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

August 19, 2003 Board Meeting

9-1

Subject

Approve entering into interest rate swap transactions of up to $700 million to capture savings and reduce interest rate risk

Description

Interest rates continue to track at exceptionally low levels. On June 25, 2003, the Federal Reserve cut the Federal Funds Rate by another 25 basis points to one percent. While longer-term rates have risen from their record lows, Metropolitan still has opportunities to continue to lower the cost of its debt obligations and reduce the variability of its net interest exposure. The financial opportunities available to Metropolitan include the use of interest rate swap transactions. Consistent with the Board's Master Swap Policy, the Ad Hoc Committee (consisting of the Chairman of the Board, the Chairman of the Budget, Finance and Investment Committee and the Chief Executive Officer) authorized the Chief Financial Officer to execute up to $200 million of interest rate swaps to offset a fixed receiver swap executed in March 2002. If medium term rates return to lower levels, this transaction could yield about $3 million to $3.5 million annually in interest rate savings over the next three years.

Consistent with the Master Swap Policy, board approval is required for multiple swap transactions during any three-month period. Staff has identified a number of opportunities for Metropolitan to utilize interest rate swaps to lower the costs of its debt obligations and to mitigate the impact of interest rate volatility over the next twelve- to eighteen-month period. The swap transactions will be used in conjunction with the issuance of water revenue refunding bonds to lower the cost of Metropolitan's fixed rate water revenue bonds, and to potentially fix the cost of a portion of Metropolitan's variable rate revenue bonds for up to eighteen months at yields of around 1 percent.

Proposed Revenue Bond Refunding

Metropolitan has the opportunity to refund approximately $300 million of fixed rate water revenue bonds by issuing variable rate revenue bonds, the proceeds of which will be used to fund an escrow account to pay the interest and principal on the refunded water revenue bonds. In order to lock in low fixed rates available in the current market, Metropolitan would execute a floating to fixed rate swap (fixed payer swap). This transaction is similar to previous "synthetic" bond refundings completed over the past two years. Metropolitan would pay a fixed rate to one or more counterparties and would receive a variable rate that is similar (but not necessarily identical) to the interest payments on the variable rate bonds. Figure 1 below provides an illustration of the transaction.

Floating to Fixed Rate Swap

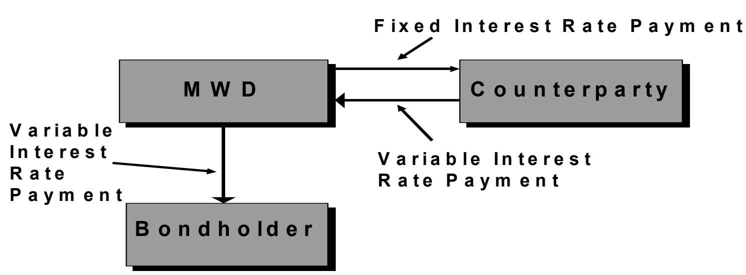

Figure 1

A $300 million revenue bond refunding would decrease Metropolitan's debt service costs by over $19 million. Average annual savings would total over $1 million per year. Metropolitan's most recent synthetic refunding was completed in September 2002. In that transaction, Metropolitan issued variable rate revenue bonds and entered into a floating to fixed interest rate swap to take advantage of low fixed interest rates. Savings from the September 2002 financing are estimated to be greater than $700,000 per year. Similar to the September 2002 transaction, the variable rate that Metropolitan will receive for the proposed transaction will be based on a percentage of the London Interbank Offer Rate (LIBOR). LIBOR is a taxable interest rate, and will be adjusted to reflect the fact that Metropolitan's bonds bear a tax-exempt interest rate.

Proposed Conversion of Variable Rate Bonds to Fixed Rates

Metropolitan has $755.2 million of variable rate revenue bonds that have interest rates that are set on a daily or weekly basis. These bonds take advantage of the short-end of the yield curve, and in today's interest rate market have very low rates. Over the past twelve months the cost of Metropolitan's variable rate revenue bonds has averaged approximately 1.38 percent (including 21 basis points for the cost of liquidity facilities and remarketing fees). Figure 2 illustrates the annual average cost of Metropolitan's variable rate bonds, the Bond Market Association (BMA) index, and the LIBOR index since 1998:

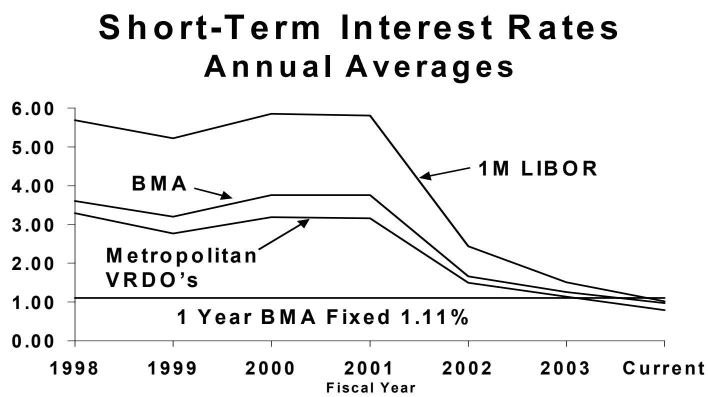

Figure 2

As indicated in Figure 2, variable interest rates are at extremely low absolute rate levels. In addition, the spread between taxable and tax-exempt interest rates is quite narrow (BMA has traded on average over 80 percent of LIBOR for the past year). However, due to technical factors in the tax-exempt marketplace, there is limited potential for short-term interest rates to decline much further on a sustained basis. With yields at historically low levels, money fund managers are hard pressed to provide attractive rates to short-term investors and maintain existing management fee levels. Short-term yields in the swap market are relatively flat over the next 18 months. Metropolitan may be able to take advantage of the low interest rate environment by entering into short-term floating to fixed interest rate swaps to lock-in a historically low interest rate for the next 12 to 18 months for a portion of the $755.2 million variable rate revenue bonds outstanding. Short-term BMA swap rates (fixed payer rates) for the next twelve to eighteen months range between 1.11 percent and 1.34 percent.

Such a transaction would provide greater certainty regarding debt service payments over the next 12 to 18 months, is consistent with a strategy of extending the duration of the debt portfolio during low interest rate periods, and helps ensure that Metropolitan will pay historically low rates on a portion of its variable rate bonds. It is also consistent with Metropolitan's asset/liability strategy, helping to better match investment return and debt service. Not all of the variable rate debt would be offset because variable rate exposure is still appropriate given funds available in Metropolitan's short-term investment portfolio. With the technical factors affecting the downside of the short-term market, the likelihood of short-term rates rising is higher than short-term rates falling (based on history and current institutional constraints). Similar to the proposed refunding transaction, Metropolitan would lock in low fixed rates available in the current swap market by executing a fixed payer swap with one or more counterparties for a twelve-month to eighteen-month term. Metropolitan would pay a fixed rate to the counterparties, and in return would receive a variable rate that is similar (but not identical) to the interest payments on the variable rate bonds. This transaction would enable Metropolitan to pay interest costs of a little over 1 percent for the next 12 to 18 months on up to $400 million of debt. This will enable Metropolitan to help mitigate the volatility of short-term interest rates over the next 12 to 18 months.

Policy

In accordance with Section 4 of Metropolitan's Master Swap Policy, board approval is required for multiple interest rate swap transactions over a consecutive three-month period.

California Environmental Quality Act (CEQA)

CEQA determination for Option #1:

The proposed action is not defined as a project under CEQA because it involves continuing administrative activities, such as general policy and procedure making (Section 15378(b)(2) of the State CEQA Guidelines). In addition, the proposed action is not subject to CEQA because it involves the creation of government funding mechanisms or other 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 pursuant to Sections 15378(b)(2) and 15378(b)(4) of the State CEQA Guidelines.

CEQA determination for Option #2:

None required

Board Options/Fiscal Impacts

Option #1

Adopt the CEQA determination and approve the use of interest rate swaps, in a total notional amount not to exceed $700 million to enable Metropolitan to lower its cost of debt.
Fiscal Impact: Will vary depending on amount of bonds refunded and actual level of interest rates over the next 12 to 18 months. Savings on a $300 million refunding bond issue could total $19 million. Converting a portion of variable rate revenue bonds to a fixed rate could result in interest savings per $100 million notional swap of between $250,000 and $500,000. If short-term interest rates fall, interest costs would be higher by about $250,000 without the swap.

Option #2

Do not approve additional interest rate swaps.
Fiscal Impact: Metropolitan would not be able to take advantage of the low interest rate environment, and could forego additional debt service savings.

Staff Recommendation

Option #1

Brian G. Thomas 7/22/2003
Brian G. Thomas *Date*
Chief Financial Officer

Ronald R. Gastelum 7/24/2003
Ronald R. Gastelum *Date*
Chief Executive Officer

BLA #2379