MWD
METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

COMMITTEE ITEM

- **Budget, Finance and Investment Committee**

November 17, 2003 Committee Meeting

7a

Subject

Strategy for potential bond refunding

Description

In August 2003, the Board approved the use of interest rate swaps in conjunction with the issuance of water revenue refunding bonds to lower the costs of Metropolitan's debt obligations. Since August, staff has been monitoring the municipal market and reviewing additional financing opportunities available to lower Metropolitan's debt service costs. To lower future costs, Metropolitan would issue variable rate water revenue refunding bonds, with the proceeds being used to fund an escrow account and pay the interest and principal on refunded water revenue bonds. To lock in a low enough fixed rate to effect a bond refunding transaction, Metropolitan would then execute a floating to fixed interest rate swap (fixed payer swap). The transaction would be similar to previous "synthetic" bond refundings completed over the past two years. Metropolitan would pay a fixed rate to one or more counterparties and 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 interest rate swap portion of the proposed refunding transaction.

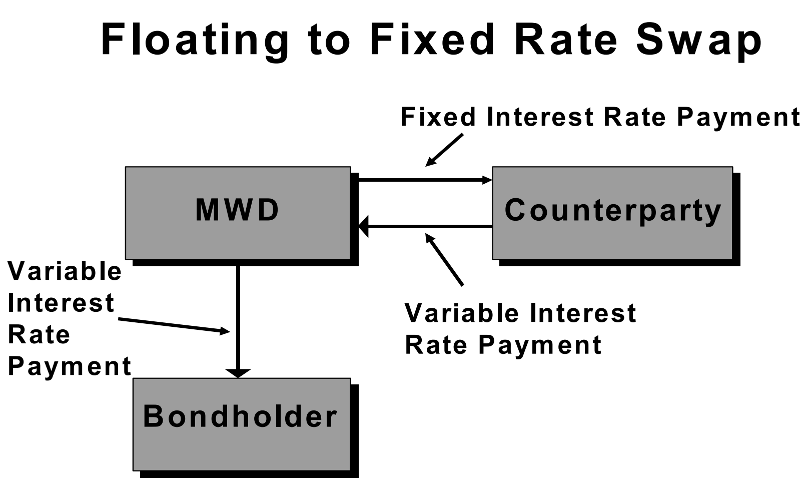

Figure 1

A $300 million revenue bond refunding could produce more than $19 million (present value) of debt service savings to Metropolitan, with average annual savings of over $1 million. However, even though interest rates continue to be at historically low levels, the current interest rate environment does not allow Metropolitan to price the fixed payer interest rate swap transaction, issue water revenue refunding bonds, and still allow Metropolitan to meet bond refunding savings targets and requirements. Therefore, staff has worked with its financing team (JP Morgan, UBS, PFM, and PRAG) on an execution strategy that would enable Metropolitan to realize cost savings while setting transaction targets to achieve debt service savings consistent with the recently adopted refunding guidelines. For example, it can be determined with great certainty what interest rate levels are required for Metropolitan to price an interest rate swap, issue refunding bonds, refund existing debt obligations, and meet the savings requirements of Metropolitan's bond refunding policy. By doing so, Metropolitan can use other financial products to lock in costs savings that are not available in the current market.

Selling an Option

As described at the October Budget, Finance and Investment Committee meeting, Metropolitan could enter into a "swaption agreement" (an option to enter into an interest rate swap). A swaption is a financial product offered by Metropolitan's swap counterparties whereby Metropolitan sells to the swap counterparty the right, but not the obligation to enter into an interest rate swap with Metropolitan at a designated fixed interest rate and time in the future. The fixed interest rate would be set at the level necessary to meet Metropolitan's refunding targets. If interest rates drop to these pre-determined levels, the swap counterparty would elect to put Metropolitan into an interest rate swap transaction, and Metropolitan would be able to meet its bond refunding savings targets, reducing overall debt service costs. In return for selling the option to the swap counterparties, Metropolitan would receive an option premium from the swap counterparties. Figure 2 below provides an illustration of a swaption and the interest rate swap should the counterparties elect to exercise their option to put Metropolitan into the swap transaction.

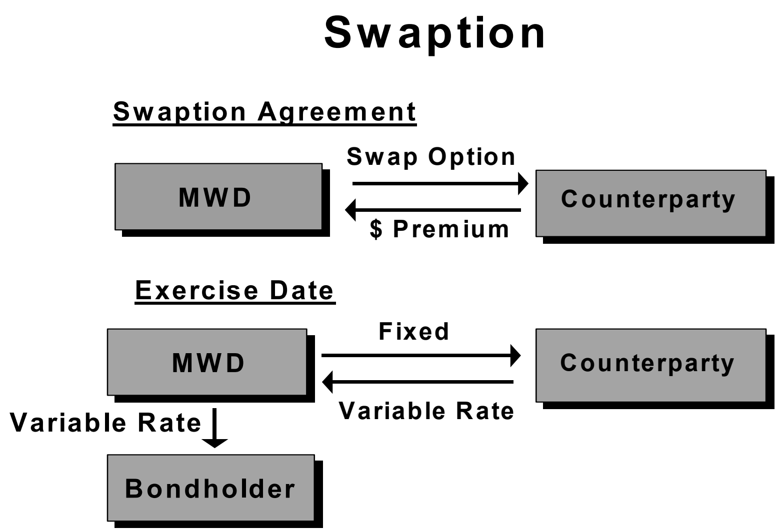

Figure 2

As illustrated in Figure 2, Metropolitan sells to each swap counterparty the right (or option) to put Metropolitan into an interest rate swap at a designated future date. In return for that option, Metropolitan would receive a payment from each swap counterparty. Since the counterparty has the option to enter Metropolitan into an interest rate swap in the future, the counterparty also has the right not to enter the swap with Metropolitan. The decision by the counterparty to put Metropolitan into the swap is driven by the market swap rate at the time of execution. Whether or not the counterparty chooses to enter the swap with Metropolitan at the future date, Metropolitan retains monies paid to Metropolitan for the swaption. In addition, if the swaption were not exercised, Metropolitan would retain the right to call the bonds that were not refunded, allowing Metropolitan the ability to refund those bonds at a future date.

For example, Metropolitan could sell an option to a counterparty that gives the counterparty the right to put Metropolitan into a fixed payer swap, whereby Metropolitan pays 3.15 percent and receives 61.3 percent of one-month LIBOR for about $2 million (based on October 17 rates and an approximate notional amount of $400 million). This option would allow the counterparty to put Metropolitan in the swap two months from now. If the swap rate is lower than 3.15 percent two months from now, the swap would be executed, Metropolitan would issue variable rate bonds to fund the advance refunding escrow, and Metropolitan's annual debt service would be reduced on average by at least $1 million per year. Regardless of interest rate movement, Metropolitan would retain the $2 million.

The counterparty will use the options market to hedge its net exposure created by the swaption trade with Metropolitan. As interest rates change over time, the value of the swaption to the counterparty will change. The value of the swaption is affected by a number of things, including:

- The size of the swaption
- The expected volatility of interest rates
- The shape of the yield curve
- The term of the option
- The type of option
- The general level of interest rates

Selling swaptions is particularly attractive in volatile and uncertain markets. These conditions are currently present in the financial markets.

From Metropolitan's perspective, the swaption would enable Metropolitan to realize value from the call option on outstanding bonds even if interest rates do not fall to rates necessary to refund (call) the bonds. Given Metropolitan's already low cost of outstanding fixed rate water revenue bonds (approximately 4.88 percent as of September 30, 2003) the ability of Metropolitan to take advantage of the call option value on those bonds (an option value that Metropolitan paid for at the time of issuance of the bonds) is limited as interest rates have to continue to reach historically low levels. In addition, Metropolitan retains the call option premium (payment) from the swap counterparties regardless of the counterparties' decision to exercise the swaption or not. Staff, working with Metropolitan's financial advisors, will be able to determine the appropriate market price (value) of the swaption.

Metropolitan has similar risks with swaptions as it would have with executing interest rate swaps and issuing refunding bonds. Should the counterparty choose to put Metropolitan into an interest rate swap at the exercise date of the swaption, the interest rate would be an agreed upon rate at the time Metropolitan entered into the swaption. Even though the agreed upon interest rate would enable Metropolitan to realize cost savings, interest rates could still be lower in the future. But, as with any decision to refund debt, once interest rates reach levels that meet existing cost savings targets, the decision is made to capture those savings. The opportunity cost that interest rates will be lower in the future is always present regardless of the financing strategy under consideration.

Staff will work with the Ad Hoc Committee to determine the appropriate parameters for this strategy. If market conditions are not favorable or the risks too great, Metropolitan will not enter into a swaption agreement.

Policy

Metropolitan is authorized to execute interest rate swap transactions and enter into swaption agreements in accordance with the terms and conditions detailed in Metropolitan's Master Swap Policy.

Fiscal Impact

Cost savings will be dependent on terms and conditions of swaption agreement, overall level of interest rates, and amount of bonds eligible to be refunded.

10/28/2003

Brian G. Thomas — *Date*
Chief Financial Officer

10/28/2003

Ronald R. Gastelum — *Date*
Chief Executive Officer

BLA #2595