- **Board of Directors**
  Business and Finance Committee

March 11, 2008 Board Meeting

7-2

Subject

Approve Appropriation No. 15453 in the amount of $900,000 to pay costs of issuance for Water Revenue Refunding Bonds through December 31, 2008

Description

In January 2008, U. S. Treasury yields began falling primarily due to a flight to quality that resulted from continuing negative news on investment losses related to subprime mortgages, heightened recessionary fears, and global equity markets which continued to erode. In the municipal market, the value of monoline bond insurance companies declined due to exposure in their structured finance business, causing the bond rating agencies to reconsider their "AAA" credit ratings (a rating that is required to provide insurance in the municipal bond industry), and in many cases downgrading credit ratings. Monoline bond insurers provide a guaranty that both the principal and interest on municipal bond obligations will be repaid in a timely manner if a municipal issuer should default on a payment. The primary business purpose of the municipal bond insurance companies is to insure debt issued by such municipalities. Many of the monoline bond insurers expanded their business by insuring the debt related to subprime mortgages and structured investment vehicles such as collateralized debt obligations (CDOs).

As a result of the municipal bond insurers' exposure in the structured finance business, the monoline insurance companies such as XLCA, AMBAC, FGIC, MBIA and ACA have experienced an erosion of their capital base due to losses from their exposure to insuring debt related to sub-prime mortgages and structured investment vehicles. As a result of these losses, the bond credit rating agencies are questioning whether the capital of these monoline insurers is adequate to cover potential future losses as their claims-paying ability has been eroded. Many of the monoline bond insurers have had their credit ratings downgraded since early January 2008. The credit downgrades of the monoline bond insurers have had a ripple effect on investors, municipalities, and other issuers throughout the country.

As discussed with the Business and Finance Committee at its February 11, 2008 meeting, primarily due to Metropolitan's favorable credit ratings of "AAA/Aa2/AA+", Metropolitan has not used municipal bond insurance companies nearly as much as other lower rated municipalities. However, Metropolitan has still been negatively affected by the credit downgrades of certain municipal bond insurers over the past month. Metropolitan has used municipal bond insurance for a small portion of outstanding fixed rate and variable rate water revenue bonds, and for all of Metropolitan's auction rate securities (ARS) program. In addition, the credit downgrades will impact the future costs of administering Metropolitan's variable rate debt program due to the ongoing squeeze on credit and liquidity. This has resulted in higher prices for liquidity used to support variable rate debt. The biggest impact to Metropolitan has been on the XLCA-insured auction rate securities.

Metropolitan's uninsured variable rate revenue bonds are performing significantly better (lower interest rates) than the insured variable rate revenue bonds and the insured auction rate securities. This is a clear indication of the value and demand for Metropolitan's high stand-alone credit ratings. However, recent turmoil in the auction rate market due to the fallout from the credit downgrades of the municipal bond insurers has caused a number of auction rate programs in the municipal market throughout the country to experience higher interest costs or even experience failed auctions. Investors in auction rate securities (including Metropolitan's $500.3 million of ARS) have demanded higher interest rates as investors have begun to lose confidence in the auction rate market primarily due to: (1) the lack of liquidity for the long-term auction rate security absent the ability to "put" the auction rate securities back to the broker-dealer, (2) the reduced quality of insurance backing the security, and

(3) the lack of ability or unwillingness of the broker-dealer firms to hold the securities in inventory (as the capital base of the firms has eroded due to the high levels of ARS and other securities currently held by each of the broker-dealer firms).

Auction rate securities are short-term debt instruments with long-term maturities. The interest rate on Metropolitan's ARS resets every seven days through an auction process whereby broker-dealers hired by Metropolitan (Citigroup, Bank of America Securities LLC, Morgan Stanley, Goldman Sachs & Co, Inc., De La Rosa & Co., and UBS Investment Bank) seek bids from both current and prospective ARS investors (primarily high net worth individuals and corporate cash managers). After all bids are received, the interest rate that clears all the sell bids is the rate that Metropolitan pays for the next seven days on all of the ARS in an auction. However, due to reasons described earlier that are negatively impacting the ARS market, even the rate resets for Metropolitan's auctions have increased. In fact, during the week of February 11 to February 15, Metropolitan's ARS reset at rates from 3 percent to 10 percent. However, through February 28, Metropolitan has not had a failed auction. Should a Metropolitan auction fail at a future date, in accordance with the terms and conditions of the financial agreements, the interest rate for the failed auction would be set at the maximum rate of 12 percent during the next seven-day auction period.

Due to the increasing cost of Metropolitan's $500.3 million ARS program and the uncertainty over the long-term prospects of an efficiently functioning auction rate market, Metropolitan staff has analyzed potential financing options for Metropolitan to utilize to mitigate the increasing costs of the ARS program. After considering options varying from doing nothing to refunding the ARS with fixed rate debt, staff has determined that refunding the ARS with uninsured variable rate demand obligations is the most effective action for Metropolitan.

Metropolitan's authority to enter into water revenue refunding bond transactions is through the Fourth Supplemental Water Revenue Bond Resolution (Resolution 8387). The Fourth Supplemental Resolution authorizes the Ad Hoc Committee, made up of the Chairman of the Board, the Chairman of the Business and Finance Committee, and the General Manager, to approve the aggregate principal amounts, terms, and conditions of sale of each series of Water Revenue Refunding Bonds.

Additional Refunding Opportunity

In addition to the refunding of the ARS, Metropolitan has the opportunity to refund approximately $128 million of the outstanding Water Revenue Refunding Bonds, 1998 Series A issue. The call date on the 1998 Series A issue is July 1, 2008, so Metropolitan may currently refund the 1998 Series A bonds any time after April 1, 2008 through the issuance of either variable rate water revenue refunding bonds or fixed rate water revenue refunding bonds. Any bond refunding of the 1998 Series A bonds will be in accordance with the requirements set forth in Metropolitan's bond refunding guidelines and upon approval of the Ad Hoc Committee.

Appropriation No. 15453 for Transaction Costs

An appropriation will be required to pay expenses associated with the issuance of Water Revenue Refunding Bonds. Appropriation No. 15453 will be designated for refunding Metropolitan's Water Revenue Refunding Bonds, 1998 Series A issue, and the $500.3 million of auction rate securities comprised of the following issues: Water Revenue Bonds, 2005 Authorization, Series D-1; Water Revenue Bonds, 2005 Authorization, Series D-2; Water Revenue Bonds, 2006 Authorization, Series B; Water Revenue Refunding Bonds, 2007 Series A-1; Water Revenue Refunding Bonds, 2007 Series A-2; and Water Revenue Refunding Bonds, 2007 Series B. Metropolitan contemplates issuance of two separate water revenue refunding bond transactions. The appropriation will have an expiration date of December 31, 2008.

The following table provides a breakdown of estimated expenses for Appropriation No. 15453:

Legal Counsel Fees	$ 250,000
Rating Agency Fees	240,000
Financial Advisory Fees	130,000
Liquidity Bank Counsel Fees	100,000
Liquidity Bank Closing Fees	100,000
Printing/Mailing	50,000
Escrow/Verification/Other	30,000
Total	$ 900,000

Actual expenses for the appropriation would be reduced if one or more of the proposed transactions are modified or do not occur. Expenses for bond refunding transactions are incorporated into the savings analysis reported to the Board (savings are reported net of all expenses). Metropolitan will be working with Bank of America and Citigroup to refund the ARS.

Policy

Chapter 1.6 of Part 5 (Sections 235-239.4) of the Metropolitan Water District Act: Revenue Bonds
Metropolitan Water District Administrative Code Section 5108: Appropriations

California Environmental Quality Act (CEQA)

CEQA determination for Option #1:

The proposed actions are not defined as a project under CEQA because they involve continuing administrative activities, such as general policy and procedure making (Section 15378(b)(2) of the State CEQA Guidelines). In addition, the proposed actions are not subject to CEQA because they involve 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 actions are 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

Option #1

Adopt the CEQA determination and

a. Authorize General Fund Appropriation No. 15453 in the amount of $900,000 to cover the expenses associated with the water revenue refunding bond transactions; and
b. Authorize reimbursement of expenses paid from the General Fund by bond proceeds. The appropriation would expire on December 31, 2008.

Fiscal Impact: Reduction in debt service payments of at least $2 million per year, thereby mitigating anticipated increases in water rates and charges

Business Analysis: Authorization to fund costs associated with the issuance of water revenue refunding bonds is required.

Option #2

Do not proceed with authorization for the appropriation to fund water revenue refunding bond transactions.
Fiscal Impact: May miss the opportunity to reduce debt service costs at favorable interest rate levels, and will continue to be exposed to the higher costing auction rate securities market
Business Analysis: Capital market access would be delayed, thereby limiting Metropolitan's options or ability to reduce debt service costs.

Staff Recommendation

Option #1

2/29/2008

Brian G. Thomas *Date*
Chief Financial Officer

2/29/2008

Jeffrey Kightlinger *Date*
General Manager

BLA #6041