules and confirmations as approved in accordance with Article II, Section 2.01 (a) (ii) and (iii) of the Master Resolution. The swap agreements between Metropolitan and each qualified swap counterparty shall include payment, term, security, collateral, default, remedy, termination, and other terms, conditions and provisions as the Chief Financial Officer, in consultation with the General Counsel, deems necessary or desirable.

**4. Transaction Approval**

The approval guidelines for each authorized swap transaction shall be as set forth in Article II, Section 2.01 (a) (iii) and Section 2.01 (c) of the Master Resolution and in this Section 4. The required approval of any swap transaction will be based upon the notional amount of the swap and the average life of the swap. The following table sets forth the approval requirements for each swap transaction:

----- Approval Requirements -----			
<u>Average Life of Swap</u>	<u>Board Approval</u>	<u>Ad Hoc Committee</u>	<u>CEO / CFO CFO Approval</u>
5 years or less	greater than \$300M	>\$ 50M, up to \$300M	\$ 50M or less
>5 years <10 years	greater than \$250M	>\$ 50M, up to \$250M	\$ 50M or less
10 years or greater	greater than \$200M	>\$ 50M, up to \$200M	\$ 50M or less

In addition, if multiple swap transactions with one or more counterparties are contemplated over a three-month period, which would exceed the approval limits as described above, then the additional transaction approvals would be required. The total notional amount of swap transactions including the average life of the swap agreements over a consecutive three-month period shall be considered to determine if approval is required from the Board or the Ad Hoc Committee (comprised of the Chairman of the Board, the Chairman of the Audit, Budget and Finance Committee, and the President and Chief Executive Officer).

For example, if Metropolitan enters into a \$50 million swap agreement for 15 years, approval for this transaction would be required from the Chief Financial Officer (in consultation with the President and Chief Executive Officer of Metropolitan and the General Counsel of Metropolitan) only. However, if within the same three month period Metropolitan proposes to enter into a second 15 year swap agreement for \$50 million, then approval for the second swap transaction would be required by the Ad Hoc Committee of the Board.

## 5. Qualified Swap Counterparties

Metropolitan shall be authorized to enter into interest rate swap transactions only with qualified swap counterparties. Qualified swap counterparties are identified in Metropolitan's Board approved investment banking team. The composition of the approved swap counterparties will change from time to time as changes are made to Metropolitan's investment banking team. Qualified swap counterparties must be rated at least "Aa3" or "AA-", or equivalent by any two of the nationally recognized rating agencies (i.e. Moody's, Standard and Poor's, or Fitch); or have a "AAA" subsidiary as rated by at least one nationally recognized credit rating agency. In addition, the counterparty must have a demonstrated record of successfully executing swap transactions as well as creating and implementing innovative ideas in the swap market. Each counterparty shall have minimum capitalization of at least \$150 million.

Metropolitan may negotiate or competitively bid an interest rate swap transaction based on a review of the market impact to Metropolitan of such competitive bid.

## 6. Termination Provisions

All swap transactions shall contain provisions granting Metropolitan the right to optionally terminate a swap agreement at anytime over the term of the agreement. In general, exercising the right to optionally terminate an agreement produces a benefit to Metropolitan, either through receipt of a payment from a termination, or if a termination payment is made by Metropolitan, in conjunction with a conversion to a more beneficial (desirable) debt obligation of Metropolitan as determined by Metropolitan. The Chief Financial Officer or the Ad Hoc Committee, as appropriate, in consultation with the General Counsel, shall determine if it is financially advantageous for Metropolitan to terminate a swap agreement.

*Mandatory Termination: A termination payment to or from Metropolitan may be required in the event of termination of a swap agreement due to a default or a decrease in credit rating of either Metropolitan or the counterparty. It is the intent of Metropolitan not to make a termination payment to a counterparty that does not meet its contractual obligations. Prior to making any such termination payment, the Chief Financial Officer shall evaluate whether it is financially advantageous for Metropolitan to obtain a replacement counterparty to avoid making such termination payment.*

In the event of default by a counterparty whereby Metropolitan would be required to make a termination payment, Metropolitan will proceed as follows:

- In order to mitigate the financial impact of making such payment at the time such payment is due; Metropolitan will seek to replace the terms of the terminated transaction with a replacement counterparty. The new or replacement counterparty will make an upfront payment to Metropolitan in an amount that would offset the payment obligation of Metropolitan to the original counterparty.

- If a satisfactory agreement with a replacement counterparty is not reached, Metropolitan will be required to make a swap termination payment to the original defaulting counterparty. Funds for such payment shall be made from available monies. The Chief Financial Officer shall report any such termination payments to the Board at the next Board meeting.

## 7. Term and Notional Amount of Swap Agreement

Metropolitan shall determine the appropriate term for an interest rate swap agreement on a case by case basis. The slope of the swap curve, the marginal change in swap rates from year to year along the swap curve, and the impact that the term of the swap has on the overall exposure of Metropolitan shall be considered in determining the appropriate term of any swap agreement. In connection with the issuance or carrying of bonds, the term of a swap agreement between Metropolitan and a qualified swap counterparty shall not extend beyond the final maturity date of existing debt of Metropolitan, or in the case of a refunding transaction, beyond the final maturity date of the refunding bonds. At no time shall the total notional amount of all swaps exceed the total amount of outstanding water revenue bonds.

## 8. Swap Counterparty Exposure Limits

In order to diversify Metropolitan's counterparty risk, and to limit Metropolitan's credit exposure to any one counterparty, limits will be established for each counterparty based upon both the credit rating of the counterparty as well as the relative level of risk associated with each existing swap transaction. The risk measure will be calculated based upon the mark-to-market sensitivity of each transaction to an assumed shift in interest rates. Assuming a 25 basis point movement in the swap rate, the maximum net exposure (termination payment) per counterparty shall not exceed the following amounts:

<u>Credit Rating</u>	<u>Maximum Net Sensitivity to a 25 Basis Point Shift in the Yield Curve</u>
Fully Collateralized	\$10,000,000
AAA	\$10,000,000
AA	\$ 8,000,000

"The maximum net exposure limitations establish guidelines with respect to whether Metropolitan should enter into an additional swap agreement with an existing counterparty. For example, assume Metropolitan executed a fifteen-year \$400 million notional amount swap with a "AAA" rated counterparty. If the yield curve moved 25 basis points, Metropolitan could have a significant market exposure to that swap counterparty (i.e. in order to terminate the swap Metropolitan would have to make a payment of up to \$10 million dollars). The same scenario would apply to a fully collateralized counterparty. If such event occurred, the Chief Financial Officer would



evaluate whether it is prudent and advisable to enter into additional swap transactions with such counterparties in order to mitigate the exposure to such counterparty. For "AA" rated counterparties the maximum net exposure limitation is reduced to \$8 million given its lower credit rating."

The calculation of net interest rate sensitivity per counterparty will take into consideration multiple transactions, some of which may offset market interest rate risk thereby reducing overall exposure to Metropolitan. In addition, additional exposure provisions are as follows:

- The sum total notional amount per swap counterparty may not exceed 25 percent of Metropolitan's total revenue bond indebtedness.
- The appropriate collateral amount will be determined on a case by case basis, and approved by the Chief Financial Officer in consultation with the General Counsel.

If the sensitivity limit is exceeded by a counterparty, Metropolitan shall conduct a review of the exposure sensitivity limit calculation of the counterparty. The Chief Financial Officer shall evaluate appropriate strategies in consultation with the Office of the General Counsel to mitigate this exposure.

## **9. Collateral Requirements**

As part of any swap agreement, Metropolitan shall require collateralization or other credit enhancement to secure any or all swap payment obligations. As appropriate, the Chief Financial Officer, in consultation with the General Counsel may require collateral or other credit enhancement to be posted by each swap counterparty under the following circumstances:

- Each counterparty to Metropolitan may be required to post collateral if the credit rating of the counterparty or parent falls below the "AA" category. Additional collateral for further decreases in credit ratings of each counterparty shall be posted by each counterparty in accordance with the provisions contained in the collateral support agreement to each swap agreement with Metropolitan.
- Collateral shall consist of cash, U.S. Treasury securities and Agencies.
- Collateral shall be deposited with a third party trustee, or as mutually agreed upon between Metropolitan and each counterparty.
- A list of acceptable securities that may be posted as collateral and the valuation of such collateral will be determined and mutually agreed upon during negotiation of the swap agreement with each swap counterparty.
- The market value of the collateral shall be determined on at least a monthly basis.
- Metropolitan will determine reasonable threshold limits for the initial deposit and for increments of collateral posting thereafter.
- The Chief Financial Officer shall determine on a case by case basis whether other forms of credit enhancement are more beneficial to Metropolitan.

## 10. Reporting Requirements

A written report providing the status of all interest rate swap agreements will be provided to the Board of Directors at least on a quarterly basis and shall include the following information:

- Highlights of all material changes to swap agreements or new swap agreements entered into by Metropolitan since the last report.
- Market value of each of Metropolitan's interest rate swap agreements.
- The net impact to Metropolitan of a 25 basis point movement (up or down) with the appropriate swap index or curve.
- For each counterparty, Metropolitan shall provide the total notional amount position, the average life of each swap agreement, the available capacity to enter into a swap transaction, and the remaining term of each swap agreement.
- The credit rating of each swap counterparty and credit enhancer insuring swap payments, if any.
- Actual collateral posting by swap counterparty, if any, per swap agreement and in total by swap counterparty.
- A summary of each swap agreement, including but not limited to the type of swap, the rates paid by Metropolitan and received by Metropolitan, and other terms.
- Information concerning any default by a swap counterparty to Metropolitan, and the results of the default, including but not limited to the financial impact to Metropolitan, if any.
- A summary of any planned swap transactions and the impact of such swap transactions on Metropolitan.
- A summary of any swap agreements that were terminated.

The Chief Financial Officer together with the General Counsel shall review Metropolitan's swap policy on an annual basis and recommend appropriate changes to the Board. In addition, the following information shall be provided to the Board on an annual basis:

- The current authority for Metropolitan to enter into interest rate swaps.
- Proposed interest rate swap transactions for the upcoming fiscal year.
- Financial objectives to be achieved utilizing interest rate swaps for the upcoming fiscal year.
- Interest rate swap approvals required in accordance with the Master Swap Policy.