MWD
METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

BOARD ACTION

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

May 11, 2004 Board Meeting

9-2

Subject

Authorize entering into interest rate swap agreements in a total notional amount not to exceed $300 million to reduce debt service costs and reduce the variability of Metropolitan's net interest exposure

Description

Executive Summary

Metropolitan has executed interest rate swap agreements totaling $1.1 billion since 2001. These agreements have been used to advance refund revenue bonds and to manage Metropolitan's variable rate exposure. These interest rate swap transactions have resulted in present value savings of about $92 million. Today's low interest rate market provides additional opportunities to reduce the cost of Metropolitan's debt by taking advantage of the current relationship between taxable and tax-exempt debt. As discussed at the April 20, 2004 board workshop, Metropolitan can execute a "basis swap" to produce estimated net present value savings of between $10 million and $35 million, depending on actual market conditions, the term, the execution strategy, and notional amount of the swap. Given the Board's approval of this recommendation, staff will work with 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) to select counterparties from Metropolitan's team of investment banks, structure the transaction, and execute the transaction as appropriate.

Background

In August 2003, the Board authorized the use of up to $700 million of interest rate swaps to help reduce Metropolitan's debt service costs and reduce the variability of its net interest exposure (the net cost to Metropolitan from changes in interest rates to variable rate debt and to the investment portfolio). Since that time, interest rates have continued to track at exceptionally low levels increasing the financial opportunities available to Metropolitan. As conditions stand today, short-term tax-exempt interest rates have declined, but short-term taxable interest rates have declined even further. The resulting reduction in spread between tax-exempt and taxable interest rates is an unusual market condition that offers Metropolitan the opportunity to further decrease the carrying cost of its debt through the use of interest rate swap transactions. Consistent with the August 2003 authorization, and the Board's Master Swap Policy, the Ad Hoc Committee authorized the Chief Financial Officer to enter into two interest rate swap transactions.

The first interest rate swap transaction under the August 2003 authorization was priced on November 17, 2003, when Metropolitan executed a $338.2 million interest rate swap under which Metropolitan pays a fixed rate of 3.257 percent. The interest rate swap was used in conjunction with an issuance of variable rate water revenue refunding bonds to produce approximately $21.1 million of net present value savings.

The second interest rate swap transaction under the August 2003 authorization was priced on January 16, 2004, when Metropolitan executed a $162.5 million interest rate swap under which Metropolitan pays a fixed rate of 2.917 percent. The interest rate swap was used in conjunction with an issuance of variable rate water revenue refunding bonds to produce approximately $11.4 million of net present value savings.

Both the November 2003 and the January 2004 interest rate swap transactions were "synthetic" fixed rate bond refunding transactions whereby Metropolitan pays a fixed rate to a swap counterparty, and in return receives a variable rate payment based on the one-month London Interbank Offer Rate (LIBOR). LIBOR is the principal floating rate benchmark for taxable issues, and given current market conditions produces a more efficient financing transaction, providing the greatest savings to Metropolitan. The percentage adjustment factor to the LIBOR rate reflects the historical market relationship between Metropolitan's variable rate bonds and the LIBOR or taxable rate. The variable rate received by Metropolitan from the counterparties will be similar, but not necessarily identical to, the interest payments on the variable rate water revenue refunding bonds issued to effect the transaction. Figure 1 below provides an illustration of the transactions:

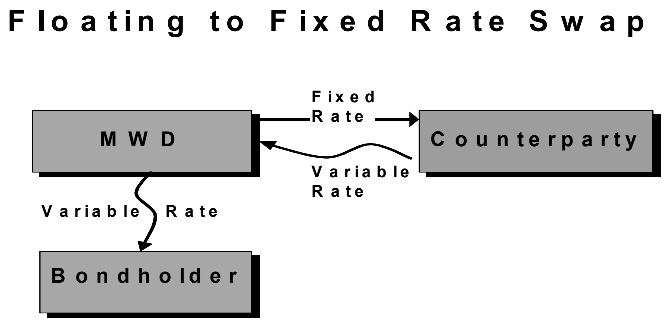

Figure 1

Basis Swaps

In addition to the synthetic bond refunding opportunities previously described, Metropolitan has the opportunity to continue to take advantage of favorable market conditions by entering into BMA to LIBOR basis swaps to generate additional cash flow savings. The Bond Market Association (BMA) Municipal Swap Index is a high-grade market index comprised of tax-exempt variable rate bonds (similar to Metropolitan's variable rate revenue bonds). The BMA index is a national index that is used as the basis for establishing variable rates in interest rate swap transactions. LIBOR is the primary floating rate benchmark used in the taxable market. Figure 2 is an illustration of a BMA to LIBOR basis swap transaction:

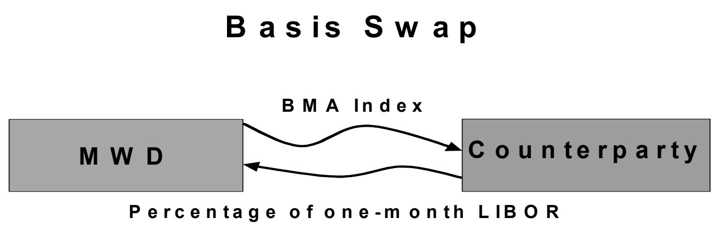

Figure 2

As illustrated in Figure 2, a typical example of a basis swap is Metropolitan agreeing to pay to a counterparty or counterparties a rate based on the BMA tax-exempt short-term index, and receive a payment from a counterparty or counterparties that is based on some percentage of the taxable short-term index, LIBOR. The percentage of LIBOR to be received by Metropolitan is dependent on a number of factors including market rates and the term of the interest rate swap agreement. The main difference in a BMA to LIBOR basis swap and the other interest rate swap transactions Metropolitan has entered into thus far is that the basis swap is comprised of variable rate payments only, and does not include a fixed rate component. If the BMA payment from Metropolitan averaged less than the percentage of LIBOR payment received from the counterparty, then Metropolitan would have a net benefit over the term of the transaction. As presented to the Board at the April 20, 2004 board workshop on interest rate swaps the main benefits to Metropolitan of basis swaps are:

1. Metropolitan can realize cash flow savings that otherwise would not be available;

2. Metropolitan can realize these cash flow savings without using the call option feature of outstanding bonds, thereby preserving the option to refund outstanding bonds at a future date;
3. Metropolitan would no longer need to issue variable rate bonds, eliminating the risks and costs associated with variable rate debt (liquidity facility fees, broker-dealer fees, remarketing agent fees);
4. Cash flow savings can be structured to fit Metropolitan's needs, savings may be taken up front, over time, or a combination of both; and
5. Less mark-to-market volatility than traditional interest rate swaps, making longer term swap transactions more feasible.

The most opportune time for Metropolitan to take advantage of opportunities presented by BMA to LIBOR basis swaps would be when interest rates are at absolute low levels and BMA is at a historically high percentage of one-month LIBOR. As short-term tax-exempt interest rates have declined, short-term taxable interest rates have declined even further. Therefore the spread between BMA and one-month LIBOR has compressed, offering additional financing opportunities to issuers such as Metropolitan.

Based on historical data analysis, as interest rates change over time and the spread between the tax-exempt and taxable markets change, it is anticipated that the spread between BMA and one-month LIBOR will revert back to historical averages of 67 percent (if federal tax rates do not change). As such, the cash flow value to Metropolitan of a BMA to LIBOR basis swap locked into current market spreads (percentages) would increase over time because Metropolitan would be receiving a payment based on a higher percentage of LIBOR.

In order to take advantage of current market opportunities provided through the use of interest rate swaps, additional authority from the Board to enter into interest rate swap transactions will be required. The August 2003 board authorization for up to $700 million of interest rate swap transactions has been reduced by the November 2003 ($338.2 million) and January 2004 ($162.5 million) interest rate swap transactions, resulting in a remaining authorization level of $199.3 million.

In addition to the existing authorization of $199.3 million, staff is requesting an additional board authorization to enter into interest rate swap transactions such as BMA to LIBOR basis swaps of up to $300 million to take advantage of current market conditions to reduce debt service costs and reduce the variability of Metropolitan's net interest exposure.

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 that exceed the approval limits defined in the Master Swap Policy.

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 swap transactions in a total notional amount not to exceed $300 million to enable Metropolitan to lower the cost of its debt service and reduce the variability of Metropolitan's net interest exposure.

Fiscal Impact: Will vary depending on the notional amount, term, actual level of interest rates, and the spread between tax-exempt and taxable indices for the interest rate swaps.

Option #2

Do not approve the additional authorization for interest rate swap transactions.

Fiscal Impact: Limits Metropolitan's ability to take advantage of market conditions and could forego additional savings on future debt service costs.

Staff Recommendation

Option #1

Brian G. Thomas 4/26/2004

Brian G. Thomas *Date*

Chief Financial Officer

Ronald R. Gastelum 4/26/2004

Ronald R. Gastelum *Date*

Chief Executive Officer

BLA #2861